

Inquiry into Water Pricing in South Australia

Stakeholder Workshop

4 March 2019

SUMMARY REPORT



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Background and context

In August 2018 the South Australian Treasurer established an inquiry into water pricing in South Australia (“the Inquiry”). The objective of the Inquiry is to consider and report on the reasonableness of the opening value of SA Water’s Regulated Asset Base (RAB), which forms part of the SA Government’s broader consideration of whether the revenue that SA Water is permitted from its drinking water retail service reflects the cost of providing these services.

Since being established, the Inquiry has delivered three discussion papers detailing its investigations into the opening value of the RAB. The latest paper, *A Cautious Conclusion*, was released in December 2018, and provided tentative recommendations that could form the basis of the Inquiry’s response to the Treasurer.

Prior to the release of the Inquiry’s fourth discussion paper (expected to be released in May 2019) and its Final Report to the Treasurer (due in June 2019), the Inquiry sought a workshop with key stakeholders to:

- canvas feedback on the findings presented in *A Cautious Conclusion*
- better understand stakeholder views in regards to matters still under consideration, and
- consider any other matters in relation to the Inquiry.

The Inquiry’s Final Report will be considered by the SA Government and may inform the value of the RAB and related matters for the next regulatory determination by the Essential Services Commission of SA (ESCOSA) for SA Water covering the period 2020-21 to 2023-24.

Workshop approach

The workshop was held on 4 March 2019. It was attended by representatives from the SA Government, SA Water, Essential Services Commission of South Australia (ESCOSA), Water Services Association of Australia (WSAA), as well as various consumer advocacy groups and their technical advisors (a full list of attendees is provided at Appendix A). The workshop agenda was split into four key topics under further consideration of the Inquiry, followed by an opportunity to discuss any other relevant matters:

Topic 1 - Reasonableness

Topic 2 - Methodology and process for setting the initial RAB

Topic 3 - Treatment of contributed assets

Topic 4 - Implementation considerations

Summary Report

This report is provided as a summary of the workshop discussion. It has been structured in accordance with the workshop agenda. For simplicity, where possible, discussion points have been grouped into key themes.

This report presents the views expressed by participants during the workshop. The workshop was delivered under ‘Chatham House Rules’ and, subsequently, no attribution of these views to individuals or organisations has been made. Importantly, the basis of these views has not been reviewed as part of the report, and the Inquiry makes no representations in regard to their validity.

Topic 1 - Reasonableness

Session overview

Topic 1 explored stakeholders' views regarding the Inquiry's interpretation and application of the term reasonableness. The Water Pricing Inquirer, Lewis Owens, introduced the topic and explained the Inquiry's approach taken within *A Cautious Conclusion*. This was followed by a presentation of research and comments regarding 'reasonableness' in a regulatory context.

Participants were asked to consider two questions in relation to the Inquiry's interpretation of reasonableness:

- 1 What are your views on the approach taken by the Inquiry in considering "reasonableness"? (Sensible, Fair, Moderate)
- 2 What are your views in regard to the proposed treatment of decisions as a recommendation? (Reasonable, Not Reasonable or Unfair, Unreasonable).

Alignment to the Terms of Reference

1(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

Discussion themes

In considering the Inquiry's interpretation of "reasonableness", participants' comments could be broadly broken into three themes:

- 1 The elements and categorisation of reasonableness
- 2 The importance of the perspective the inquiry chooses to take
- 3 Temporal context and considerations.

The elements and categorisation of reasonableness

Participants raised a number of considerations in regard to the Inquiry's proposed elements of reasonableness, as well as Uniting Communities' written submission to the Inquiry which proposed that "ethical" should be included as a fourth element. Discussion included whether:

- 'ethical' is already covered by 'fair'; and whether inclusion would open the inquiry's framework to subsequent challenge or criticism regarding the ethical nature of decisions.
- 'moderate' and 'prudent' in the categorisation proposed in *A Cautious Conclusion* could be in conflict in certain circumstances
- 'sensible' reflects or includes 'sustainable' (social, environmental and economic) and whether this link could be explicitly drawn.

