



## Submission

**To:** **Inquiry into Water Pricing in SA**

**By Email:** [waterpricinginquiry@sa.gov.au](mailto:waterpricinginquiry@sa.gov.au)

**Topic:** **A Cautious Conclusion**

**- Response**

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## **Introduction**

Uniting Communities welcomes the opportunity to contribute to this Inquiry. We are a major provider of community services in South Australia, including a number of services to assist people dealing with poverty and income disadvantage that means that paying for essential services is often difficult.

## **About Uniting Communities**

Established in 1901, Uniting Communities' mission is to create a compassionate, respectful and just community in which all people participate and flourish.

Uniting Communities works with South Australians across metropolitan and regional South Australia through more than 100 community service programs. We are a team of more than 1,500 staff and volunteers who support and engage with over 20,000 South Australians each year.

Uniting Communities offers programs for young people, families and children and older people, around mental health and wellbeing issues, disability support, respite for Carers, housing and crises, alcohol and other drugs intervention, counselling and rehabilitation, medical issues, and financial and legal services issues.

Our input is driven by specific comments from a number of people who have received services from us and from staff who provide services. We also add the distilled experiences of thousands of individuals, families and communities with whom we work through services, including financial counselling, aged care services, disability services, services, Lifeline and many more.

## **Reasonableness**

The understanding and application of "reasonableness" has rightly been identified by the Inquiry as a core question.

In assessing the meaning of the term "reasonableness" from the terms of reference the Inquiry says in "A Cautious Approach" that it *"has considered how it should apply the test of reasonableness to the key decisions that were taken in establishing the initial RAB and has explored the legal principles behind this test. It has concluded that there are three key elements to the definition of reasonable:*

- 1. Sensible, credible, sound judgement, logical*
- 2. Fair, just, proper, good faith, legal*
- 3. Moderate, prudent, not extreme, pragmatic*

*This then leads the Inquiry to propose using the following broad categorisation of the key decisions to guide it in its advice to the Treasurer"*

- reasonable the decision made should stand*

- *not reasonable or unfair (a decision which was not in breach of the principles or rules, but was not balance between the interests of the government as owner and consumers) - the Treasury should consider the possibility of adopting a more just/fair treatment*
- *unreasonable (a decision not in compliance with the rules and breaching at least one of the sensible/fair moderate criteria) the Treasury should seriously consider changing the previous treatment of the matter”*

For Uniting Communities the understanding of ‘reasonableness’ is crucial in determining the advice that the Inquiry should provide to Treasury and ultimately the action that the SA Government should take with the Gordian knot that is revaluation of the SA Water RAB (Regulated Asset Base).

Reasonableness, particularly in a regulatory sense, must begin with the best interests of customers as the driving imperative. This is also the prime objective for the regulator (ESCoSA) from the SA Essential Services Commission Act 2002, which requires the regulator and consequently regulated entities to protect South Australian consumers’ long-term interests with respect to the price, quality and reliability of essential services. The outcomes of this Inquiry have the capacity to act to reduce prices for consumers, many of whom struggle to meet basic living costs: rent, energy, water.

While it may not be a dictionary definition of reasonable, we strongly suggest that ‘ethical’ needs to be part of the understanding of the meaning of reasonableness, leading us to propose a fourth aspect of reasonableness, “ethical” being added to the Inquiries’ three measure, resulting in four elements of reasonableness:

1. Sensible, credible, sound judgement, logical
2. Fair, just, proper, good faith, legal
3. Moderate, prudent, not extreme, pragmatic
4. Ethical (doing the right thing)

The questions of reasonableness, regulatory judgement and ethics are all the subject of an extensive literature. We briefly draw on three recent pieces of regulatory thought, all from the UK, to further explore the reasonableness question posed by the Inquiry. First we make the following comments about the emerging notion of ‘ethical regulation’ and particularly draw on “Ethical Business Practice and Regulation” Christopher Hodges and Ruth Steinholtz, Hart publishing 2017.

They state *“ethical business regulation is an open relationship of trust between businesses and regulators built on evidence that both sides can be trusted.”* We add that this occurs in the context of regulators and the regulated businesses both being fully focused on the best outcomes for consumers. We assert that the best outcomes for consumers are achieved through ongoing open and trusting collaboration with customers, and businesses then implementing decisions agreed with customers and validated by regulators

Hodges and Steinholtz also state that the design and operation of a regulatory system will be most effective when the parties adopt the following principles:

