Submission to: ESCoSA

Subject: SA Water Regulatory Business Proposal 2016-2020

Submission prepared by:

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Uniting Communities

Uniting Communities works with South Australian citizens across metropolitan, regional and remote South Australia through more than 90 community service programs.

Our vision is: A compassionate, respectful and just community in which all people participate and flourish.

We are made up of a team of more than 1500 staff and volunteers who support and engage with more than 20,000 South Australians each year.

Recognising that people of all ages and backgrounds will come across challenges in their life, we offer professional and non-judgemental support for individuals and families.

Uniting Communities has provided financial counselling services for many years along with a range of low income household support services. It is through working with clients in these services that we have understood that periods of rapidly rising utility prices for extended periods over the past decade are amongst the main reasons for people being pushed in financial stress. The unpredictability of utility bills and rapid increases have broken many lower income household budgets, despite the skill of low income people to manage their finances.

Submission regarding SA Water Regulatory Business Proposal 2016-2020

Uniting Communities welcomes the opportunity to contribute formally to considerations of the SA Water Regulatory Proposal for the period 2016-2020 having been involved for some time in regulatory proposals regarding utilities, and having been part of discussions with SA Water in the lead up to this proposal being lodged.

We wish to highlight the main reason for Uniting Communities being involved in this process is as a direct consequence of our work with low income and disadvantaged households. Specifically over recent years we have observed through our financial counselling services and related services for low income people, that the main presenting issue for financial stress has been dramatic increase in utility bills. These have been increasing, both electricity and water, at higher rates than has income for lower income households and further the increases have been substantial in many instances and unexpected, putting great stress on very tight household budgets with fixed income. In short, the capacity to pay increased essential service bills has not been there for many low income households. Therefore, the price of water is of fundamental concern to Uniting Communities on behalf of the very large number of South Australian households who really struggle to pay their water bills, recognising that water is the most essential services of all essential services.

SA Water Proposal

We have reviewed and carefully considered the SA Water Revenue Proposal 20016-2020 and believe that the revenue sought is higher than is prudent and certainly higher than is in the interest of consumers. We contend that a four to five year regulatory period constitutes 'the long term' for many consumers, so we are taking a long term consumer interest, while also recognising that the shorter term is very important to many consumers too.

We start to explain our submission to ESCoSA that the SA Water proposal 2016-20 is too high with reference to chart 1 which simply shows our understanding of average total SA Water charges for the last decade. The data was kindly supplied by SA Water, the note is ours.