Overall, the discussion appeared to reflect a broad recognition that the elements used by the Inquiry to consider and respond to the 'reasonableness' of the opening value of the RAB were in and of themselves, reasonable.

When asked, participants also did not offer any particular strong views or objections to the classifications used by the Inquiry regarding assessment of decisions regarding the SA Government RAB (Reasonable, Unfair or Not reasonable, Unreasonable) and the associated recommendations to the Government associated with each category.

The importance of the perspective the inquiry chooses to take

It was acknowledged that the Terms of Reference do not provide guidance on the perspective from which reasonableness is to be applied, and that any assessment of the reasonableness of the opening value of the RAB is subject to the perspective the Inquiry chooses to take.

In that context, the workshop discussed a number of important considerations when choosing a perspective:

- legal vs regulatory perspective:

Participants noted that the Inquiry had chosen more of a regulatory reasonableness test rather than purely legal, given that all decisions were well within any legal boundaries. There was no objection made to this as a necessary prerequisite during the discussion.

To inform this perspective, discussion highlighted some of the public's expectations of regulation, in particular protecting the long term interests of consumers and avoiding price shocks.

- compliance vs consistency with other jurisdictions

Without offering any opinion of the validity of each, discussion noted the significant difference between assessing reasonableness in terms of compliance with policy and/or national initiatives, as opposed to comparing the approach taken in other jurisdictions.

- the reasonableness of the process vs the outcome:

It was suggested that, ultimately, there is a public expectation for the reasonableness of both the process and the outcome.

A reasonable process could be viewed as a necessary prerequisite for getting a 'good' outcome, or the credibility of the outcome. An outcome that is not acceptable raises questions about the appropriateness or legitimacy of the process.

It was noted that Water prices have risen threefold over the past decade. If the reason for such increases was transparently conveyed to customers, the prices (and process) may have been more readily accepted.

Temporal context and considerations

The workshop also discussed the importance of due consideration of whether the Inquiry is assessing the reasonableness of the RAB in retrospect or rather in the context of the time of decision-making. Depending on the view taken, considerations should include:

- the data available at the time
- the environmental and political context, such as the millennium drought and growing acknowledgement of the scarcity of water
- changes in the public expectations of regulatory process and outcomes, or the importance placed on compliance with the NWI principles.

Topic 2 – Methodology and process for setting the Initial RAB

Session overview

Topic 2 unpacked the key technical, timing and process considerations that led to the opening value of the RAB, and canvassed stakeholders' views regarding the reasonableness of each. The session was broken into three parts:

- 1 The application of the accounting methods in setting the RAB (process)
- 2 The regulatory accounting methods and calculations used to determine the RAB (technical)
- 3 Timing of the commencement date.

A number of presentations were used to share expert perspectives and inform attendees. Whole-of-group discussions gave all the opportunity to contribute views and ideas.

It is acknowledged that the technical complexity of the topic restricted the ability for some participants to share meaningful views on the 'technical' and 'timing' aspects of the RAB.

Alignment to the Terms of Reference

1(a)(i) Asset valuations used to establish drinking water prices in the years leading up to 2013

1(a)(ii) The process for setting the initial RAB for 2013

1(a)(vi) RABs for drinking water services in other jurisdictions, having regard to the key drivers and variables that may affect the value

Discussion themes

Nonetheless, comments could be grouped into the following three themes:

- 1 The reasonableness of the RAB value (from an outcome perspective)
- 2 Technical and process options and limitations
- 3 Timing of decisions, legacy assets and the line in the sand.

The reasonableness of the RAB value (from an outcome perspective)

Comments from various participants challenged the view that the value of the RAB was unreasonable. The three key arguments are explained in turn below.

The value of the RAB and water prices relative to other jurisdictions

First, some participants shared insights from other jurisdictions to contextualise discussion of South Australia's RAB and water price, and argued that SA Water bills are not high relative to other utilities after adjustment for population density. Data was presented that indicated SA Water's typical water and waste water bill in 2017-18 was mid range compared with other utilities (specifically, ninth of 17 utilities listed) and that against an index set at 1998, SA Water's real price increases were the second lowest of the capital cities, although the 1998 index point was not explained for relative prices at the time.

