Review of prices for WaterNSW rural bulk water services

Draft Report & Draft Determination

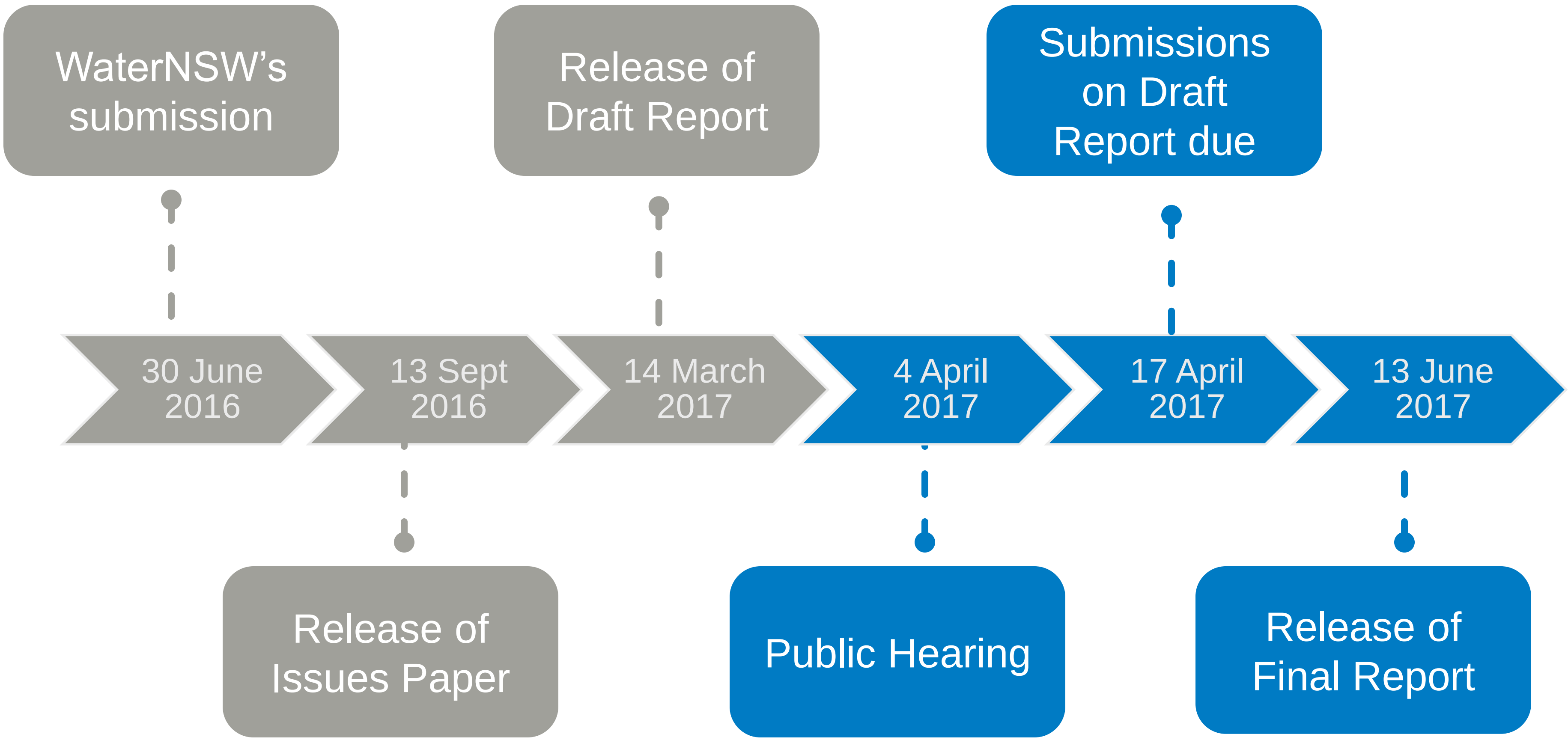
Water Pricing Team

4 April 2017

Agenda

1. Welcome & introduction
2. Overview of draft decisions
3. Draft decisions on expenditure & cost shares
4. Draft decisions on MDBA & BRC costs
5. *Lunch break*
6. Draft decisions on price structures & managing volatility
7. Draft decisions on valleys below full cost recovery
8. Other questions & comments
9. Closing remarks

Submissions close on 17 April 2017



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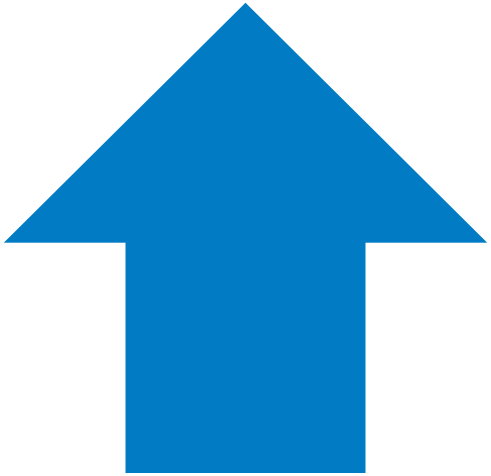
WaterNSW’s efficient core costs are falling

1. WaterNSW has significantly reduced its operating expenditure
2. Our draft decisions would result in further reductions in WaterNSW’s notional revenue requirement (efficient costs)
3. These cost savings would flow through to most valleys, & most customers would experience a decrease in bills (<u>before inflation</u>)

However, MDBA costs are rising

Although we have applied an efficiency saving to MDBA costs, MDBA charges are increasing.

This has put upward pressure on total bills in the Murray & Murrumbidgee valleys, in particular HS customers in the Murray valley.

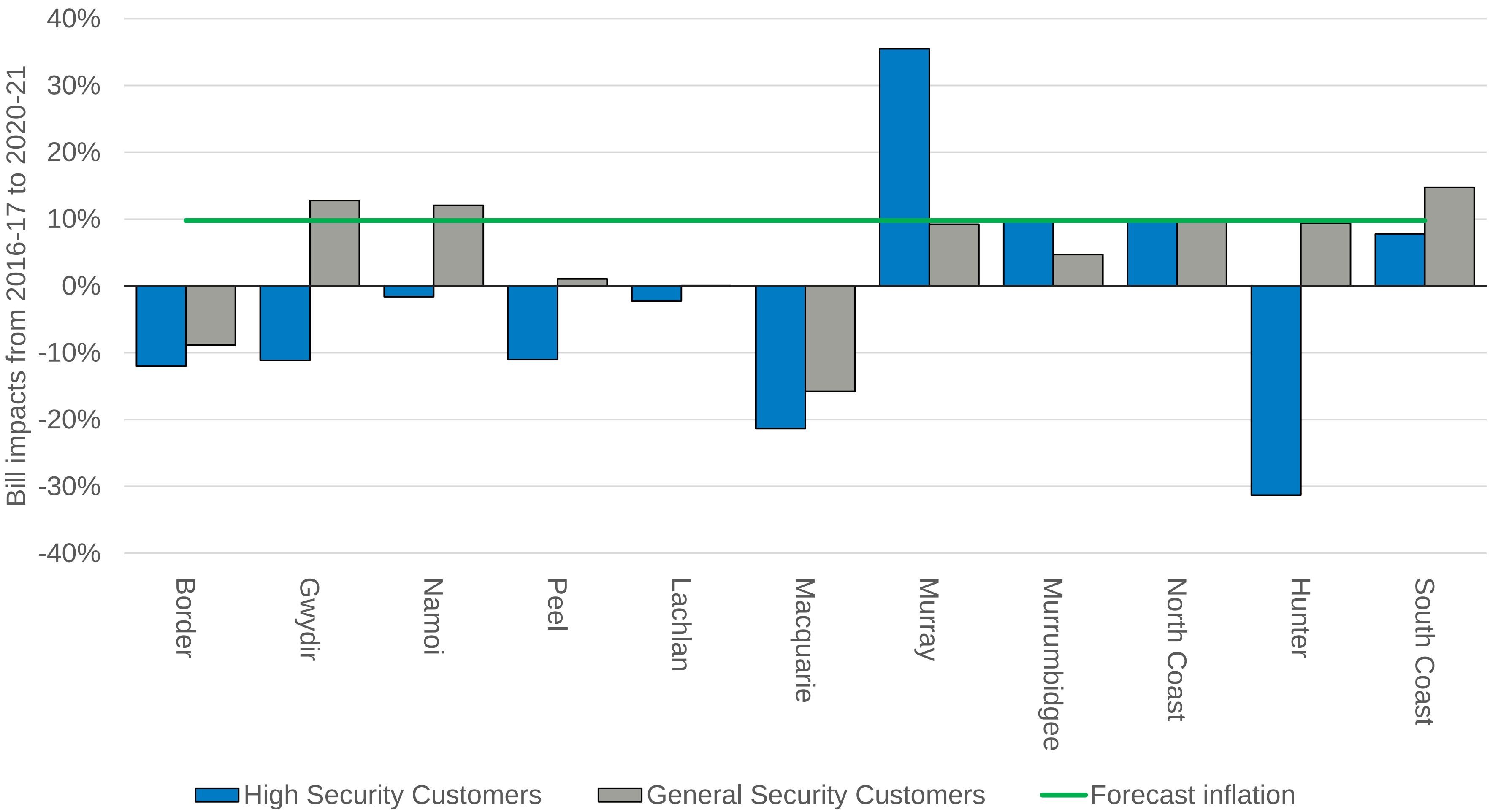


We have also made changes to price structures

We are considering making changes to tariff structures for Lowbidgee valley, FRWS & BRC/MDBA charges, & the HS premium for all valleys.

