

DIVING DEEPER

INQUIRY INTO WATER PRICING IN SA



**Lewis W Owens
Independent Inquirer
28th September 2018**

TABLE OF CONTENTS

BACKGROUND	3
TERMS OF REFERENCE	3
THE EXPLORATORY ESSAY	4
1. INITIAL FEEDBACK.....	5
1.1 Context.....	6
1.2 Implications.....	7
1.3 Discussion.....	8
2. THE PRICING APPROACH TAKEN BY DTF DURING 2004/05 TO 2012/13	12
3. FURTHER ISSUES IN SETTING A REGULATED ASSET BASE (RAB)	13
4. TERM OF REFERENCE 2: PRELIMINARY THOUGHTS	17
5. NEXT STEPS	20

This Report has been produced independently by the SA Water Pricing Inquiry (SAWPI) on the request of the South Australian Government and therefore remains the property of the South Australian Government. The information, statements, statistics and commentary contained in this report have been prepared by SAWPI from publicly available material and from discussions held with stakeholders. SAWPI has based this Report on information received or obtained, on the basis that such information is accurate

BACKGROUND

In early August 2018, the SA Treasurer established an inquiry into water pricing in South Australia. The Inquiry is to help advise the Government if the revenue SA Water is permitted to raise from its drinking water retail services reflects the cost of providing these services.

The Inquiry's Final Report (due by 30 June 2019) will be considered by the Government and may inform the value of the Regulated Asset Base (RAB) and related matters for the next regulatory determination by the Essential Services Commission of SA (ESCOSA) for SA Water covering the four year period 2020-21 to 2023-24.

The Terms of Reference of the Inquiry are as follows.

TERMS OF REFERENCE

- 1. The Inquiry will consider and report on the following matters relevant to the regulation of SA Water's drinking water services:**
 - a. The reasonableness of the opening value of SA Water's regulated asset base (RAB) established by the Second Pricing Order made by the then Treasurer on 17 May 2013, including:**
 - i. Asset valuations used to establish drinking water prices in the years leading up to 2013;**
 - ii. The process for setting the initial RAB for 2013;**
 - iii. The treatment of customer contributions in setting the Initial RAB;**
 - iv. The treatment of the capital costs (and Commonwealth funding) for the Adelaide Desalination Plant (ADP) in setting the Initial RAB;**
 - v. Compliance with the National Water Initiative Pricing Principles in relation to the recovery of capital expenditure;**
 - vi. RABs for drinking water services in other jurisdictions, having regard to the key drivers and variables that may affect the value; and**
 - vii. Any other matter which may contribute to an understanding of the level of the SA Water drinking water services RAB.**
 - b. Whether there should be a change to the value of the Initial RAB (as subsequently adjusted each year since 2013 for depreciation and inflation) for the 2020 Price Determination by ESCOSA.**
- 2. If there are any changes proposed to the RAB valuation, the Inquiry will also consider and report on a possible implementation program and timetable which would ensure a fair and reasonable balance between the interests of consumers and the Government (as Owner of SA Water).**

- 3. The Inquiry will also consider whether there are issues associated with setting the allowed return on the RAB, including whether the methodology should anticipate inflation and returns expected by the market during the relevant regulatory period, to ensure a fair and reasonable balance between the interests of consumers and the Government (as Owner of SA Water).**

In conducting the Inquiry, the Independent Inquirer may have regard to reviews, recent developments and practices relating to the economic regulation of utilities in Australian and overseas jurisdictions.

Under additional guidelines for the Inquiry, actual SA Water charges for water are not to be considered. In addition, costs included by ESCOSA in its water pricing determinations will not be considered, by virtue of these being included in a Direction issued by the Minister for Environment and Water under Section 6 of the Public Corporations Act 1993.

THE EXPLORATORY ESSAY

An Exploratory Essay was released in late August 2018 to a number of key players involved in water pricing in South Australia over the past 15 years, including officers of the Department of Treasury and Finance (DTF), ESCOSA, SA Water Corporation, Business SA and SACOSS. A number of individuals who were involved in previous water pricing reviews within those organizations, but who no longer are employed there, were also included in the process. In addition, the Essay was discussed with officers from the Economic Regulation Authority in Western Australia and a number of water regulation consultants from within the main accounting consulting firms in Australia.

