

15 February 2019

Mr Lewis W Owens
Independent Inquirer
South Australian Water Pricing Inquiry
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Working for your business.
Working for South Australia

Dear Mr Owens

I write in response to your comprehensive draft decision report entitled 'A Cautious Conclusion' and write subsequent to our November 2018 submission to the South Australian Water Pricing Inquiry (the Inquiry).

Executive Summary

- The Inquiry's draft decision report has thoroughly investigated all possible approaches to how SA Water's RAB could have been constructed, and the evidence presented is very helpful for all interested parties to have an adequately informed debate on the primary determinant of South Australia's water related charges, including waste-water.
- While there are two primary approaches to calculating the value of SA Water's RAB, if appropriate adjustments are made for inflation and contributed/legacy assets, both the Economic Value approach and the less favoured Depreciated Optimised Replacement Cost approach may in this case result in comparable outcomes
- In considering the reasonableness of the former State Government's approach to setting the RAB, evidence from independent regulators interstate should be prioritised over legal definitions pertaining to reasonable decisions
- The relativity of waste-water asset values in both SA Water's current and previous asset value calculations provides very strong grounds for the Inquiry's final report to make its conclusions inclusive of all asset classes
- Business SA recognises the need to consider transition arrangements for any RAB adjustment but we reiterate that the determination of the RAB should be blind to ownership, consistent with National Competition Policy principles

Should you require any further information or have questions, please contact Andrew McKenna, Senior Policy Adviser, on (08) 8300 0000 or andrewm@business-sa.com.

Yours sincerely,

Anthony Penney
Executive Director, Industry and Government Engagement





Why this matter is important to South Australian businesses

As South Australia's Chamber of Commerce and Industry, with a history dating back to 1839, Business SA is the peak business membership organisation in the State. Our more than 3,000 members are affected by this matter in the following ways:

- In a state whose business community has been battered by high electricity and gas prices over recent years, the tripling of SA Water's potable water price since the late 2000's is yet another cost driver damaging the competitiveness of local companies, particularly those in the manufacturing and agri-business sector that face strong interstate and overseas competition
- While the high cost of water impacts businesses directly, high costs passed onto households also reduces their disposable income which could otherwise be spent in local businesses
- Business SA has long pushed for an independent review of the value of SA Water's asset base and this Inquiry is a critical step to overcome the disappointment of the previous State Government's 2014 Inquiry into Water Pricing which did not consider SA Water's RAB value

The Consideration of Reasonableness:

The terms of reference for the Inquiry direct the Inquirer to consider and report on the reasonableness of the opening value of SA Water's regulated asset base (RAB) as established by the second pricing order of 17 May 2013. Business SA accepts that the legal approach to defining a reasonable decision is appropriate under administrative law. However, the primary test which needs to be applied in the context of this Inquiry is what reasonable approach an independent regulator would have taken if tasked with determining the value of SA Water's RAB. While we acknowledge the Inquiry has supported the latter approach in principle, the actual basis of the draft decision appears weighted towards the legal definition of what a reasonable person would have done.

Considering the inquiry is not a legal review of the original decision under administrative law but rather advice to the Government on whether a better decision is available, the 'plain English' definitions of reasonable should be more relevant to the task of the inquiry – "sound Judgement", "fairness", "sensible", "appeals to common sense", "good judgement".

This approach alters the reference point – and 'burden of proof' – for what is reasonable and what is unreasonable. It is clear from regulatory precedents under the National Water Initiative (NWI) in Australia that a reasonable decision would:

- not capture the value of the declining WACC
- remove the value of pre-corporatisation contributed assets
- correct for CPI inflators
- consider the economic value of legacy assets based on prices/revenues reflecting the prior implicit contract with customers
- review the capex to assess its efficiency before including it in the RAB.



From the evidence available interstate, it is clear that the reasonable approach for an independent regulator would have been to determine the initial 2004 value of the RAB based on the lower bound of the depreciated optimised replacement cost (DORC) approach and the economic value (EV) approach.

While Business SA does not dispute the Inquiry's judgement on what a reasonable person would do, the test of reasonableness in this instance should be primarily based on what reasonable decision an independent regulator would have taken, rather than the legal definition of what a reasonable person would have done.

The whole premise behind this Inquiry is that for too long South Australian consumers have been paying water prices based on an economic building block model where the primary driver of price is the value of assets determined by SA Water's owner, the State Government. Consequently, to determine the reasonableness of that approach, it is necessary to focus on what the outcome would have been if the value of the RAB had initially been set through the reasonable decisions of an independent regulator.

Valuation Approach:

Business SA's initial submission to the Inquiry outlined our position that the former State Government's use of the DORC method without adequate consideration of the EV method was unreasonable. Notwithstanding, we accept the difficulty faced by the Inquiry in recalculating the RAB value using an EV approach. Like you, we also acknowledge that no approach is perfect, which is why other jurisdictions have typically adopted the lower bound from calculating RAB values using both methods.

While the debate of which approach to use has merit, if the Inquiry adopts the DORC method and works back to make appropriate adjustments for contributed and legacy assets, inflation and other matters related to what was rolled forward into the final opening RAB in 2013, the final result in this case should be comparable to using the EV method. Such an outcome should give the Inquiry comfort that its choice of method does not make a fundamental difference to the result, provided appropriate adjustments are made.