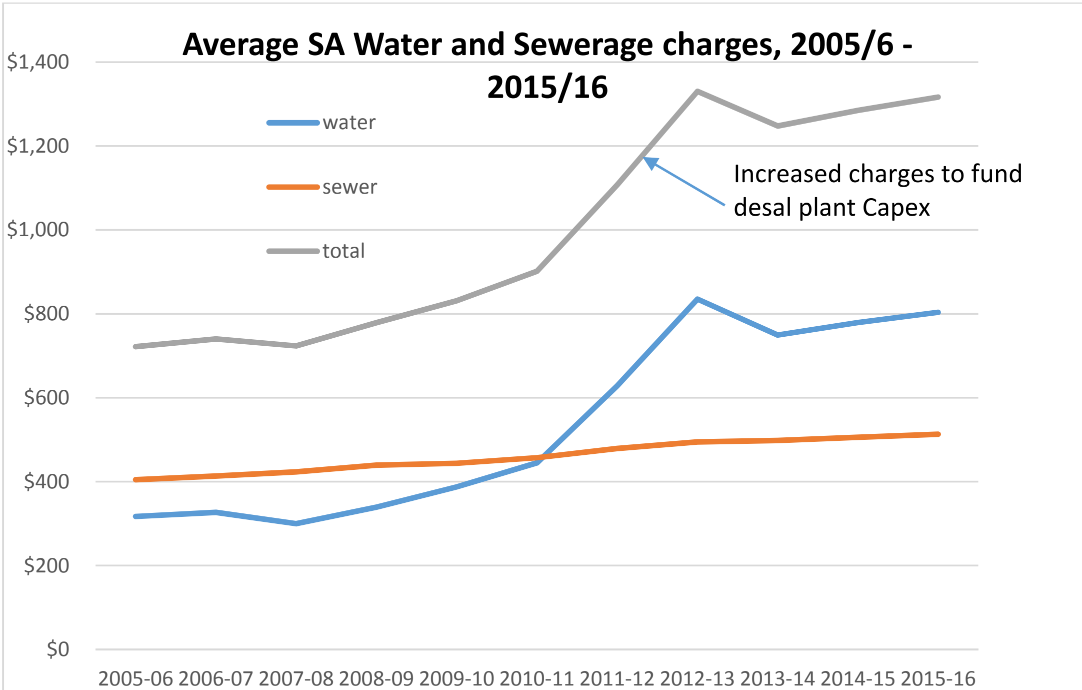
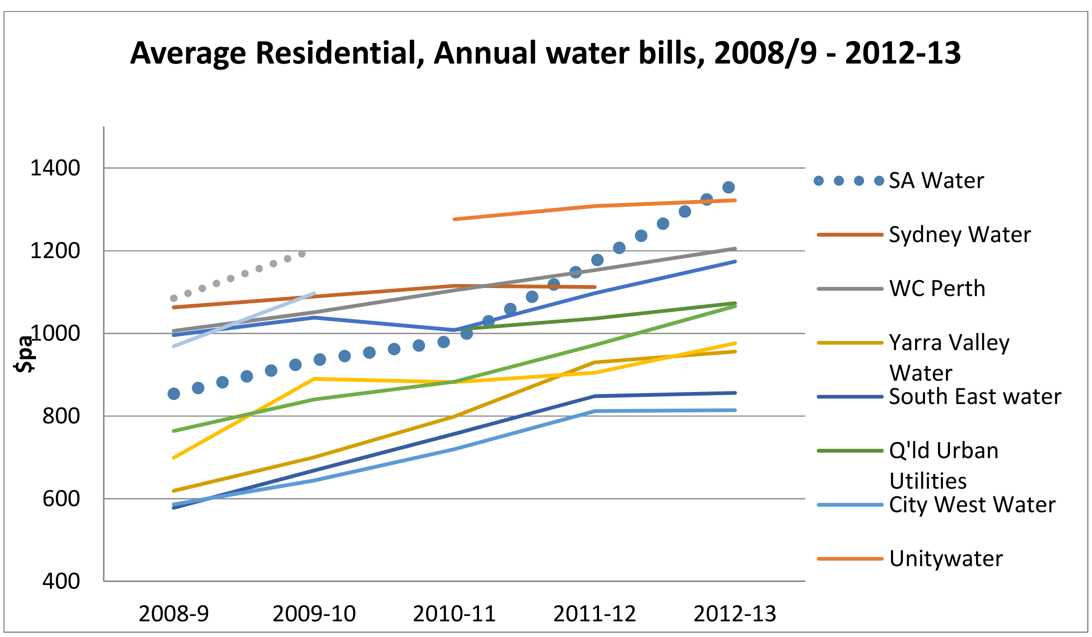


Chart 1. Source of data, SA Water.

Chart 2 shows SA Water prices in comparison to other comparable utilities showing that SA Water prices are at the high end of comparable utilities across Australia (we note that there is much debate about comparability of different water and sewerage provision businesses, however we make the general observation that they are providing relatively similar businesses with similar infrastructure, and so high cost for South Australia is of concern.) We recognise that this data set does not include 2013-14, where SA Water says that South Australian prices dropped a little with comparison to other providers.



Source: National Water Commission's annual National Performance Reports

An important observation however is that SA water and sewerage bills were in the 'middle of the Australian water utility pack' up to 2010-11, but climbed to be the highest in the country by 2012-13 – a dramatic rise, in comparison to sister utilities over 2 years, with commensurate deleterious impact on thousands of SA households.

Base Year

Chart 3 takes the data from Chart 1 and dis-aggregates it into three different periods: pre-desal, during desal and post desal. In this way we reflect on the substantial impact of increased SA Water charges to help fund the desalination fund had have on average annual water charges for South Australian residents.