The Essay presented a summary of the key events in water pricing in SA from the early 2000s until mid-2013, based on publicly available information. This period covered the introduction of Transparency Statements and Regulatory Statements from DTF outlining how Cabinet had set water prices for the following year and concluded in June 2013 with a second Pricing Order from the Treasurer declaring an Initial Regulated Asset Base value for water assets of \$7.77 billion to be used by ESCOSA in its first Water Pricing Determination in June 2013.

The purpose of the Essay was to facilitate discussions with the key players in order to check the accuracy of the Essay and to seek their input into refining the Inquiry's research program.

This report (Diving Deeper) presents the main feedback received on the Essay and the proposed lines of inquiry. It will be used in further discussions with the key players and other interested parties to seek their assistance in addressing the Terms of Reference. It is intended that a further report summarizing the outcomes of this additional research and deliberation will be released in December 2018.

1. INITIAL FEEDBACK

The feedback from the key players on the Exploratory Essay was that the substance was generally correct, and that it seemed to be comprehensive in scope, but it was necessary to understand better the **context** in which the decisions were being taken, and to ensure the scope of the Inquiry explored the **implications** of any recommendation to change the RAB as part of Term of Reference 2 (concerning a possible implementation program and timetable). This feedback will be elaborated on below.

There was a range of views received, from those supporting the full and immediate adoption of the independently determined RAB, through to those urging caution about the extent of changes to the RAB value. Underpinning these views are the fundamental questions: **what is a RAB, and how should it be set?** Those questions will also be explored below.

Alongside these issues for some parties was a further concern: the limitation in the Terms of Reference of the Inquiry to water pricing, and the exclusion of waste-water pricing from consideration. The Terms of Reference were set by the Treasurer in response to a Liberal Party election policy for the March 2018 State Election (“An End To Spiralling Water Prices”) which stated that in Government it would establish an inquiry into water pricing to “...inform improvements to the pricing of water...” such that “...water users will pay fair and just prices”.

It does seem to the Inquiry that the Terms of Reference address that promise. It further notes that price increases for waste-water in South Australia have been significantly below those for water over the past 10 years, and the national comparison of waste-water prices has SA Water in the lowest price quartile compared to other major water businesses around Australia. For those reasons, the Inquiry is comfortable with concentrating its efforts on the water pricing issue and leaving it to others to determine if there are similar issues in the waste-water sector.

1.1 Context

Many of those providing feedback on the Exploratory Essay were keen to emphasize the overall political and societal climate within which the decisions were being made, which supported the large price rises over the period.

Firstly, there was the political agenda for micro-economic reform driven by the Commonwealth and States, which from the mid-1990s had targeted government-owned enterprises and sought to make them more competitive. As part of this, there was a specific program directed towards reform of the water industry, with many utilities inefficient and failing to recover even their basic costs of operation (to be fair, many of these were the smaller water utilities in NSW and Queensland operated by local government, but larger utilities such as SA Water were also included). This culminated in the National Water Initiative (NWI), and a set of Pricing Principles were developed for pricing water (but not waste-water). Adherence of each State and Territory to these NWI Pricing Principles was to be closely monitored and National Competition Payments from the Commonwealth were at risk for non-compliance.

Second, and related to the above, was the limited state of knowledge about the water industry and hence the rules were constantly being changed as better understanding developed. The Pricing Principles evolved over a number of years, and the implementation over the early years was one of constant modification and correction as Governments attempted to modify their existing approaches to the new guidelines. The first few years to 2007 were seen as a period of constant adjustment to the evolving policy environment. DTF was involved in the formation of these Pricing Principles.

Third was the impact of the serious drought that was developing in the eastern States, and in SA there were reduced flows in the River Murray and into Adelaide reservoirs. As each year went by, a fear developed that this was the future and we were not equipped to handle it. Government programs were rapidly developed and introduced, as reflected in the Water for Good program initiative in SA. There was strong public support for action, and experts and the media were vocal in urging for programs to improve water security and to avoid waste. Better management of this valuable resource was called for, including not only the development of climate-independent sources (desalination) and greater use of recycled water and storm-water, but also changing the price of water to reflect its scarcity. The societal support for these actions was very strong, and there was wide agreement that these actions were necessary to ensure the future of the State. As the drought extended, the sense of urgency increased and programs (such as the desalination plant) were brought forward at increased expense.