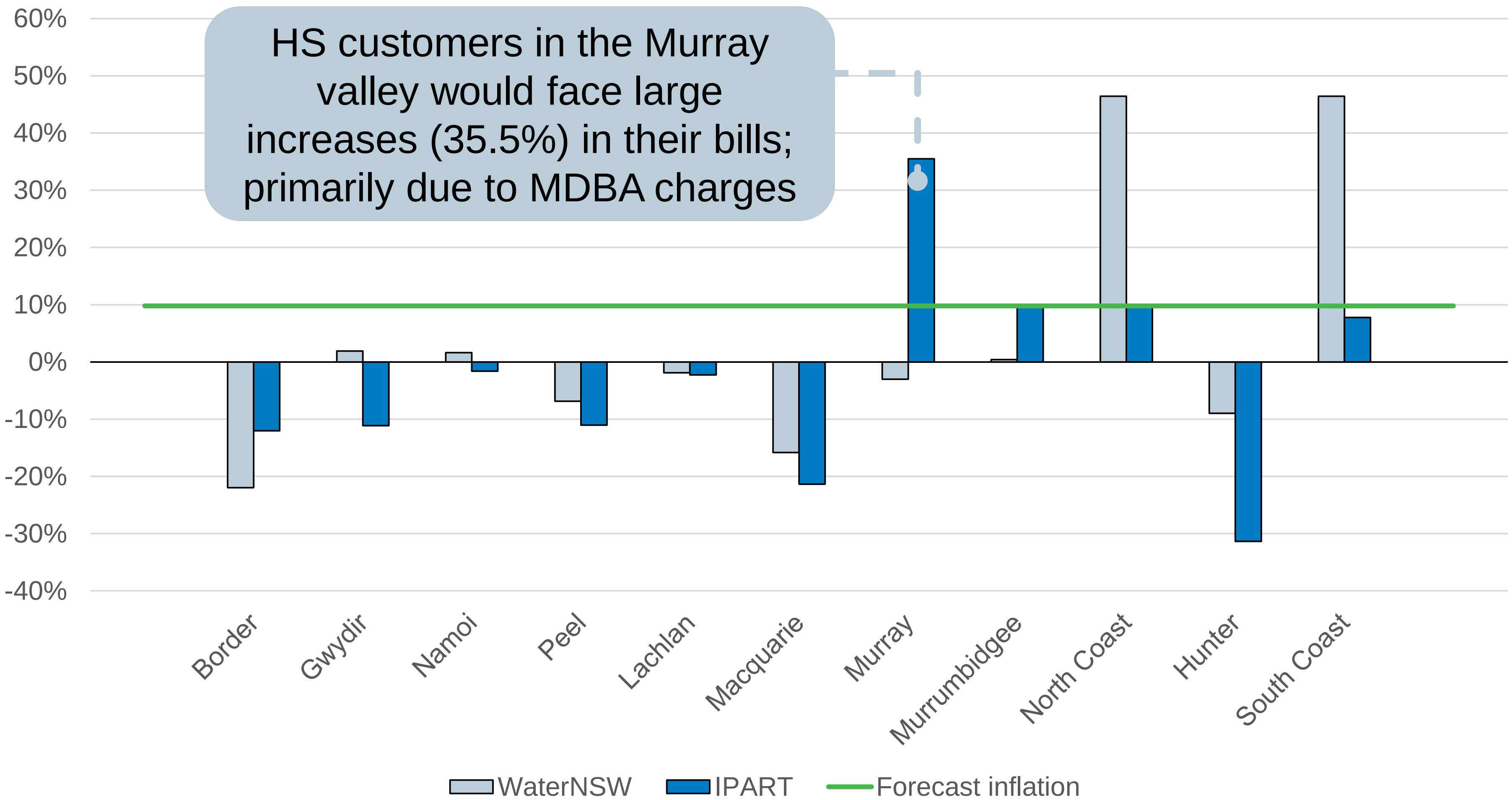
Our draft decisions on price structures would impact entitlement charges – particularly in the Gwydir, Hunter & Murray valleys.

Bills would increase below the rate of inflation in most valleys



Includes BRC/MDBA charges. Bill impacts presented in nominal terms (ie, before inflation).

Compared to WaterNSW, our bill impacts for most HS customers are generally lower



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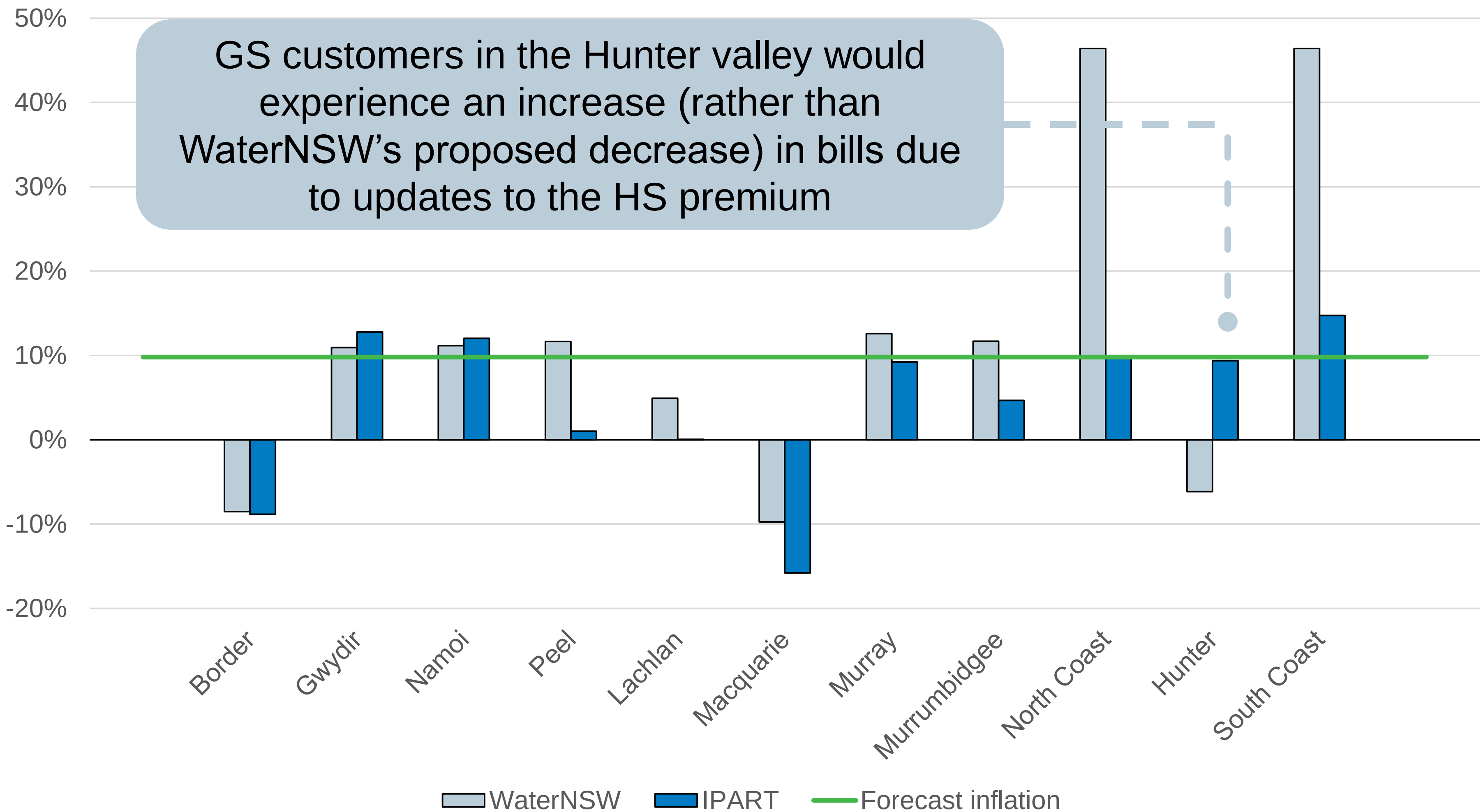

