WATER SERVICES
ASSOCIATION OF AUSTRALIA

15 May 2018

Dr Ron Ben-David
Chairman
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Dear Dr Ben-David

The Water Services Association of Australia (WSAA) is the peak body that supports the Australian urban water industry. Our members provide water and sewerage services to over 20 million customers in Australia and New Zealand and many of Australia's largest industrial and commercial enterprises.

WSAA facilitates collaboration, knowledge sharing, networking and cooperation within the urban water industry. The collegiate approach of its members has led to industrywide advances to national water issues.

WSAA welcomes the opportunity to participate in the price submission process and congratulates the ESC on the implementation of the PREMO model. Specifically, WSAA wishes to briefly respond to the arguments put by the Consumer Action Law Centre (CALC) that the revenue allowance to fund debt be reduced by 100 basis points. In WSAA's view this would not promote affordability of services in the long term.

CALC argue that:

> Borrowing costs are applied to 60 per cent of a corporation's asset base. The Commission uses a 10-year trailing average approach to determine the allowed revenue requirement. The cost of debt for Victorian water businesses have been based on the 10-year Reserve Bank of Australia's published BBB rated bonds including some adjustment mechanisms—currently estimated to be 6.05 per cent in 2017-18.
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> The report commissioned by Consumer Action recommends that the Commission set the cost of debt at around 5 per cent. This is 100 basis points lower than the levels proposed in the Commission's draft decisions.
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> The report by CME notes that because Victorian water companies—government owned entities—present less risk than a private corporation and deliver societal benefits through their operations, they should be able to borrow on terms that reflect this reality.

WSAA's members support measures which are in the long term interests of consumers. In particular we support ensuring services are efficient and affordable. The PREMO model is a significant innovation in economic regulation to drive this objective. As part of the process Victorian utilities are proposing annual ongoing operating efficiency rates, financial hardship policies, and in many cases price decreases compared to inflation.

In turn, economic regulation is one part of the broader governance framework to ensure that utilities operate in the long term interests of consumers. This framework was agreed to by all governments in the Competition Principles Agreement over two decades ago but remains as relevant today.

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It contains a number of elements which operate as a package:

- Corporatisation of government-owned utilities with government as shareholder and independent boards
- Independent prices oversight or economic regulation
- Competitive neutrality in input and output markets.

A key feature underpinning the efficiency of the urban water sector has been the adoption of the corporatisation model. This provides utilities with clear objectives, commercial incentives and managerial autonomy in return for strong accountability and performance monitoring.

This is supported by competitive neutrality which is the principle that government-owned utilities should not be advantaged or disadvantaged with respect to potential competitors, or to other sectors of the economy. While there is the emergence of competition in the water industry – particularly in NSW – competitive neutrality remains important even when a utility does not face direct competition. This is because it improves the incentives facing managers and boards to operate businesses efficiently. Competitive neutrality principles extend to the regulations applying to utilities but also to the costs of borrowing and raising funds.

The CALC submission questions whether it is appropriate to pay a commercial return on debt when utilities borrow from Government.

While some water utilities in Australia borrow at commercial rates in the market, it is common for water utilities to borrow from the government through their respective state Treasury Corporations. Treasury Corporations are able to borrow at lower rates than stand-alone utilities.

In line with competitive neutrality policy, and full cost recovery, the cost of debt should reflect the underlying risk of the borrower and not the source of funds. The risks of a water business are not reduced because they can borrow from government sources. To ensure that utilities face a cost of debt that reflects their true level of risk, most governments levy a fee that represents the difference between the cost of debt to the government and that of an equivalent investment grade firm (in this case BBB rated bonds) operating in that industry. These fees are variously described as debt guarantee fees, or in Victoria, the Financial Accommodation Levy. Thus, the principles agreed to in the Competition Principles Agreement have been strongly embedded in government policy. They have also been widely implemented by economic regulators such at IPART in NSW and the Australian Energy Regulator, as well as the ESC in Victoria.

The policy rationale underpinning the adoption of this policy is also strong. As noted it is important that utilities face a commercial cost of debt to promote efficiency, whether or not there is competition. If the cost of debt were to be decoupled from the business, managers have less incentive to manage borrowings prudently. For example a business would not face the consequences of adopting a very high gearing level – which potentially places costs on future generations. In addition if the cost of debt is lower than that of the actual business, projects may become viable which do not confer an appropriate return to the community.

In summary, while WSAA agrees that affordability is a key objective for the water industry, it considers that requiring utilities to pay a commercial cost of debt is a strongly supported policy principle that aids that objective in the long term.

If you would like to discuss these matters further please contact Stuart Wilson, Deputy Executive Director [redacted].

Yours sincerely

Adam Lovell
Executive Director