In summary, it was suggested that the decisions taken by the Government during this period need to be seen in the context outlined above: of a fundamental long-term change in the availability of water arising from climate change and the need for a comprehensive and rapid response from government to protect our future. While in hind-sight the response may have been excessive, it was justified at the time and was supported by the wider community. Many of the issues are still as relevant today.

This view justified the Government's actions in retaining price-setting powers during a volatile period, until such time as the key investments were completed and it was then appropriate for the Government to move the price-setting role to the independent regulator ESCOSA.

It was noted by others that, while this may be a justification for the actions taken, it resulted in most of the expenditures throughout the period not being subjected to the scrutiny that an independent price regulator would have imposed on the process. The Auditor-General commented over a number of these years that the procurement processes of SA Water were below optimal.

The challenge for this Inquiry will be to examine what might have been the outcome if a regulator had been responsible for these pricing decisions throughout this period, rather than the Government who was also the Owner and therefore potentially conflicted in its objectives.

1.2 Implications

A number of those providing feedback on the Exploratory Essay were keen to encourage the Inquiry to ensure that its investigations included consideration of the wider issues which are impacted by setting a RAB, especially when it is a publicly owned monopoly business delivering an essential service and its profits are returned to the SA Government for the benefit of the wider South Australian community.

Those people supporting this wider review believed the Inquiry should do more than just propose a new Initial RAB (almost everyone the Inquiry talked to assumed it would be lower). They believed the Inquiry should also have regard to the impact on other areas, including:

- revenue to the Government, the overall budget implications, and the consequences for government programs such as Customer Service Obligations, support for low income consumers, and other health, education and business programs;
- the benefits of lower prices on business competitiveness and water poverty for low-income consumers;
- financial sustainability of SA Water, impairment of assets, its credit rating and consequences for the State's balance sheet and credit rating; and
- resource security, in terms of the impact of lower prices in encouraging the greater use of a scarce resource.

These matters could be considered by the Inquiry under Term of Reference 2, which requires it to consider (if any changes are recommended to the RAB) a possible implementation program and timetable which would ensure a fair and reasonable balance between the interests of consumers and the Government as Owner.

Alternatively, these might best be matters that the Government takes into account when it considers the Inquiry's Final Report and any recommendations concerning the RAB for the 2020 ESCOSA determination.

Questions to Consider

1. **Should the Inquiry limit itself to recommending a new RAB to replace the Initial RAB set in the Second Pricing Order of May 2013?**
2. **Alternatively, should the Inquiry expand its approach to include consideration of other factors in coming to a view about a revised Initial RAB, including the consequences of any change?**
3. **If (2), should the preferred value of the RAB be changed to reflect these other factors, or should their impact simply be considered in the recommended implementation program and timetable?**

1.3 Discussion

The feedback on the Exploratory Essay has crystallized a key issue for the Inquiry, and that concerns the nature of its task.

The Exploratory Essay presented an in-depth description of the water pricing decisions from 2004-05 to 2012-13, as set out in the Transparency and Regulatory Statements over this period, culminating in the ultimate decision by the Treasurer to set an Initial RAB value in May 2013.

The Essay raised questions about a number of elements of the process and decisions over that 10 year period including the starting asset value, the treatment of contributed assets, the role of legacy assets, the use of an annuity instead of straight-line depreciation, the treatment of the Customer Service Obligation (CSO) payment to equalize country and metropolitan prices, the escalation factors used, the 2012-13 revenue path used to set the Initial RAB, and the underlying application over the whole period of a certain view about the NWI Pricing Principles (and especially the belief that the Principles **required** a move to the maximum revenue outcome based on a 6% WACC which was ultimately applied to all assets, existing and new).

The Essay indicated that it would be necessary to review each of these aspects if the Inquiry was to form a sound conclusion as to what was a fair and reasonable Initial RAB.

However, it is now apparent to the Inquirer that such a complicated process may not be necessary. Indeed, there may be a much simpler approach, based on determining what might have been the RAB value in June 2013 if independent price regulation had been undertaken by ESCOSA from 2004. In other words, the actual journey with all of its yearly variations is a distraction; it may be more productive to focus on the beginning of price regulation in 2004 and then applying the approach that a regulator would have applied, rather than what the Government did (given its conflicting role as owner and price-setter).