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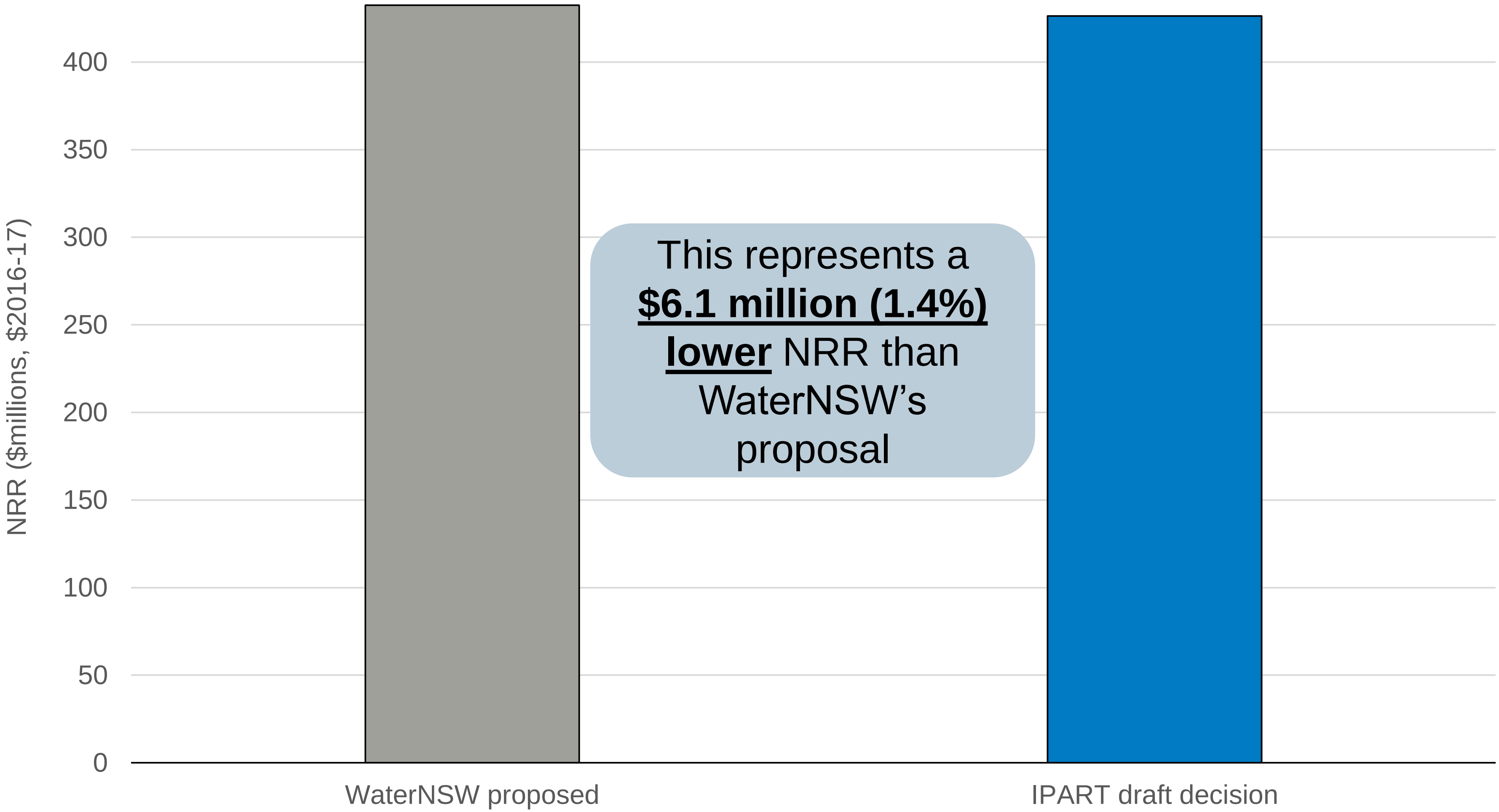
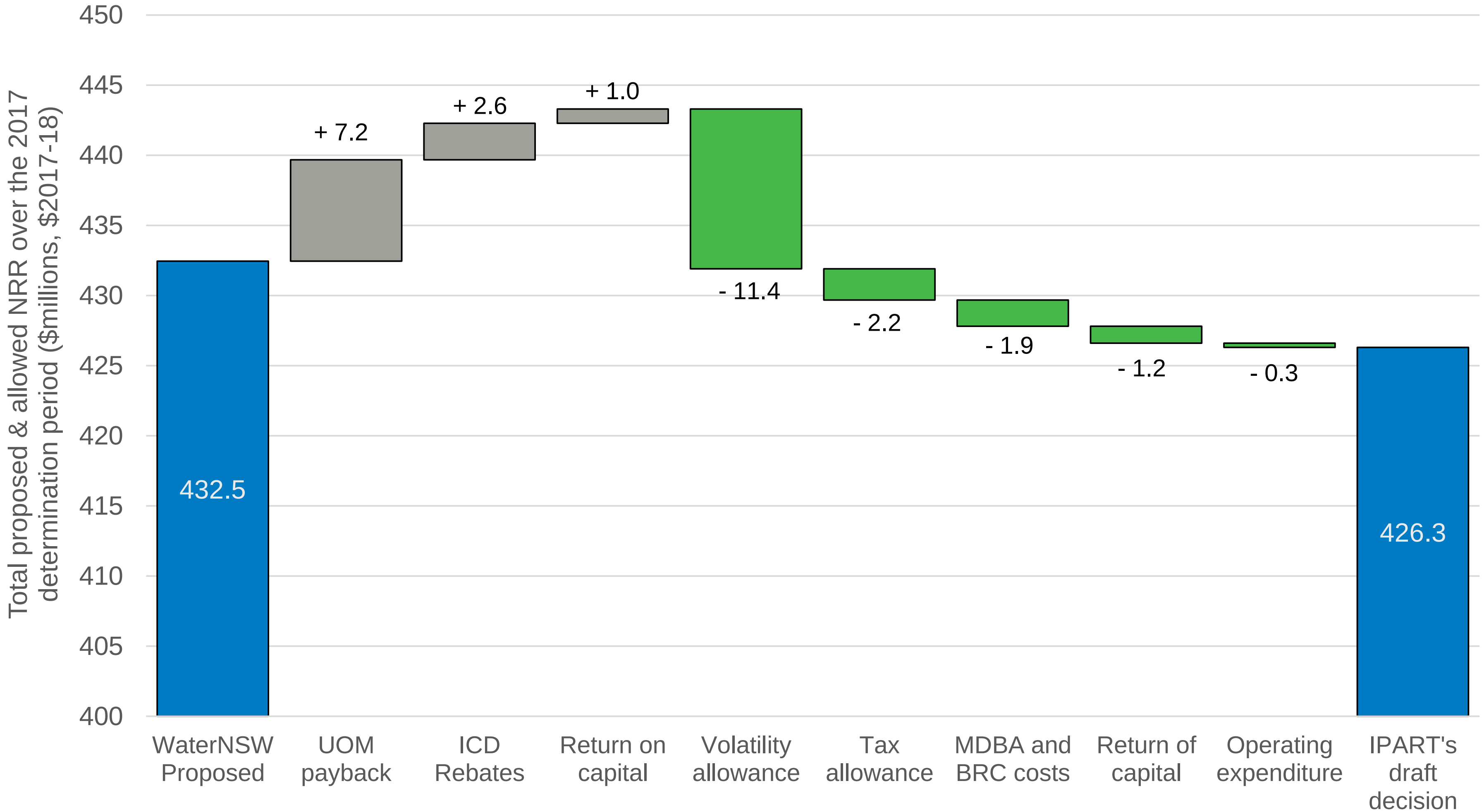
Our draft decisions on expenditure