A higher RAB valuation leads to service sustainability, greater price stability and offsets future replacement costs

Second, various participants suggested that a higher RAB value could potentially be viewed as 'beneficial' because:

- 1 The long term price path is not impacted by adjustments to the RAB
- 2 The SA Water RAB provides long term financial sustainability – current prices contain sufficient revenue to maintain current service standards
- 3 Reducing the RAB now would lead to higher price increases in forward years
- 4 additional revenue provides funding for future (higher) replacement costs and, and as a result, reduces future price rises (effectively a 'sinking fund').

These perceived potential benefits were in turn countered by the views that:

- returns sufficient to secure investment in future capital works are provided through the regulatory revenue setting process (and recouped through pricing), and that a higher RAB value leads to inflated revenues and prices
- there is no existing mechanism for this revenue to be reinvested (and deducted from a future RAB increase), thus factoring future CAPEX costs into the RAB value would ultimately result in the consumer 'double-paying', and
- the comments assume that price stability is valued greater by consumers than lower prices that are then followed by higher relative price rises (i.e. that flatter prices are a better outcome than price variability involving a period of lower prices).

The significant rises in price between 2005 and 2012 placed an implicit environmental or scarcity premium on the price of water

Third, at various points throughout the workshop, stakeholders suggested that the price rises over the 2005 -2012 period led to a heightened consumer appreciation for the scarcity of water, and was effectively perceived as an 'environmental' price signal now factored into water pricing.

It was suggested that a lower price resulting from any reduction in the RAB could remove this 'implicit' environmental factor, and that consideration should be made as to whether 'explicit' environmental/scarcity factors should be incorporated into the tariff structure.

Technical and process considerations

Presentations were given on the Deprival Value, Economic Value and the Line in the Sand, providing background and explaining the respective methodologies and principles of each.

General feedback from the group acknowledged that there appeared to be no single “right” approach or “right” value. Various approaches to RAB valuations have occurred inter-state and were invariably linked to the government objectives (or desired outcomes) at the time, reflecting the subjective nature of choosing a ‘reasonable’ approach.

The Deprival Value

Definitions of the Deprival Value and the ‘Line in the Sand’ were presented, along with a potted history of their adoption as principles within the regulation of Australia’s water industry.

The discussion highlighted that the National Water Initiative Pricing Principles (2010) allow for a variety of acceptable asset valuation techniques (DRC, DORC, ORC, indexed actual cost, ODV or another recognised valuation method). As mentioned previously, discussion centred on the approaches from other states, often subject to the respective government’s objective at that time (but SA was quite different from all others). It was acknowledged that this may complicate the task of the Inquiry, as there does not seem to be a single approved approach.

Economic Value

The presentation noted that Economic Value is a widely used approach to asset valuation that has the benefit of recognising the distinction between legacy and new assets. It values existing assets consistent with the implicit pre-existing contract with customers, and draws a ‘line in the sand’ so that new asset decisions are then evaluated on a commercial basis. The presentation noted that the key considerations in applying the Economic Value approach are: what are the cash flows – current and future? Over what period? What is the discount rate? And what are the sensitivities and cross-checks?

Line in the Sand

The workshop discussed the line in the sand principle, how it was applied and where it might most appropriately be drawn. Discussion suggested that in the South Australian context for SA Water’s RAB, no clear single line in the sand was drawn and rather multiple ‘lines in the sand’ were drawn. One explanation for this was suggested to be the line in the sand was updated to be reflective of the improving data quality through time, overlaid with a gradual shift towards full economic regulation.

The workshop acknowledged the difficulty in applying the line in the sand methodology for this reason, and no clear feedback was provided regarding an appropriate place to draw the line in the sand.

Timing

Timing of the commencement of the Initial commencement date

A presentation outlined the advantages and disadvantages of the various options to adjust the commencement date for the RAB, which is rolled forward to the opening value. Participants benefitted from the exploration of each of the options, however, no firm feedback was provided.