The question arises: **why start at 2004?** There are a number of good reasons for this.

Firstly, this is the first year in which a Transparency Statement was produced, so publicly available information exists on which to base an analysis.

Second, it coincides with the commencement of the National Water Initiative where the SA Government signed up to the national initiatives to reform the water industry, including independent price setting.

Third, it was a period where prices were relatively stable, increasing at a steady 2 or 3 percent per annum, and therefore where a “line in the sand” methodology for setting an Initial RAB based on a Deprival Value was appropriate (unlike in 2013 when prices were increasing at between 20 to 25% pa and were not a sound basis for estimating future revenues and hence RAB).

Fourth, given we have decided to compare the SA experience with Western Australia, it is relevant that the first independent Inquiry into water pricing in WA was undertaken by the Economic Regulation Authority in 2005 (and subsequently in 2009, 2013 and 2017). Given the similar experiences of WA and SA with severe drought over this period, there may be lessons or comparisons that can be drawn from such an exercise.

The problem with this proposed approach is, of course, that we can never actually know what an independent regulator would have decided on the particulars of each investment and operating expenditure event. An independent regulator would (as it does now and has ever since ESCOSA assumed responsibility from the time of its first regulatory determination in 2013) challenge the proposed capital and operating expenditures, impose efficiency dividends, potentially remove projects and programs that it believed did not pass the regulatory test, and in general apply a level of scrutiny that might have reduced the levels of operating and capital expenditure that flowed through into prices over this period. But it is impossible now to identify what, if any, changes would have occurred.

Of course, this problem applies as well to the other approach of examining the year by year price changes. We will not be in a position to challenge the legitimacy of individual expenditure decisions even if we drill down into the range of items listed previously.

The simpler approach will allow us to determine what the Initial RAB would have been (accepting without question the actual capital expenditures over the period) if the standard regulatory process for rolling forward the RAB had been followed from 2004 prior to the large capital expenditures from 2006 onwards. We can conclude that the number so derived is likely to be on the high side relative to what it might have been if the regulator was challenging the numbers throughout the period, but we can then possibly undertake some sensitivity analysis of what further impact the presence of regulator challenge might have added.

In summary, it is proposed to adopt the following approach to estimating a base case RAB.

The Inquiry will commence with the value of the Asset Base as reported in the 2004-05 Transparency Statement, with the value reduced by the \$94m of contributed water assets which were subsequently removed in the 2005-06 Transparency Statement (representing the estimated value of contributed water assets since the date of corporatization of SA Water on 1 July 1995).

Using standard regulatory practice adopted across Australia, this value will be rolled forward, by adding the value of new capital expenditure each year, deducting depreciation expenses, and escalating the resulting number by the actual CPI for the year.

This process will be repeated each year, until the number for June 2013 is derived (in Dec 2012 dollars); this can be compared to the Initial RAB number specified by the then Treasurer in the Second Pricing Order.

The following key points should be noted with this proposed approach:

- The asset values are escalated by CPI and not by some other escalator such as the Producer Price Index used by SA Water to escalate the statutory asset value in its accounts: the use of CPI is standard regulatory practice, as the purpose of the RAB is to determine a price or revenue stream in real dollars. It should be noted, however, that actual CPI will be used and not estimated CPI – this is also consistent with the process followed by a regulator at each determination when asset values are adjusted retrospectively by actual CPI.
- The approach (at least at this stage) accepts the opening value of the assets as reported in the first Transparency Statement in 2004/05 after removing the \$94m of post 1995 contributed assets; in other words, it treats that value as arising from a “line in the sand” decision and removes further consideration of the composition of that number (including such matters as the value of contributed assets prior to July 1995, and whether the legacy assets should be treated differently).
- All new capital expenditures from 2004-05 onwards are accepted at full value into the RAB.
- The impact of the 2012-13 price path is removed, as the Government’s “line in the sand” decision in May 2013 is no longer appropriate.
- The approach does require a view on the appropriate depreciation allowance to be used each year, but there is likely to be reasonable agreement between the numbers used in the Transparency Statements, SA Water and ESCOSA so this should not be a major issue.