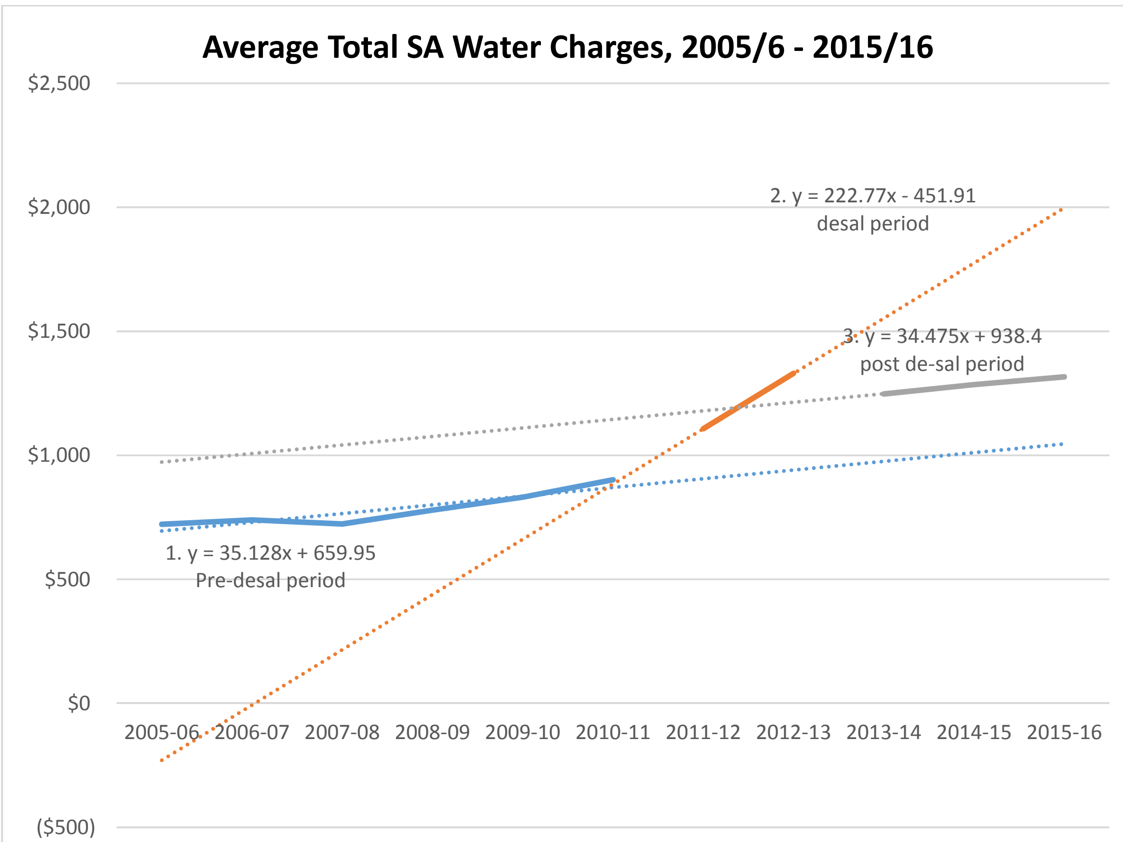


Chart 3. Source of data, SA Water, analysis by Uniting Communities.

We summarise the 'during desal period' as the period where customers were hit with an initial increase of up to 60% on their water bills. This period 2011-2013 shows both a substantial increase on previous years' bills and a much steeper rate of increase over that short period of time. This is reflected by the slope coefficient of the linear trend line being much larger than the corresponding coefficients for the other trend lines also shown on the graph.

This 'desal period increase needs to be seen in comparison to the pre desal period (2005-2010/11) where the annual price increases were more or less in line with CPI and were quite predictable for household customers compared to the dramatic increases during the desal period. The final period is the first regulatory period under new regulatory arrangements for SA Water where interestingly the slope of the trend line is almost identical to the pre-desal period.

This analysis suggests to us that it is quite inappropriate of SA Water to be using 2014-15 as the base year for their considerations of prices for the second regulatory period. This builds on the 'desal years' of high and abnormal spending and is not representative of an efficient operation environment based on previous and more recent operating annual expenditure. The use of 2014-15 as the base year of the next regulatory period seeks to 'lock in' abnormal costs as normal, to the detriment of consumers.

The years 2010-11 to 2012-13 are quite different from all other years over the past decade, they must be regarded as 'outlier years', shaped by the very large capex required to build the desalination plant and State Budget increased charges to start building the desalination plant. We believe that a much more sensible base year would be the end of the pre desal period as we have described it (2010-11). Considering the pre-desal with the post-desal period we see that the rate of increase per year is moderate and relatively predictable for households, yet the post desal period is at a higher level, there has been a step change in average water charges for SA residents, compared to the long term pre-desal period, based on a 'step change increase associated with consutrcting the desal plant. This suggests to us that the desal period has been used to ramp up ongoing average total water bills for South Australian households and business customers without any significant change in operating costs or running the business.

This is why we believe that SA Water through its 2016-20 regulatory period is seeking to 'lock in' price increases and hence revenue that is higher than is in the best interests of customers based on all years over the past decade, other than when the desalination plant was being constructed.

We know that SA Water argues that the proposed prices for what they call the "second regulatory period" take into account ongoing financing for the desalination plant however we argue, and customers believe, that they have paid a substantial upfront charge for the desalination plant. SA Water can't have their desal capex (cake) and have ongoing return to capital (and eat it) too.