Topic 3 – Contributed Assets

Session overview

Topic 3 explored the reasonableness of the decision that assets contributed prior to SA Water's corporatisation would not be removed from the RAB and considered the options to appropriately value these assets.

A presentation was given to walk participants through the methodology applied by the Inquiry to calculate a value, prior to tables being asked two questions:

- 1 Should the assets contributed prior to corporatisation remain or be removed from the RAB? (pp 31-37)?
 - a) On what basis?
- 2 What is the most reasonable basis to value the contributed assets prior to corporatisation?
 - a) Is the method used by the Inquiry to calculate the value of contribution assets prior to 1987/88 reasonable (p 37)?
 - b) What is the most reasonable period to calculate a value for contributed assets:
 - I. 1965/66 – 1994/95
 - II. 1965/66 – 1987/88 (1988/89 – 1994/95
 - III. Other?

Alignment to the Terms of Reference

1(a)(i) Asset valuations used to establish drinking water prices in the years leading up to 2013;

1(a)(iii) The treatment of customer contributions in setting the Initial RAB

1(a)(v) Compliance with the National Water Initiative Pricing Principles in relation to the recovery of capital expenditure

Summary of discussion

Stakeholders generally agreed that contributed assets have some value (ie it is not zero), however, the information is unreliable and determining what value to apply is difficult. The question for the Inquiry is how to determine a justifiable value.

Some participants suggested that contributed assets should be included as they needed to be replaced. The counter-view was that customers shouldn't be charged for assets that did not cost the owner (SA Government). Notably, the efficient cost of repairs and replacement of these assets was allowed by the Regulator (Essential Services Commission of SA- ESCOSA) in previous revenue determinations.

In that context, it was suggested that the third methodology (indexation) applied by SA Water within its 2004 memo to the SA Government was more appropriate than the first (historic).

A participant noted that there could be an alternative methodology to the three applied by SA Water in its 2004 memo; that is, keep revenues constant, have the rate of return fixed and back calculate for the desired RAB. It was proposed that this would provide a new RAB and the difference between the existing and the value calculated under this method would be a new value of the pre corporatisation contributed asset base. It is beyond the scope of this report to consider the validity of this approach.

Topic 4 - Implementation considerations

Session overview

Topic 4 canvassed issues and opportunities the SA Government should consider in implementing any proposed change in the RAB. Brief table discussions were held prior to reporting back to the group.

Alignment with the Terms of Reference

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 SA Government (as Owner of SA Water)

Discussion themes

Transparency, communication and engagement

There was general recognition that the SA Government could use a revised RAB value as an opportunity to raise the level of communication and perceived transparency in relation to water pricing in South Australia. Specific suggestions included:

- clear communications regarding the SA Government's objective and desired outcomes for the Inquiry and any resultant revaluation of the RAB; for example is the key objective 'fair pricing', or 'reduced prices or another objective'?
- undertake meaningful consultation with key stakeholders before acting on the Inquiry's report.

As discussed under Topic 2, it was suggested that a reduction in the price of water resulting from any reduction in the RAB could remove an 'implicit' environmental charge, and that consideration should be made as to whether 'explicit' environmental/scarcity factors should be incorporated into the tariff structure.

While outside the scope of the Inquiry, the suggestion was also made that the SA Government may wish to consider how the public may view subsequent price rises following a price reduction. It was mentioned (without specific reference) that the public values a loss greater than they value an equivalent gain, and therefore, the perception of price savings now may not offset the negative perception of relatively smaller future price rises.

Finally, the question was raised whether the ability for the Treasurer to change the RAB at each price determination should be removed. Comments throughout the workshop referenced the gradual shift to independent regulation of South Australia's water supply. Removing the Treasurer's power to alter the value of the RAB could be seen as a final step towards full independent regulation and remove the perceived conflict of interest that the ultimate asset owner is able to influence revenue outcomes; which is likely to have, in part, led to this inquiry.