1. *“a policy of supporting ethical behaviour. The regulatory system will be most effective in affecting the behaviour of individuals where it supports ethical and fair behaviour.*
2. *Ethical regulators. Regulators should - self-evidently - adopt unimpeachable, consistent and transparent ethical practice.*
3. *Ethical businesses. Businesses should be capable of demonstrating constant and satisfactory evidence of their commitment to fair and ethical behaviour that will support the trust of regulators and enforcers, as well as of employees, customers, suppliers and other stakeholders*
4. *A learning culture. A blame culture will inhibit learning and an ethical culture, so businesses and regulators should encourage and support an essentially open collaborative ‘no-blame’ culture, save where wrongdoing is intentionally or clearly unethical.*
5. *A collaborative culture. Regulatory systems need to be based on collaboration if they are to support an ethical regime and to maximise performance, compliance and innovation*
6. *Proportionate responses. Where people break rules or behave immorally, people expect to see a proportionate response.”*

In referencing Hodges and Steinholtz, The Water Industry Commission of Scotland (WICS) says:

*“(their) work on ethical business regulation appears to be closely aligned with the practical steps that we are taking. For example we agree strongly with conclusions that a constructive relationship backed by strong incentive to ‘do the right thing’ will maximise performance, compliance and innovation...”*

WICS also says that there are *“several steps required to reduce the potential for information asymmetry, ensure there is no regulatory capture and empower customers and communities to the maximum extent possible the steps include:*

- *engagement*
- *managing risk*
- *monitoring and reporting*
- *governance.”*

We reference WICS for a couple of reasons, firstly the approach to water regulation in Scotland is generally considered, internationally, as a leading approach to regulation and particularly consumer engagement in water regulation. This has led to considerable interest in applying aspects of the Scottish water model to the regulation of SA Water. A number of people from South Australia, including the author of this submission, have had the opportunity to visit WICS, Scottish Water and some Scottish consumer groups over the last couple of years.

The third input that we wish to highlight is from SustainAbility First<sup>1</sup>, a UK based community organisation for which we have very high regard.

In October 2018, SustainAbility First released a discussion paper entitled “Fair for the Future - framing a licence to operate the water and energy sectors.” They propose that for fairness to permeate future energy and water sectors that are notion of a “sustainable licence to operate” must apply. This builds on the notion of a “social licence to operate” which has some currency but which we suggest is not considered as widely as it should be in Australia. A sustainable license to operate then adds environmental sustainability to the social license concept.

*SustainAbility First says that their new “Fair for the Future” project proposes that a sustainable licence to operate in the sectors is built on four pillars. These are interconnected and because the pillars are geared to actions, which can address major challenges they won’t always be ‘got right’ first time. Agility and iteration will be necessary as well adapting this thinking to each individual company’s requirements and local/regional/national environment.”*

#### Tests for Consumer Benefit (Reasonableness)

“Fairness for the Future – Sustainable License to Operate” - Sustainability First, UK

Pillar 1: Public purpose, philosophy and public service values

Company statements

Pillar 2: Making best use of different types of capital

Decision making framework; competition, cooperation, capital

Pillar 3: Roles and responsibilities

Compacts for fairness

Pillar 4: Strategy and narratives

Honest, consistent, comparable reporting

Whilst many of the process aspects of this ‘test for fairness’ are beyond the direct scope of this Inquiry, we regard them as important. Suffice to say that the responses to the actions that the SA Government takes from this Inquiry and subsequent reporting on RAB need to apply these tests for consumer benefits.

This Inquiry does however need to very closely test fairness outcomes of the recommendations that are made.

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<sup>1</sup> [www.sustainabilityfirst.org.uk](http://www.sustainabilityfirst.org.uk)

Considering the comments above, there are three key messages that we take out of this discussion about ethical regulation with particular reference to this Inquiry:

- No Blame
- Fairness and Ethical practice – “do the right thing”
- Sustainable license to operate

### No Blame

Taking a “no blame” approach means that there is no regret about past decision making regarding the valuation of the RAB. The best future outcome for customers is what matters now and this means adjusting past decisions that ‘ex post’ don’t work for current and future consumers. This needs to be undertaken without any recriminations for past decision-makers and previous decisions.

### Fairness

We have brought together the notions of fairness and ethical practice under the more general banner of needing to “do the right thing” which, like reasonableness is always going to be somewhat subjective matter. In the end this Inquiry, as with regulatory decisions in general including the SA Water 2020 decision, will need to exercise a degree of judgement.

Making proposals to “do the right thing” must remain the priority of this Inquiry. Doing the right thing also need to be from the perspective of customers who pay for SA Water services.

### Sustainable licence to operate

We think there is merit in this concept as it brings together the notion of a social licence to operate with contemporary environmental considerations. We use this terminology to maintain integrity with the SustainAbility First analysis, however for the purposes of this Inquiry we recognise that it is really the “social licence to operate” which is the imperative for making decisions about water pricing. South Australian communities need to be able to trust SA Water to do the right thing both in terms of economic efficiency in providing services of acceptable standard and in contributing to improved urban as well as catchment and other rural environments.