We have set WaterNSW's total NRR at $426.3 million over the determination period

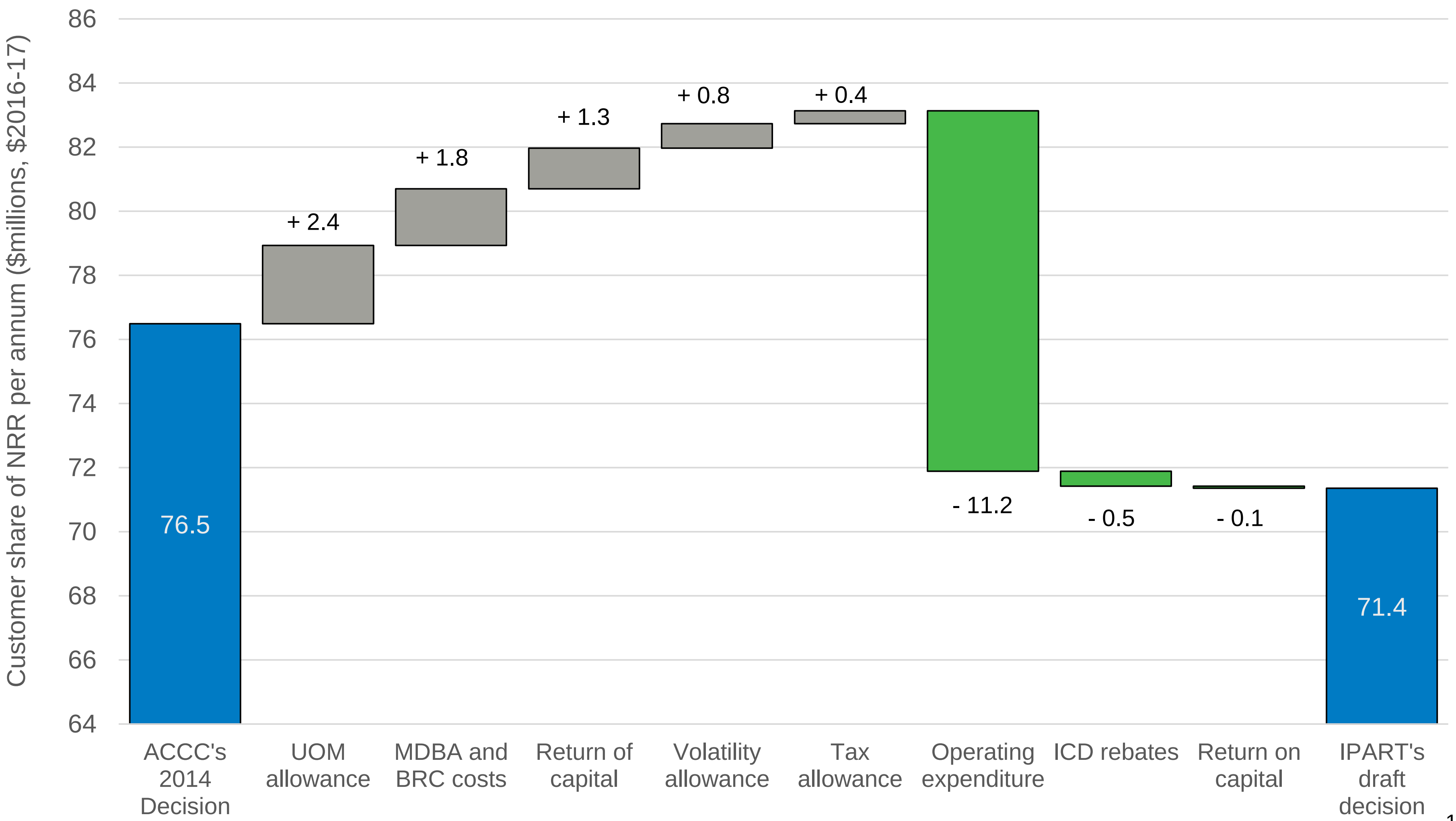


Our allowances for WaterNSW's **total** NRR is $6.1 million (1.4%) lower than WaterNSW's proposal

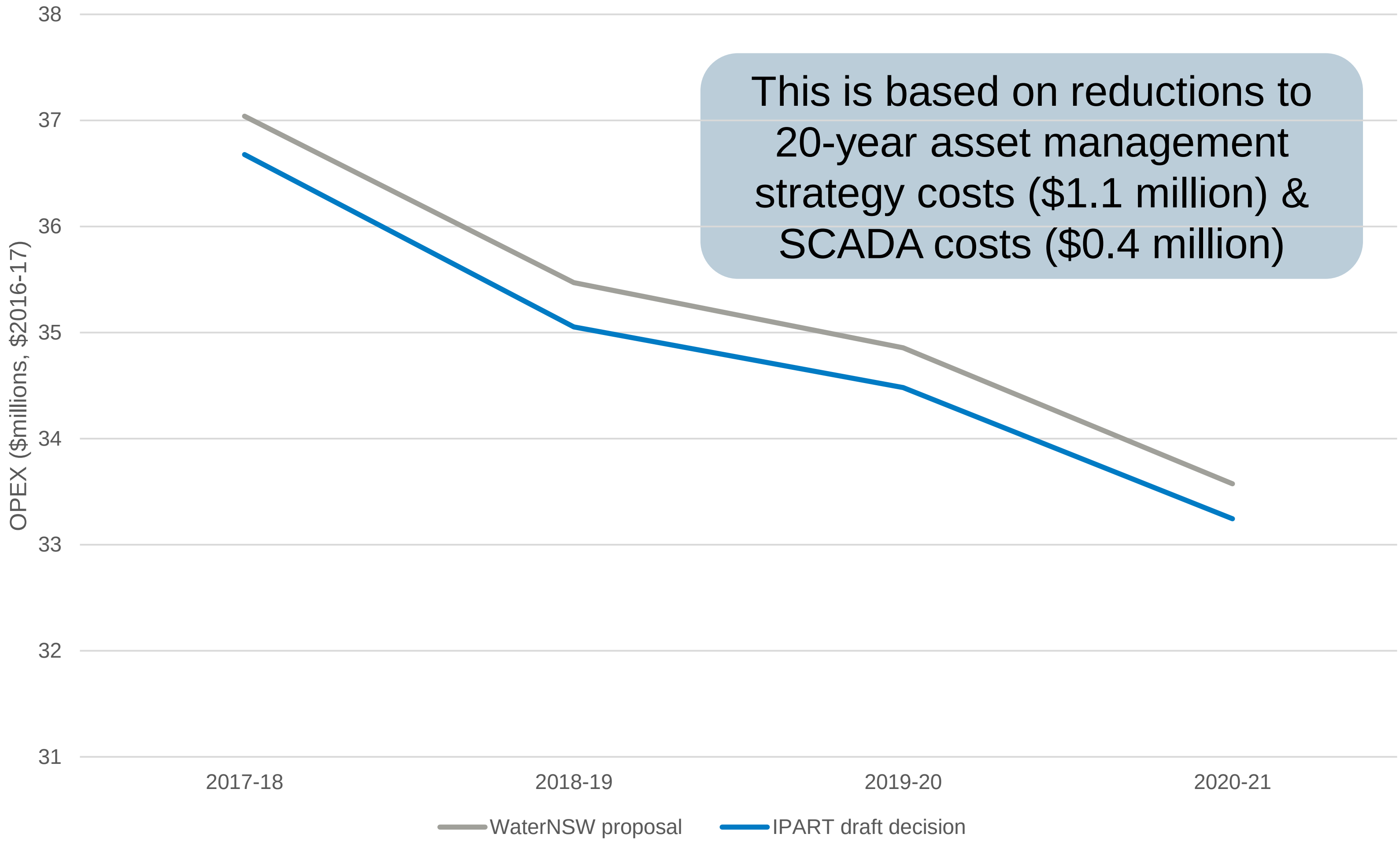


Proposed & allowed total NRR building blocks are totals for 2017-18 to 2020-21

Our allowances for WaterNSW's **annual** NRR is $5.1 million (6.7%) lower than the ACCC's 2014 Decision