Impact

Comments highlighted a number of primary and secondary flow-on affects that would need to be explored and/or further considered by the SA Government prior to determining a course of action. These included:

- how the revised RAB impacts SA Water and SA Government revenues; including whether any other mechanisms should be introduced to offset this impact (e.g. water tariff structures; taxation)
 - with regard to tariff structure, is it reasonable that an element of water tariffs reflect the scarcity of water (which became inherently acknowledged in the price rises through the millennium drought)
- any potential impact a revised RAB could have on SA Water's Debt to Equity ratio, and subsequent impacts for its credit rating and WACC
 - As a state-owned entity, whether there could be any flow on implications for the credit-rating of the State
- Whether there is any impact on the ability of SA Water to deliver a safe and reliable water supply.

Timing

The workshop highlighted a number of timing considerations, specifically:

- Timing of when a revised RAB is implemented and when the benefit is passed on to consumers:
 - Whether the reduction made and passed on at a single point of time, or whether it is phased. This included whether the tariff structure could be used to smooth the impact of revenues
 - ESCOSA approach would apply a step-change in the first year and adjust for CPI in years after
- The historical timing of when the RAB adjustment is made, i.e. is it adjusted in 2004/05 and rolled forward, 2013 and rolled forward, or is it an adjustment as of 2019?

In terms of an implementation program, it was highlighted that it would be beneficial from SA Water's perspective to have any revisions of the RAB finalised prior to SA Water's regulatory proposal to ESCOSA, due in October 2019.

Any Other Matters

Participants welcomed the opportunity to raise a number of issues that go beyond the scope of the Inquiry's Terms of Reference, but that they feel the Inquiry or the SA Government should consider:

- The decision to exclude wastewater assets from the scope of the Inquiry, with comments suggesting:
 - wastewater assets account for about a third of the SA Water's total asset base,
 - it's difficult to disentangle water and wastewater assets.
 - there hasn't seen any solid justification provided for the exclusion of waste water assets, and there is no precedent from other states.
- SA Water operational efficiency:
 - It was highlighted that, within the National Performance Report data, SA Water ranks as one of the most efficient water companies in Australia. That is, when adjustments are made for the length and quantity of SA Water's assets against the number of customers, it is one of the most efficient in the country.
 - The operational efficiency of the business has also increased recently, which has contributed to more stable prices. The uptake of technology is an important contributor to this improvement.
- With the major improvements in technology, SA Water should be able to further reduce the cost of operations and the SA Government should consider support for water technology innovation (and provide jobs in this State).
- The return SA Water's shareholders currently receive is one of the lowest in Australia (as a percentage return on statutory and regulatory asset values). However, it was also suggested this might be because the statutory and regulatory asset values are inflated.

Lew Owens asked attendees to consider whether an additional workshop should be held in the near future , and advise the Executive Officer of their views.

Appendix A: Workshop attendance list

Name	Position	Organisation
Inquiry Representatives		
Lew Owens	Inquirer	Water Pricing Inquiry
Ann Pataki	Executive Officer	Water Pricing Inquiry
Participants		
Andrew McKenna	Senior Policy Advisor	Business SA
Eric Groom	Consultant	CEPA
Adam Pamula	Director Account Management	DTF
Stuart Hocking	Deputy Chief Executive	DTF
Adam Wilson	Chief Executive Officer	ESCOSA
Nathan Petrus	Director, Consumer Protection and Pricing	ESCOSA
Ross Haig	Senior Regulatory Analyst	ESCOSA
Dean Crabb	Policy Officer	Livestock SA
Roch Cheroux	Chief Executive Officer	SA Water
Jamie Hollamby	General Manager Business Services	SA Water
Natalie Caon	Senior Manager Pricing	SA Water
Ross Womersley	Chief Executive Officer	SACOSS
Jo De Silva	Senior Policy Officer	SACOSS
Kevin Kaeding	President	South Australian Federation of Residents and Associations Inc.
Mark Henley	Manager Advocacy	Uniting Communities
Stuart Wilson	Deputy Executive Director	Water Services Association of Australia
Adam Lovell	Executive Director	Water Services Association of Australia
Dr Malcolm Abbott		Swinburne University
Ian McCauley		
Dick Blandy		