Questions to Consider

- 1. Is the proposed approach a satisfactory starting point for the Inquiry? Are there any modifications that should be made to improve the analysis?**
- 2. Are there any other factors that should be reviewed to complement this approach?**
- 3. Are stakeholders comfortable with the proposal not to explore all of the elements identified in the Essay that impacted on the yearly pricing outcomes?**

For information only, the Inquiry has undertaken some preliminary “back of the envelope” calculations using the proposed approach, and the revised RAB was estimated to be between \$300m to \$500m below the \$7.77b Initial RAB for 1 July 2013 set by the Treasurer in May 2013 (all in Dec 2012 dollars). The calculation will be refined and checked in the coming weeks and may be circulated to parties during October for their review and comment.

2. THE PRICING APPROACH TAKEN BY DTF DURING 2004/05 TO 2012/13

It is appropriate at this juncture to make some comments about the approach adopted by the Department of Treasury and Finance over the period from 2004-05 to 2012-13 in advising Cabinet in setting water prices for South Australia. That approach has been set out in the Exploratory Essay and in more detail in the individual Transparency and Regulatory Statements.

The approach followed the pricing principles of the National Water Initiative, and while there were areas where it was possible to take alternative viewpoints (the Principles were vague in places), there was clear articulation of the position taken by DTF and Cabinet.

In the view of the Inquiry, there was nothing illegal or in error in the approach taken, and it is clear that Treasury officials were acting in the interest of the Treasurer on behalf of the people of South Australia. One could perhaps argue that they were at times too diligent in their actions and were driven only to protect the interests of Treasury in securing the maximum revenues possible for the State.

Nevertheless, the period from the mid-2000s was a time of great challenge to South Australia, with the drought having a crippling impact on the economy and other key industries encountering great challenges to their survival (including from rising energy costs). There were many conflicting priorities calling on funding from the Government, and the budget situation was tight. In such a situation, it was perhaps inevitable that decisions were taken to raise revenue from water activities that impacted seriously on business and consumers. It is timely now, with the benefit of hindsight and distance, to review the impact of those decisions and where necessary, modify their impact. To do so is not a criticism of the earlier decisions, it is taking the opportunity to determine if the decisions remain appropriate and whether there is an outcome that is fairer and which makes more economic sense today.

It is credible for DTF to argue that the decision in May 2013 to set the Initial RAB for water at \$7.77 billion was legal and appropriate, as it was entitled under the NWI to draw a “line in the sand” and set the value so as to preserve the revenue stream it had presented in the forward estimates. That is one possible interpretation, and the current Treasurer would be within his rights to uphold that earlier decision.

The other interpretation, which I support, is that it was not appropriate to be using the “line in the sand” approach to set the Initial RAB in May 2013 at a time of significant price increases and where forward estimates were unreliable and easily gamed. I believe the preferred approach would have been to set an Initial RAB at a time of relative price stability, and to roll forward that value in accord with best regulatory practice.

It is the intention of the Inquiry at this time to proceed on that basis, unless it receives additional information and comment which cause it to revise this conclusion.

3. FURTHER ISSUES IN SETTING A REGULATED ASSET BASE (RAB)

The Exploratory Essay made a number of comments about asset valuation methodologies and issues. Some of those comments are repeated below.

Most regulatory determinations of the past two decades have some discussion on the asset value, and different approaches have been adopted across Australian and overseas jurisdictions: there is not one agreed approach, although most are variations on a theme. Most regulatory asset values have some relationship to the statutory financial asset valuation, but the relationship is not clear and direct (and obviously depends on the widely different approaches adopted in valuing both the statutory and the regulatory asset value for each business).

Governments have increasingly agreed that the asset valuation for their **statutory** financial statements should be determined using the “fair value” method, as defined in International or Australian accounting standards. AASB 13 (Fair Value Measurement) and AASB 116 (Property, Plant and Equipment) state that fair value can be estimated using either an income or a depreciated replacement cost (DRC) approach. An income approach looks at the net present value of the income streams forecast to be generated by the assets into the future; the DRC approach looks at the cost of replacing the assets. The main challenge with the income approach is the circularity problem (prices need to be set to generate income streams, but the resulting asset value is then used to determine the prices); and the challenge in determining replacement costs is the sheer intellectual task of determining efficient costs of replacing assets given existing cities, new technologies and cost uncertainties.