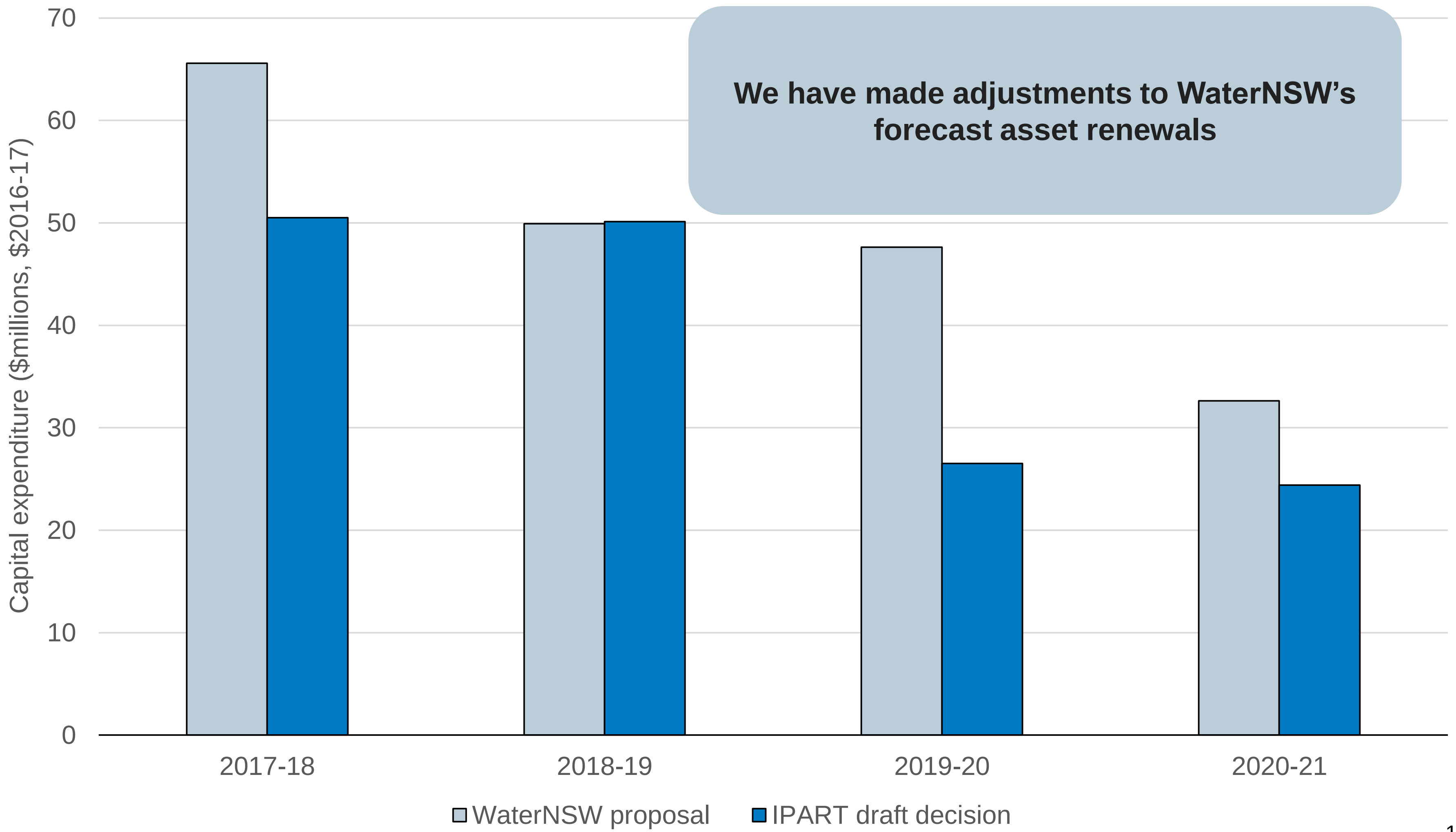


Our draft decision on OPEX is $1.5 million (1.1%) lower than WaterNSW's proposal

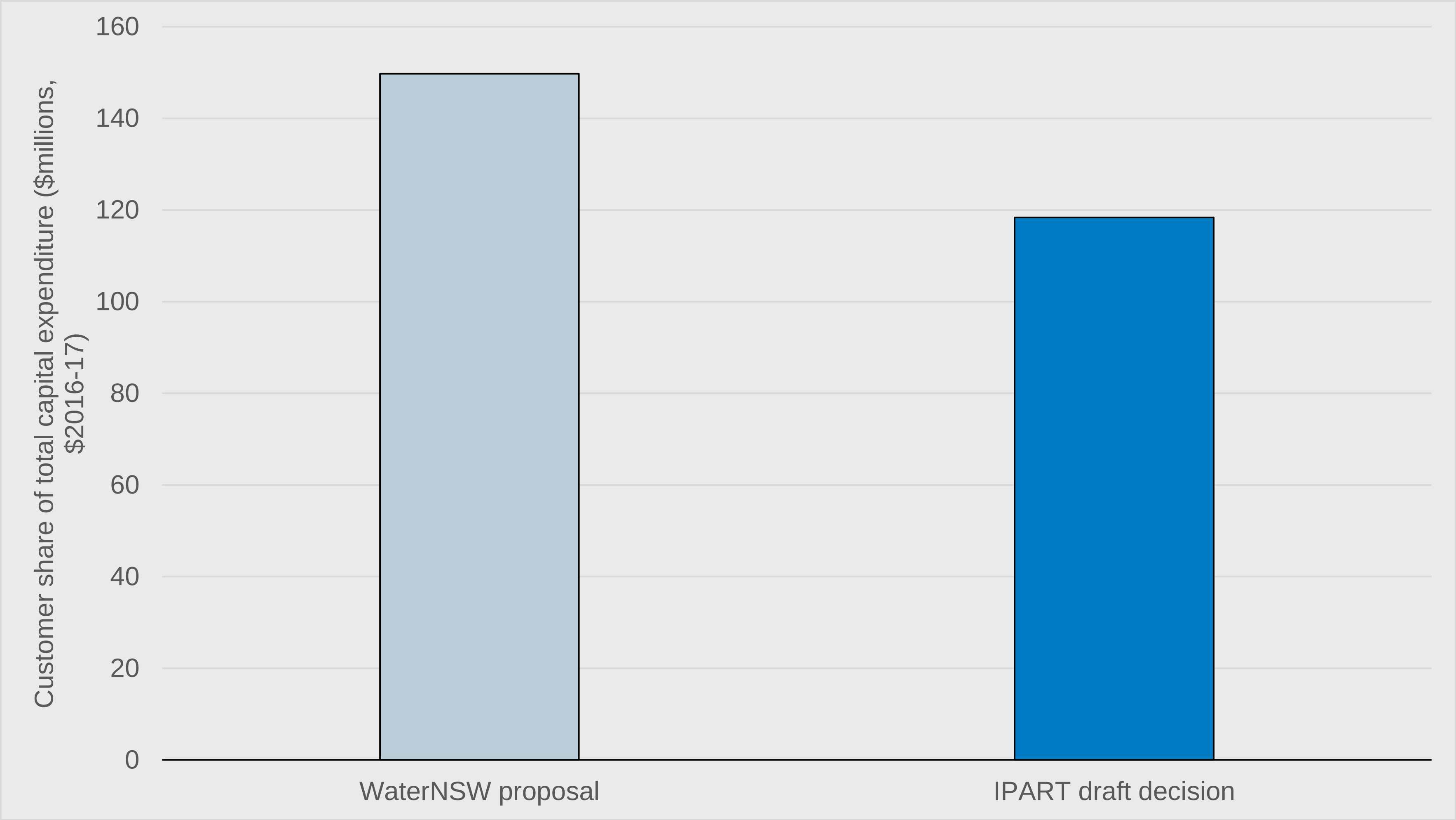


Excludes WaterNSW's proposed RTP

Our draft decision on CAPEX is $44 million (23%) lower than WaterNSW's proposal



Customer share of CAPEX is $31.4 (21%) million lower than WaterNSW's proposal



$3.2 million for fishway offset expenditure would be excluded from the Namoi RAB

In principle, we support WaterNSW's proposed approach as it is seeking to discharge its regulatory duties **at least cost.**

However, our decision is to exclude this on the basis that:

- NPCSC & Namoi Valley Irrigators Association have **not been consulted** prior to WaterNSW's submission
- **Uncertainty in timing** of the expenditure, given that half of the expenditure is planned for 2016-17
- **WaterNSW's history** of not spending allowed fishway offset expenditure

Our draft decisions on cost shares

We have maintained current cost-share ratios – for now

Cost item or activity	Customer Share
Operating expenditure	
Customer support, Customer Billing, Metering & Compliance, Water delivery & Other Operations, Corrective Maintenance, Routing Maintenance, Asset Management Planning, Insurance	100%
Hydrometric monitoring	90%
Flood Operations, Water Quality Monitoring, Dam Safety Compliance, Environmental Planning & Protection	50%
Dam Safety Compliance Capital Projects pre 1997	0%
Capital expenditure	
Asset Management Planning, Routine Maintenance, Structural & Other Enhancement, Corporate Systems, Office Accommodation Capital Projects, Information Management Projects, Water Delivery & Other Operations	100%
Renewal & Replacement	90%
Dam Safety Compliance, Environmental Planning & Protection, Flood Operations	50%
Dam Safety Compliance- Pre 1997 Construction	0%