## Reasonableness applied.

This section considers some of the key issues raised by the Inquiry and the major input into the Inquiry from Business SA, the CEPA report, and applies our perspective of what reasonableness expressed as “doing the right thing” would mean.

CEPA report says

*“The process to set SA Water’s initial RAB cannot be considered fully independent, given that the owner of the business effectively decided the valuation. The underlying assumptions and methodology are not transparent. A degree of independent scrutiny was provided by ESCOSA’s review of the Transparency Statements, and the publication of the Government’s response to ESCOSA’s findings. However, ESCOSA’s reviews were focused on the compliance of the overall approach for setting the RAB with the NWI requirements and whether adequate supporting evidence was provided to inform the SA Government’s pricing decisions, rather than a detailed assessment of the application of the approach or assumptions.”*

The CEPA report also says

*“While we support the Inquiry’s proposed approach to revising the RAB, we consider that – in light of the concerns outlined above – it should be viewed as an upper bound estimate of a plausible range of RAB values, rather than directly adopted as the new RAB. We recommend sensitivity testing of this value to develop a more robust approach to the RAB valuation. In particular, consideration of an economic value approach can assist the Inquiry in establishing a range for the opening RAB that would be in line with the deprivation value approach adopted by regulators in other States and consistent with preserving the ‘implicit contract’ with consumers. Sensitivity analysis can also assist the Inquiry in assessing the potential impact of regulatory capex challenges on the RAB. We have developed an alternative approach to considering SA Water’s RAB, which provides an example of this kind of sensitivity analysis.<sup>15</sup> In a sequence of adjustments, we have:*

- 1. Estimated an economic value ‘line in the sand’ for the RAB as at 1 July 2004, based on the net present value of free cash flows. This is accompanied by sensitivity testing on the discount rate and period of analysis, highlighting the material impact of these assumptions on the results.*
- 2. Rolled the opening 1 July 2004 RAB forward using projected rather than actual capex. Projected capex is 11% lower than actual capex for the period and this difference is applied as a proxy for the effect that efficiency testing of the capex program by an independent regulator may have had.*
- 3. Deducted the cost (exclusive of the Commonwealth Government funding) of the expansion of the ADP’s capacity from 50GL p.a. to 100GL p.a. from the capex program (\$222 million). At this stage significant questions have been raised as to whether the increase in capacity was economically efficient. Based on our mid-point estimate, if just the first change – an economic value for the opening water asset RAB – were made, the RAB for water assets in 2013 would be \$6.77 billion, \$1.00 billion below that in the Second Pricing Order of 2013. If*

*all the changes were made (including removal of \$222 million ADP expansion capex) the water asset RAB in 2013 would be \$6.24 billion, \$1.53 billion below that in the Second Pricing Order. If implemented, we estimate that this would have resulted in a reduction in SA Water's 2013/14 revenue cap (water only) of around -13%. This may be considered a proxy for the average water bill reduction across all consumers."*

The analysis from the CEPA report is broadly in line with the "cautious conclusions" of the Inquiry, though the dollar value of savings, if applied, for consumers is different.

The Inquiry concluded with the following classifications:

Unreasonable:

- The decision to capture the value of a declining WACC (\$420 million)
- Not removing pre-corporatization contributed assets (between \$161 million and \$504 million)

Not Reasonable

- Not correcting for CPI inflators and actual capex (\$88 million )

Unfair:

- Legacy assets (value would be a notional reduction)

Reasonable

- Desalination Plant costs
- Capital efficiencies without regulatory oversight

Uniting Communities supports these classifications and in terms of "do the right thing" we suggest that adjustment to the future RAB for SA Water needs to include all categories listed as unreasonable, not reasonable or unfair.

We accept that desalination plant costs were instigated through extensive public debate with the decision to build the distillation plant being very clearly a State Government decision rather than an SA Water decision.

At this stage we are uncertain about the reasonableness of "capital efficiencies without regulatory oversight" and will be happy to be part of discussions on this topic at the forthcoming forum.

In terms of doing the right thing by SA consumers, we think that the CEPA estimates for revision of the RAB value "*a reduction in SA Water's 2013/14 revenue cap (water only) of around -13%. This may be considered a proxy for the average water bill reduction across all consumers,*" are a reasonable expectation for this Inquiry to recommend and in line with a social license to operate for SA Water.

We also recognise that a transition will be needed to reach a revised RAB that is "about right," for SA consumers. We suggest that this should occur over the period of the next SA Water regulatory period, 2020-24 and developed in close cooperation with consumer interest groups.

The right RAB valuation is the lowest of reasonable estimates (eg CEPA) as this represents the price that is lowest and still efficient to be paid by current and future SA consumers.