Putting aside the challenges for establishing asset values for statutory financial reporting and taxation, the challenge for setting **regulatory** asset values is of a different nature (while clearly needing to have some common linkage to the former). The primary purpose of regulatory asset valuation is to set a price for the most efficient cost of providing the good or service, but it must also ensure that the revenue generated is sufficient to facilitate investment in ongoing asset replacement and business expansion.

Given the difficulties arising from the circularity problem with asset valuation, one approach followed in Australia for the water industry has been to adopt an asset valuation at the commencement of regulation such that prices are maintained at the then current level (the so-called “line in the sand” approach).

The ‘line in the sand’ approach, if applied so as to avoid price shocks upwards or downwards, has the effect of preserving past prices and returns, and might have the effect of locking in past monopoly prices. This may be of particular interest given the significant price rises that occurred over the period, even if they were justified on the basis of the significant increases in expenditures from water security investments.

As discussed in the Essay, a RAB is fundamentally just a number derived by a regulator to set a maximum revenue or price for a monopoly owned asset. As the RAB is used (in conjunction with the Weighted Average Cost of Capital or WACC) to set a return on an investment, it is important that the owner receive a commercial return on new investments so as to ensure their long-term investment in the business.

Regulators achieve this by adding the value of efficient new investment each year into the RAB, so the new investment receives a WACC return. To that extent, there is a “physical” element to the RAB - those new investments can be identified.

The Initial RAB (which makes up a significant part of the total for many decades until diluted by the new investments) is just a value assigned to existing assets to achieve certain policy objectives at the time price regulation commences, such as protecting the income/profit forecasts, or securing a full commercial return on existing assets as well as new ones, or making prices competitive with other States by adopting a lower value and/or return on these assets. In other words, there are options to be considered, which need to take account of a wider range of societal values and government priorities (including the impact on individuals and businesses, the economic development needs and opportunities for the State, and the environmental and sustainability impacts of low cost or high-priced water).

It is not our intention at this stage to explore the statutory asset valuation undertaken by SA Water, although this may be necessary at a later stage depending on the outcome of our proposed approach to calculating a RAB using the 2004 value as a starting point. There are two reasons for this: firstly, we may need to know what constituted the 2004 asset value used in the calculation (although if we adopt the “line in the sand” approach, the composition is irrelevant as it is just a number to preserve the expected revenue streams at 2004 into the future), and second, if any change is proposed to the current RAB, we may need to consider the possible implications for SA Water’s statutory asset valuation in terms of impairment and its financial metrics.

The approach proposed by the Inquiry is in line with the standard approach now widely adopted by economic regulators to set and roll forward a Regulated Asset Base:

- An initial RAB is either set by law/regulation or is calculated by a “line in the sand” approach or by a calculation using the Deprival Value or Depreciated Optimised Replacement Cost (DORC) approach. In SA, the RAB has been set by the Treasurer using a Pricing Order; in WA the regulator calculated an Initial RAB in 2005 using a “line in the sand” revenue Net Present Value determination. Once the Initial RAB is set, there is a general preference not to change the value at each subsequent revenue determination, unless there were major errors agreed by the parties that needed to be addressed (this occurred in WA in the 2009 Inquiry).
- Contributed assets and gifts are not included in the RAB, as there is no justification for an Owner to receive a return on assets they did not pay for. The Inquiry has confirmed that all contributed assets and gifts since corporatization in 1995 have been excluded from the regulatory asset base, and are not included by ESCOSA in any new capital additions in the RAB roll-forward since 2013 (this also applied to the Commonwealth Government contributions to the cost of the Adelaide Desalination Plant: the \$328m of contributions have been excluded from the new capital expenditure roll-forward).
- Asset values are escalated by CPI All Australian Capital Cities Index.
- There are jurisdictional variances in depreciation rates for different asset classes; regulators either use their own schedules or adopt those proposed by the business for their particular situations.

Apart from the different approaches to setting the Initial RAB, the remainder of the approach is consistent with other jurisdictions and regulatory practice. ESCOSA used this approach in its 2013 and its 2016 Revenue Determinations for SA Water.

If the proposed approach of the Inquiry to review the Initial RAB is adopted, most of the areas of dispute are addressed and it would appear only two areas remain to resolve.