Relative cost-shares since 2010

Determination	Customer share %	Govt. share %
IPART 2010 Determination	60%	40%
ACCC 2014 Determination	63%	37%
Draft 2017 Determination	67%	33%

We engaged Frontier Economics to review the cost sharing framework

Frontier proposed a new cost sharing framework:

1. Establish efficient costs of providing WaterNSW's services
2. Allocate efficient costs to specific services provided by WaterNSW
3. Subtract legacy costs to determine efficient forward-looking costs to be recovered from current & future impactors
4. Allocate efficient forward-looking costs between current & future impactors
5. Recover costs from customers (through prices), or NSW Government (or other cost-recovery mechanism)

However, there are pre-conditions for the proposed framework

1. A range of detailed information
2. Potential changes to the current information collection & billing systems
3. Potential legislative, policy or regulatory changes to enable the allocation of costs to unbilled impactors
4. Broader consultation & stakeholder engagement to ensure the cost-sharing framework is both a long-term & sustainable approach

This means that it is not feasible to implement aspects of the framework in the 2017 determination period.

However, we will review cost shares & seek to implement this framework for the 2021 determination.

Questions

1. Are our adjustments to OPEX & CAPEX reasonable?
2. Is there scope for further efficiency gains over the 2017 determination period?
3. Would Frontier Economics' proposed cost sharing framework better reflect the share of WaterNSW costs between impactors?

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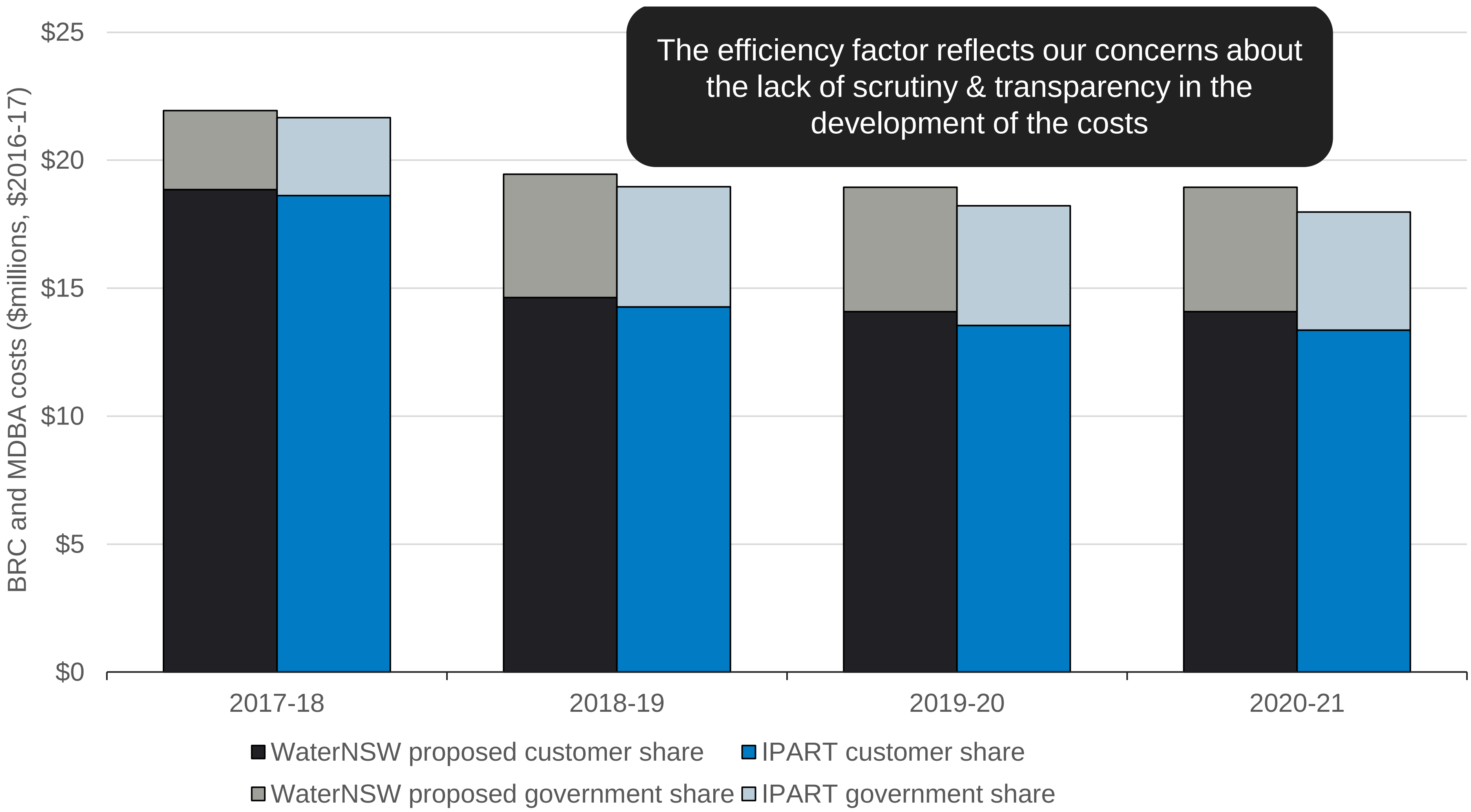
Our draft decisions on BRC/MDBA charges

1. Apply a 1.25% per annum, compounded, efficiency factor
2. Discontinue the Unders & Overs Mechanism (UOM) for BRC & MDBA costs & smooth recovery of the current balance over the 2017 determination period
3. Change the tariff structure from 40:60 to 80:20 fixed to variable for BRC & MDBA charges
4. Apply the standard HS premium (ie, not adjusted)

We have continuing concerns about the lack of transparency in BRC/MDBA costs

1. Our consultants reviewed MDBA costs & did not identify any specific reductions.
2. However, we share similar views with customers about the lack of independent scrutiny in the development of BRC & MDBA costs
3. Hence, **we are applying an efficiency factor of 1.25% <u>compounded per annum</u>** to WaterNSW's proposed BRC & MDBA costs
4. All businesses in competitive markets need to continually improve their efficiency

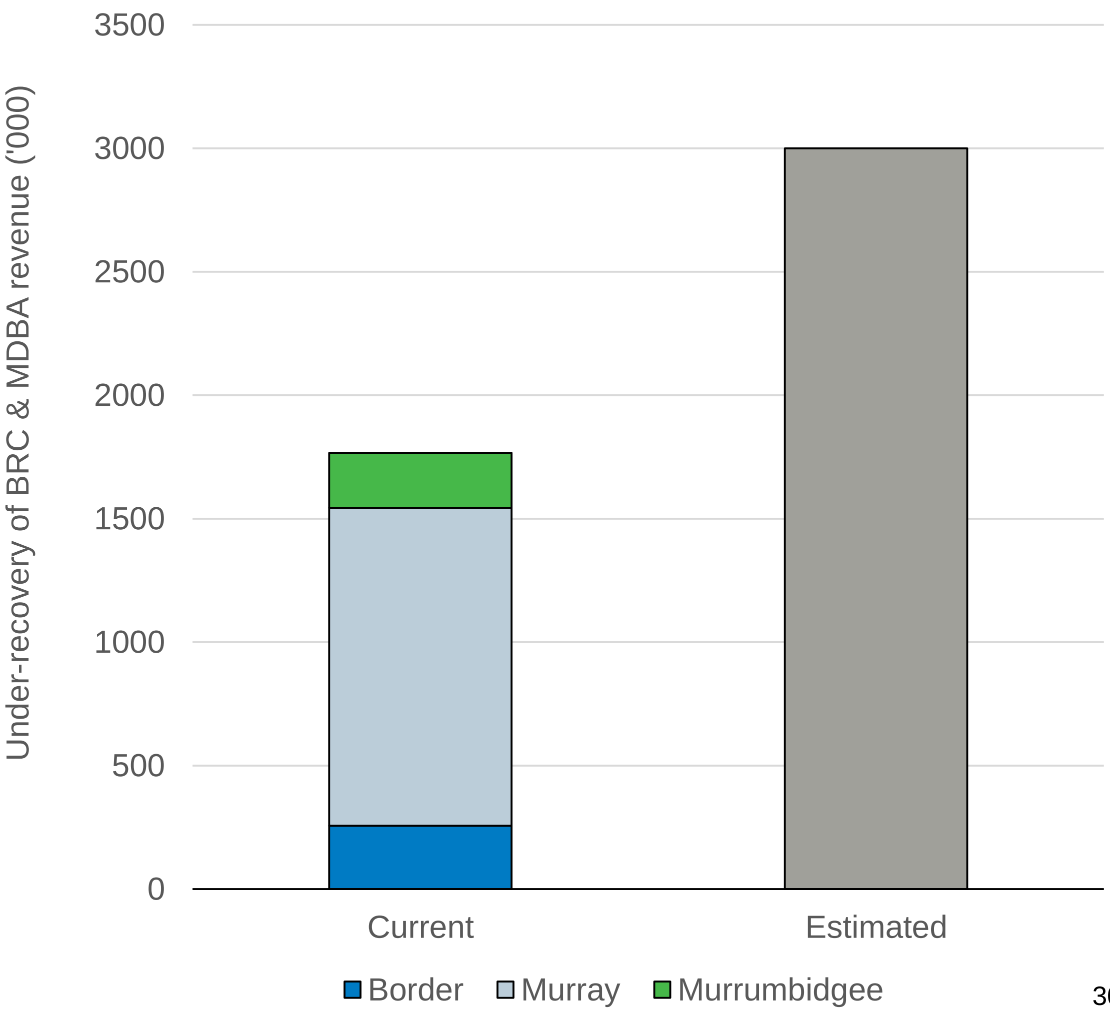
Our efficiency factor would reduce BRC & MDBA costs by $2.4 million