We believe that many SA customers would believe that they have paid for the desalination plant, though the large price increases of 2011-13. While there is no doubt some continuing financing costs exist for desal plant construction, it is very unclear what has been paid for by consumers, what percentage of the RAB is desal specific, what still needs to be paid for and how long the capex debt will be held and rate of return sought from consumers.

A critical question for ESCOSA is therefore whether the proposed revenue proposal for 2016-2020 from SA Water is effectively having customers pay more than once for aspects of the capital costs of the desalination plant, which have already been paid for through a painful (for many) large price increase during the 'desal years'.

We also strongly argue that there is not a rational, historical basis for the 2014-15 year being used as a base year. We urge ESCoSA to consider this base year question very carefully. We suggest that the 2010-11 year, CPI adjusted (using Adelaide CPI from the ABS eight cities CPI series) much better reflects the current and pending operating environment for SA Water.

All comparisons with regulatory period 1 that are made in the proposal for 'regulatory period two' need to be considered very carefully since regulatory period one was a short and abnormal period with higher than efficient revenue allowances due to the desalination plant construction and substantial bill increase that customers were required to pay up to 60% increase in one year.

The 2nd regulatory period price path should lie somewhere between trend lines 1 and 3 from chart 3, and nearer to trend line 1 which more closely reflects efficient costs.

Rate of Return

There are a couple of aspects of rate of return that we consider inflate the proposed return to capital. WE note the submission from SACOSS informed by the SA Centre of Economic Studies, and support this submission and associated analysis.

Taking the summary of measures from table 4, we provide the following comments:

1. Risk Free rate and Debt risk premium: we are strong supporters of moving to a 10 year period, but do not consider BBB corporate bond yield as suitable for a government owned business with guaranteed (regulated) revenue. The bond yield should be much nearer to actual borrowing capacity, at least AA+.
2. Averaging period: We support 10 years
3. Debt transaction costs. WE see no sound reason for introducing a debt transaction fee for end consumers to pay.
4. Risk Free Rate: With official Australian interest rates hovering around 2%, overseas official interest rates even lower, including 0.00% in Japan, international capital is available at historically low rates, and will be for the foreseeable future, we believe. A lower risk free rate makes sense for a government owned venture with guaranteed return and consequently minimal actual risk.
5. Market Risk Premium: Market risk premium of 6.0% dramatically overstates the rate of risk for SA Water with the cost of international capital very low and likely to stay low for much of the regulatory period
6. Equity beta of 0.7 is absurd. Again, we stress that SA Water is owned by an Australian state government with a guaranteed revenue and return. The risk is insignificant. The AER had Olin Henry prepare a major report for them on the value of equity beta, and we recognise the vagaries of calculating a precise number. Olin Henry's extensive analysis said that the range in which equity beta lie for regulated monopoly utilities was between 0.3 and 0.7, more likely in the lower end of this range. Taking this range of values and applying the best interests of consumers would give a point value for β at the low point in the range, 0.3. Being somewhat more generous we would accept a β value in the middle of the Olin Henry identified range, i.e. 0.5. Any value higher than this misreads the current, global financial market and overstates the level of risk faced by a government owned utility. Equity beta should be set at 0.5
7. Inflation estimate. We accept the proposed forecast of 2.5, though it is probably higher than the final result will be, particularly for South Australia during a difficult economic period.
8. Gearing 60% is acceptable
9. Gamma. A γ value of 0.5 is high – in terms of providing too high a resultant charge for end consumers. Since γ has an inverse relationship with end consumer benefit, we argue that it should have a higher numeric value than 0.5 We are also not sure of the relevance of gamma for a government owned business, given that the sole shareholder is also the tax collector. Perhaps this is a question of reporting in the ESCoSA determination.
10. Credit rating. BBB fails to recognise the actual rating at which Australian governments can borrow money. AA+ is more reasonable. We do not see any reason for accepting arbitrage returns to government through capital raising for an essential service.
11. Corporate tax rate 30%. Again, we do not see why consumers are charged a tax allowance for a government owned entity that is effectively the government (at large) paying tax to itself.

Summary

We strongly urge ESCoSA to review the base year proposed by SA Water and not regard this high cost to consumers as being a reasonable measure of efficient, ongoing costs for SA Water.

We also propose a number of aspects of rate of return that that are high, when considering current global and South Australian economic circumstances.

We support the submission made by SACOSS and the analysis of SA Centre of Economic Studies.