The first concerns the starting point of \$4.149 b of water RAB as per the 2004-05 Transparency Statement (reduced to \$4.055b by removal of \$94m of contributed assets). If this is treated as a “line in the sand” call, there is no dispute; but if stakeholders believe the number should be adjusted to remove contributed assets from before 1995, it will remain a matter for resolution. The Inquiry is pursuing the reasons why it is claimed that an estimation of this value cannot be made.

The second concerns the justification for the inclusion of the total cost of the desalination plant (minus the Commonwealth Government contributions) in the RAB roll-forward calculations, given a view that the expenditure for the doubling of capacity was not economically justified and the plant utilization demonstrates its full value should not be included in the RAB. The question of the desalination plant may not be resolvable, as it comes down to personal opinion on whether it is justified.

The desalination plant was approved by Cabinet after a full economic analysis supporting a 50GL/a capacity at a cost of \$1.374 b; the Commonwealth contributed \$100m in 2009. As the drought continued, and the opportunity arose to double the capacity for an extra \$456m of which the Commonwealth contributed half, Cabinet approved the expansion to 100GL/a at a total cost to SA Water of \$1.502b. Some have expressed doubt as to whether an economic case was presented to Cabinet supporting this expansion; the Inquiry has been unable to determine if such a case was developed (due to Cabinet Confidentiality) but it has been pointed out that Treasurer’s Instructions require an economic case to be presented on every major proposal such that it should be assumed one was done.

Those who support the inclusion of the full net capital cost of the plant in the RAB cite the following:

- The capacity of the 100GL/a plant is still insufficient to provide more than 80% of Adelaide’s daily water requirements during peak demand periods in summer;
- The plant is a key component of the State’s water security strategy, being climate independent and able (through the North-South Interconnector project) to supply water throughout the major part of the Adelaide distribution network and potentially able in time of drought to take pressure off the River Murray to ensure supply to Riverland and country regions.
- The marginal cost of the additional 50 GL/a supply (\$228m versus \$1,274 m for the first 50GL/a) was an attractive and justifiable investment which would have cost considerably more in the future if the drought had continued or another drought occurs, and the construction workforce and contractors has to be re-assembled.

Those who believe the capital expenditure of the ADP (or some part of the expenditure) should not be included in the RAB are not convinced by these points.

At this time, it is the Inquiry’s intention to accept the full expenditure on the ADP into the RAB.

Questions to Consider

- 1. How important is it that an effort is made to estimate the value of contributed assets prior to 1995, if the “line in the sand” approach for setting RAB is to be adopted for the opening RAB in 2004?**
- 2. Is there any justification for removing the full or incremental cost of the desalination plant from the allowable capital expenditure in the RAB roll-forward?**

4. TERM OF REFERENCE 2: PRELIMINARY THOUGHTS

The discussion in the earlier sections about the implications of this Inquiry provides an opportunity to seek stakeholders' views on a much broader topic, and how this might guide the way forward in our deliberations. This will be particularly relevant as we move on to consider recommendations regarding an implementation program and timetable, assuming the Inquiry does conclude some change to the RAB.

The broader question is: what do South Australians want from their water business, and can the outcome from this Inquiry assist bring that about?

As indicated, feedback on the Exploratory Essay fell into two broad categories. The first supported a comprehensive exercise to find and value all of the areas where the RAB had been over-valued and where unjustified costs had been allowed (including in the wastewater area as well) and endorsed the removal of this over-valuation and a reduction in prices at the earliest opportunity. The second supported a more considered assessment of the different priorities and an attempt to find a balanced solution that took the opportunity afforded by a reduction in RAB to address a number of priorities for business and residential consumers across the State.

Some of the key players who reviewed the Essay are involved in other regulated industries and were aware of changes in those sectors impacting on the determination of the Weighted Average Cost of Capital (WACC), and specifically in the method that is being proposed to calculate this in future (led by changes proposed by the Australian Energy Regulator and the WA Economic Regulation Authority which will potentially reduce the WACC or return to Owners by around 0.5%pa). They were also aware of the impact of the current 10 year trailing method for calculating the cost of debt for SA Water, which will see a significant reduction in WACC from 2020 (as the high cost debt from 2006-10 is replaced by the lower cost of debt from 2016 -20). These changes are expected to result in a significant reduction in tax and dividend returns to the SA Government from SA Water over the period 2020-2024, even without any change in the RAB. If the RAB is also reduced, there will be a double whammy effect, resulting in significant price reductions to consumers and revenues to the Government.