The current UOM balance for BRC & MDBA is ~ $2 million

1. The UOM was introduced to address WaterNSW's revenue volatility risk arising from the mismatch between tariff structures & cost structures

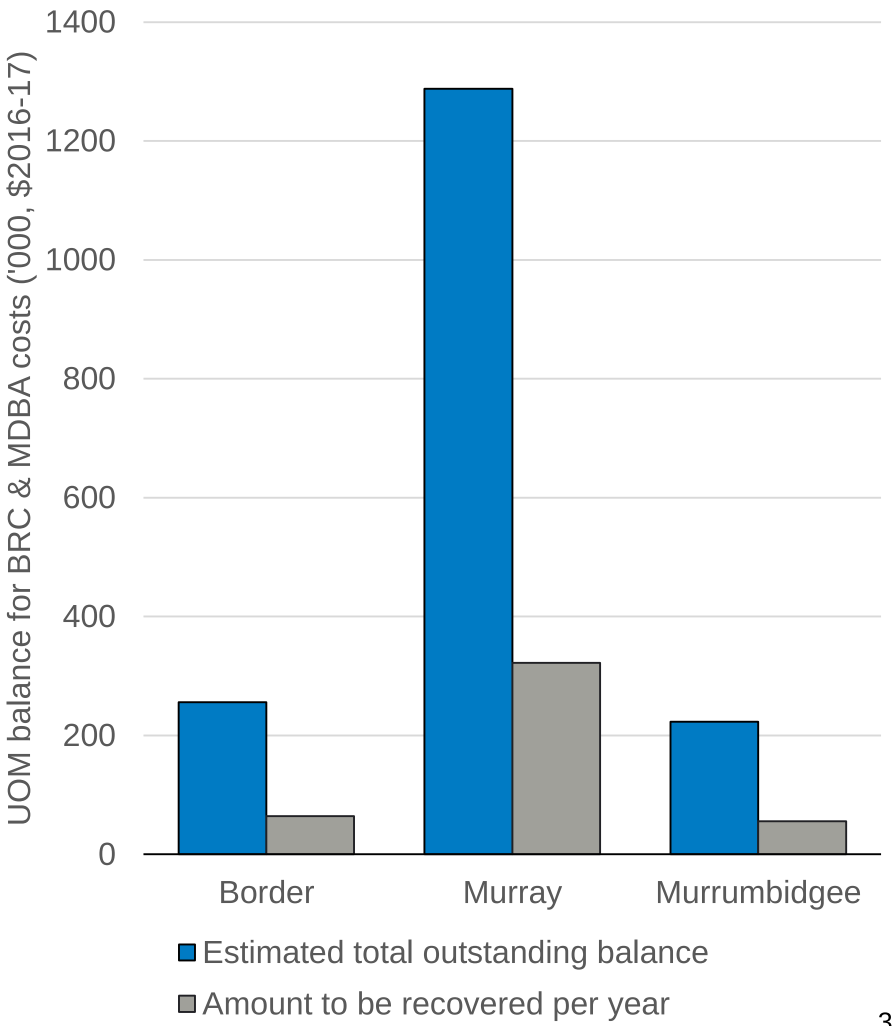
2. WaterNSW anticipates an under-recovery (UOM balance) of $3 million at the end of the determination period



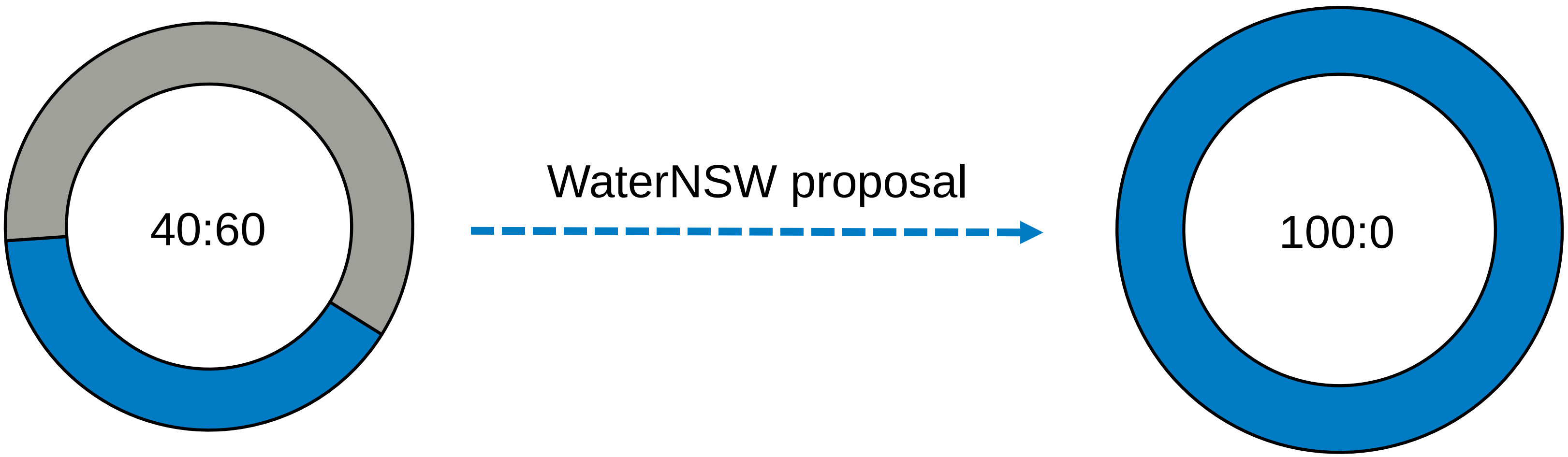
The UOM for BRC & MDBA would be discontinued

1. We have discontinued the UOM for BRC & MDBA costs as we consider that the **UOM does not materially reduce revenue volatility** (discussed further in Session 3)

2. The **outstanding (negative) UOM balance to be recovered from customers**



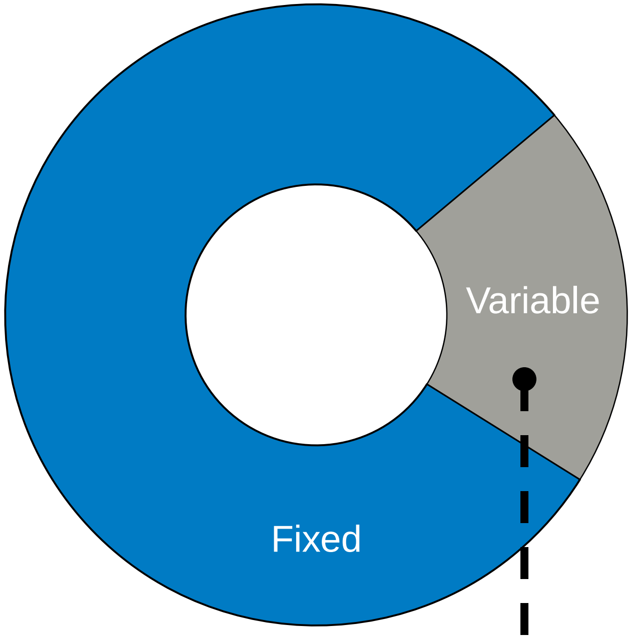
WaterNSW proposed a 100:0 tariff structure for BRC & MDBA charges