However, if weight is to be given to the DORC approach, it is essential that at a minimum the independent Hunter Water Corporation reports and the basis of the original DORC valuations are disclosed.

Notwithstanding, the DORC method will still provide the upper limit of what the RAB is valued at; a point which should be made clear in the Inquiry's final report. At a minimum Business SA would expect the Government to adopt a conservative estimate of how much SA Water's RAB should be reduced.

Legacy Assets:

Business SA acknowledges the Inquiry finding that the treatment of legacy assets was unfair, which should result in a notional reduction to the RAB.

In adopting the National Water Initiative (NWI) pricing principles which required establishing an initial asset base, other jurisdictions have taken the approach that existing assets would not necessarily receive a full commercial return as they had already been paid for by the community. While South



Australia took this approach in part, it excluded country assets, a decision which has since been embedded in the high level of RAB carried forward from the 'line in the sand' which set the opening RAB in 2013.

The Inquiry found the treatment of legacy assets by the previous State Government resulted in SA Water receiving an additional \$70 - \$80 million per annum¹.

As the Inquiry states, in principle where jurisdictions have drawn a line in the sand, full cost recovery would only apply to new investment decisions made after the date the line in the sand was drawn (the legacy date)².

We agree with the Inquiry that country assets should not have been classified as non-legacy. The Government should not have inflated the value of the RAB by classifying all country assets as non-legacy, even if they were partly returning the inflated revenues through Community Service Obligations (CSOs). The decision to pay CSOs in South Australia is primarily to ensure any additional costs SA Water incur for serving rural and regional customers, over what can be recovered through state-wide pricing, is able to be funded.

All South Australian taxpayers effectively pay for CSOs, to reflect a bipartisan Government policy decision to honour past Government policy decisions that encouraged development in regional areas. What is unclear though, is whether CSOs in South Australia are also structured to ensure returns associated with SA Water are on comparable commercial footing that would apply to a private owner. While this might be a reasonable approach from a theoretical perspective and analogous to how the State Government accounts for tax expenditures, the Government should not have simply categorised all country assets as non-legacy assets purely on the basis that it was paying CSOs.

The approach in the 2008-09 transparency statement would only have been appropriate if the CSOs were set so that together with payments from rural customers, they provided a full commercial return on rural assets.

Business SA acknowledges the Inquiry's finding that the way in which the former State Government valued legacy assets may have been technically permissible under the NWI but reiterate that it was unfair related to other jurisdictions, and it is unlikely that an independent regulator would have taken a similar approach. Furthermore, the manner in which the former State Government excluded country assets from legacy assets also needs to be adequately adjusted for in the Inquiry's final opening RAB assessment.

The value of South Australia's legacy assets should have been assessed as the lower of the DORC and EV approach, not just based on the DORC approach.

We also acknowledge your reference to other assets in the RAB and request the Inquiry's final report to deduct the value of country reservoirs no longer supplying water, or used for recreation.

¹ State Water Price Inquiry, Cautions Conclusions Report, page 39

² State Water Price Inquiry, Cautions Conclusions Report, page 38



Contributed Assets:

Business SA recognises the range of values put forward by the Inquiry with respect to pre-corporatisation contributed assets. We support the Inquiry's approach to consider all contributed assets between 1965 and 1995 for exclusion from SA Water's 2013 RAB. This is also important for waste-water assets, particularly considering they accounted for 58 percent of the \$222 million in contributed assets between 1 July 1995 and 30 June 2004.

Of the methodologies presented by the Inquiry, options (1), Historic Cost, and (3), Indexation Method, are transparent and consistent with the financial capital maintenance principles that underpin the regulatory frameworks.

However, option (1) is inconsistent with the valuation of the RAB based on current costs (DORC) rather than historic costs. Consequently, Business SA only supports option 3, as adopted by the Inquiry.

Notwithstanding, we support the full \$1,026 million (in 2004\$) RAB adjustment on the basis that waste-water assets should also be included, not just water assets.

We strongly support the Inquiry's conclusion that *'there is sufficient confidence in these numbers to adopt a value which a reasonable person would accept as sensible, fair and appropriate in the circumstances. It is unreasonable to assume the value is zero.'*³

Valuation Parameters:

Business SA acknowledges that in our initial submission, Cambridge Economic Policy Associates (CEPA) used a 6% WACC that was the lower end of the range of the WACC used in the relevant transparency statement. This is a very conservative assumption. Arguably CEPA could have used the mid-point of the range in the transparency statement which would have resulted in a lower RAB. However, the value used (6%) was consistent with concurrent regulatory decisions in other states and satisfied the test of 'what would an independent regulator acting reasonably have done?'

Furthermore, the largest impact on the valuation of the RAB is the assumed period for the calculation of the present value of the revenue stream. Again, if the test is "what would an independent regulator acting reasonably have done?", the precedents of other regulators are important:

- WA – 10 years
- IPART – 20 years
- ESC – 30 years

Subsequently, CEPA's choice of 25 years as the mid-point errs on the conservative side.

³ State Water Price Inquiry, Cautions Conclusions Report, page 37