ESCOSA is soon to commence its 2020 SA Water revenue determination process (having already released a scoping paper outlining its proposed approach), which will include a detailed consideration of the WACC and how it should be calculated over the period 2020-24. It will be calling for submissions on this matter in due course. Term of Reference 3 for this Inquiry requires us to report on certain aspects of the WACC determination, and it is intended that comments in this regard will be included in our next report which is expected to be released around December 2018.

ESCOSA is also about to undertake a review of the Third Party (TP) Access Regime which commenced in mid-2016, which outlines arrangements for third parties to access SA Water's assets for their own use.

A number of the key players raised this matter in their discussions on the Exploratory Essay, emphasizing the importance of this regime in ensuring competitively priced water supply options were available to SA businesses and communities. They believed that a functioning TP access regime was important in keeping SA Water efficient and honest in its operations, and that the current system (based around the so-called "retail minus" pricing approach) was not working effectively. The Inquiry urged these parties to make their views known to ESCOSA as part of its review later this year. Again, there is the prospect that any changes to make Third Party Access more accessible will impact on SA Water revenues and profits.

It is apparent from these few examples that major changes are likely to impact on SA Water's operations in the coming few years, with considerable downward pressure on prices, revenue and profit: this should be good news for business and residential consumers but in the view of some of our respondents, it needs to be carefully managed. They identified a number of important deliverables they required from the water industry such as:

- A secure, safe and reliable supply
- Competitive prices
- Affordable supply for all
- Support for business and job growth
- Protection from climate change and droughts
- Appropriate water quality.

It was noted that these matters involved costs and tradeoffs, and that it may not be possible to have all of them to the degree hoped for. Some feared that a sudden and large reduction in revenues to SA Water and the government may compromise the balanced achievement of these objectives, and threaten the financial viability of SA Water.

The question was asked as to whether the review of RAB might offer an opportunity for the key players and other stakeholders to look at the issues and to attempt to develop a joint position re the role of water in supporting the future of South Australia, within the context of reducing the RAB and prices.

Some mentioned the challenges facing the "driest State in the driest Continent" and emphasized the need for the Inquiry to facilitate these discussions, rather than simply placing a new RAB figure on the table and concluding its work.

As part of the Inquiry's consideration of Term of Reference 2, following the conclusion of its work on Term of Reference 1, it is possible for the Inquiry to organize in early 2019 a Workshop (or series of workshops) with key parties to consider the wider issues and to incorporate their views into its recommended implementation program.

While the Terms of Reference do not require such an expanded consultation process, they do not rule it out. If there is a view from the key stakeholders in general that they would appreciate the opportunity for such a Workshop discussion, the Inquiry will discuss with the Treasurer what this might entail and if he is supportive of such discussions.

Question to Consider:

Would key stakeholders wish to participate in a combined Workshop in first Quarter 2019 to discuss the wider issues outlined above, with a view to providing input to the Inquiry's Term of Reference 2 concerning a possible implementation program and timetable for any proposed reduction in the RAB identified in the first Term of Reference?

5. NEXT STEPS

This Diving Deeper report provides an update on the progress of the Inquiry into Water Pricing as at end September 2018.

It has presented the feedback received on the Exploratory Essay and discussed the implications of that feedback on the work of the Inquiry. It sets out an approach designed to address the matters covered in Term of Reference 1, and to form a view on whether the Initial Water RAB of \$7.77 billion was reasonable.

The report raises a number of questions for key parties and stakeholders to address, and the Inquiry intends to hold discussions with these groups and individuals in October and November to discuss their views on these questions. It intends to release to interested parties during October its modelling of the RAB roll-forward approach as outlined in this report, to focus discussions on this matter.

The Inquiry intends to release another report in early December 2018 which outlines its preliminary conclusions on Term of Reference 1. The report will also include information on its review of water pricing in Western Australia and any additional benchmarking it has undertaken comparing water prices and RAB values in SA to other jurisdictions.

The Inquiry welcomes comments on this report and on other matters covered by the Terms of Reference. Comments should be forwarded to:

Ms. A. Pataki
Executive Officer
SA Inquiry into Water Pricing
GPO Box 1045
Adelaide SA 5000

Or emailed to

waterpricinginquiry@sa.gov.au

Telephone inquiries should be directed to the Executive Officer on 8429 0634