1. This would have a substantial impact on customer bills
2. This would means that **WaterNSW transfers all of its revenue risk to customers**

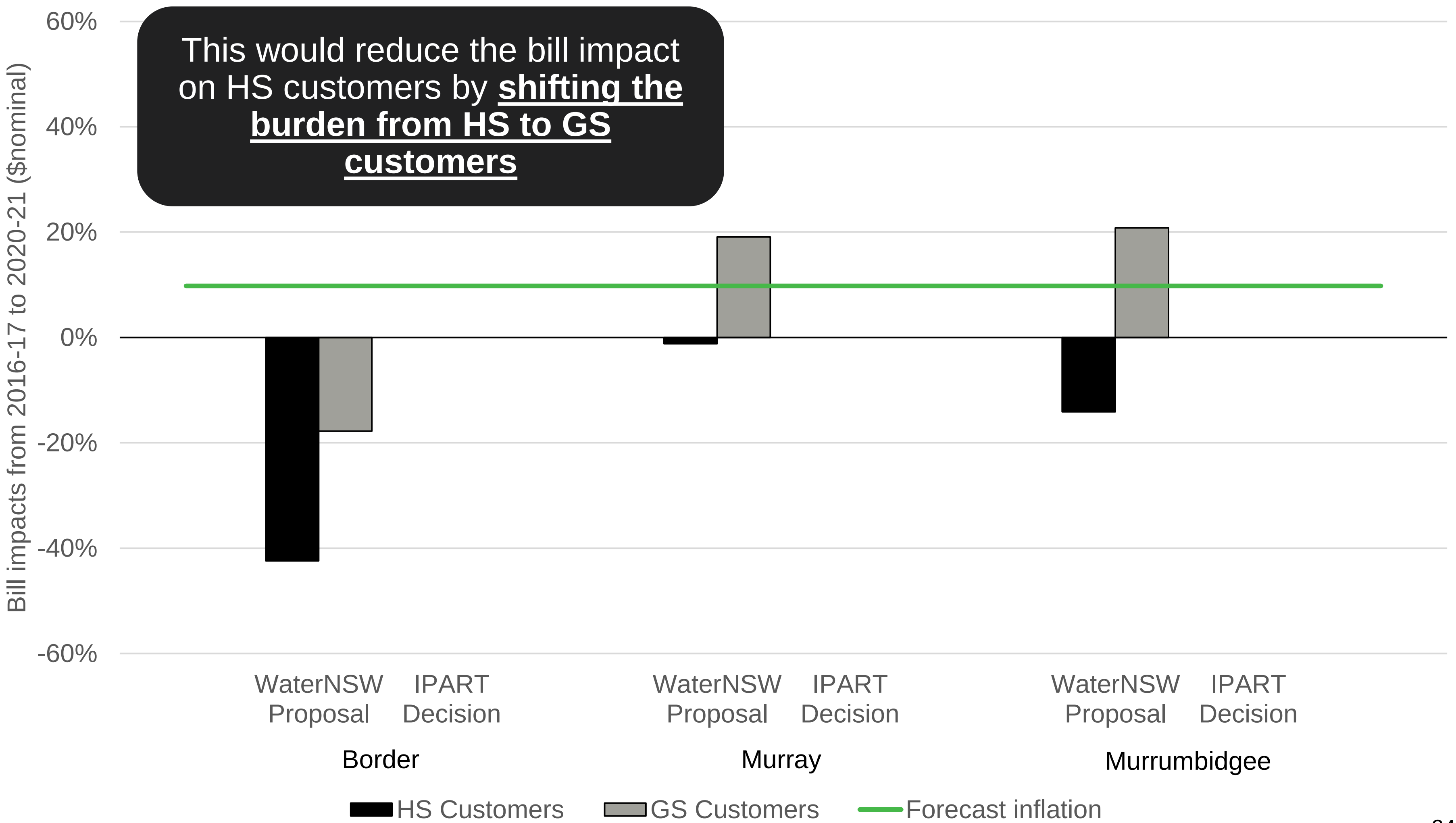
We consider an 80:20 tariff structure to be appropriate

1. This would strike an appropriate balance between:
   a) Reducing WaterNSW's revenue volatility by better matching WaterNSW's tariff structures & cost structure, &
   b) An appropriate amount of business risk.

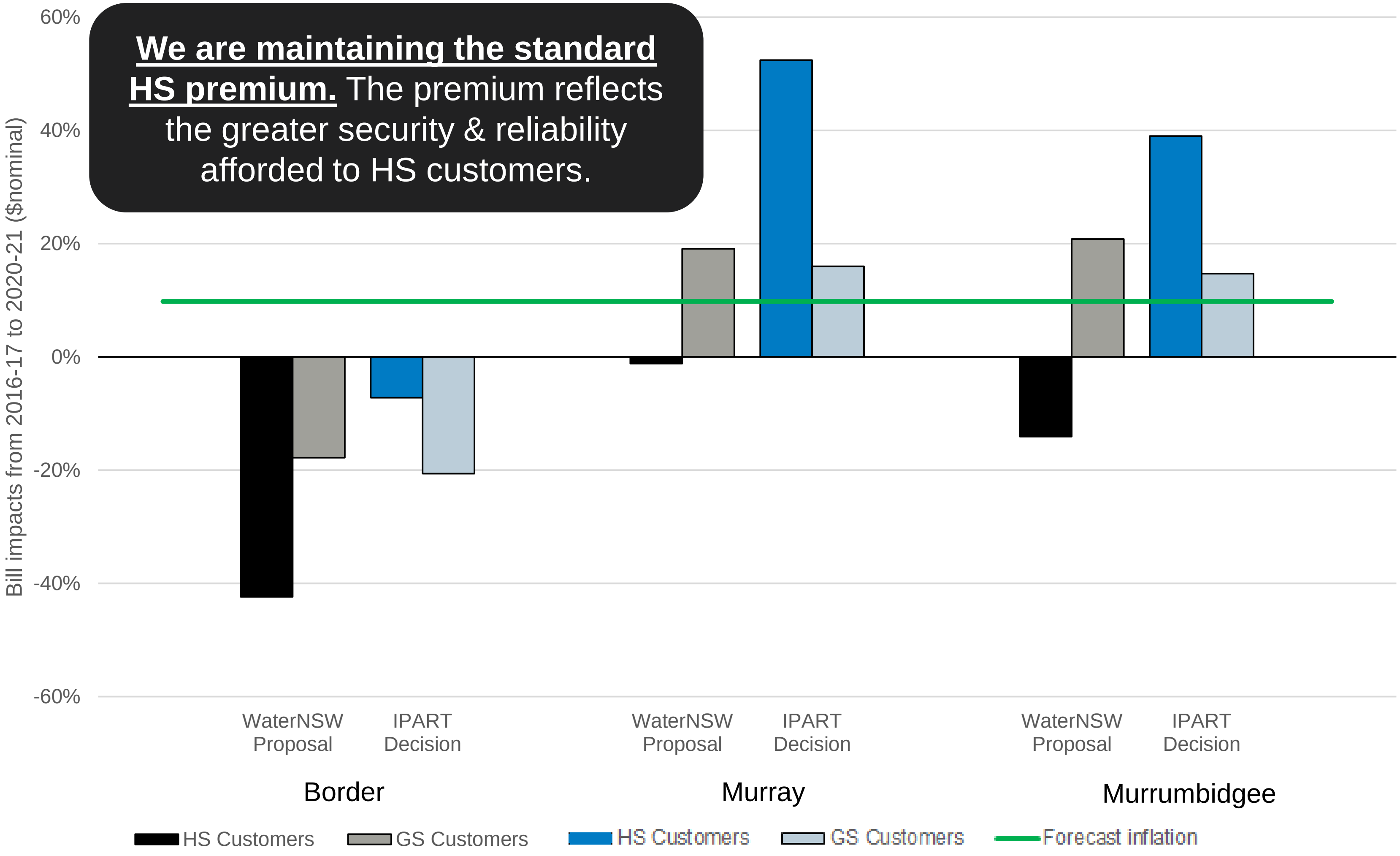


We consider it appropriate for WaterNSW to bear some revenue volatility risk, **as business revenues are not guaranteed in competitive markets**

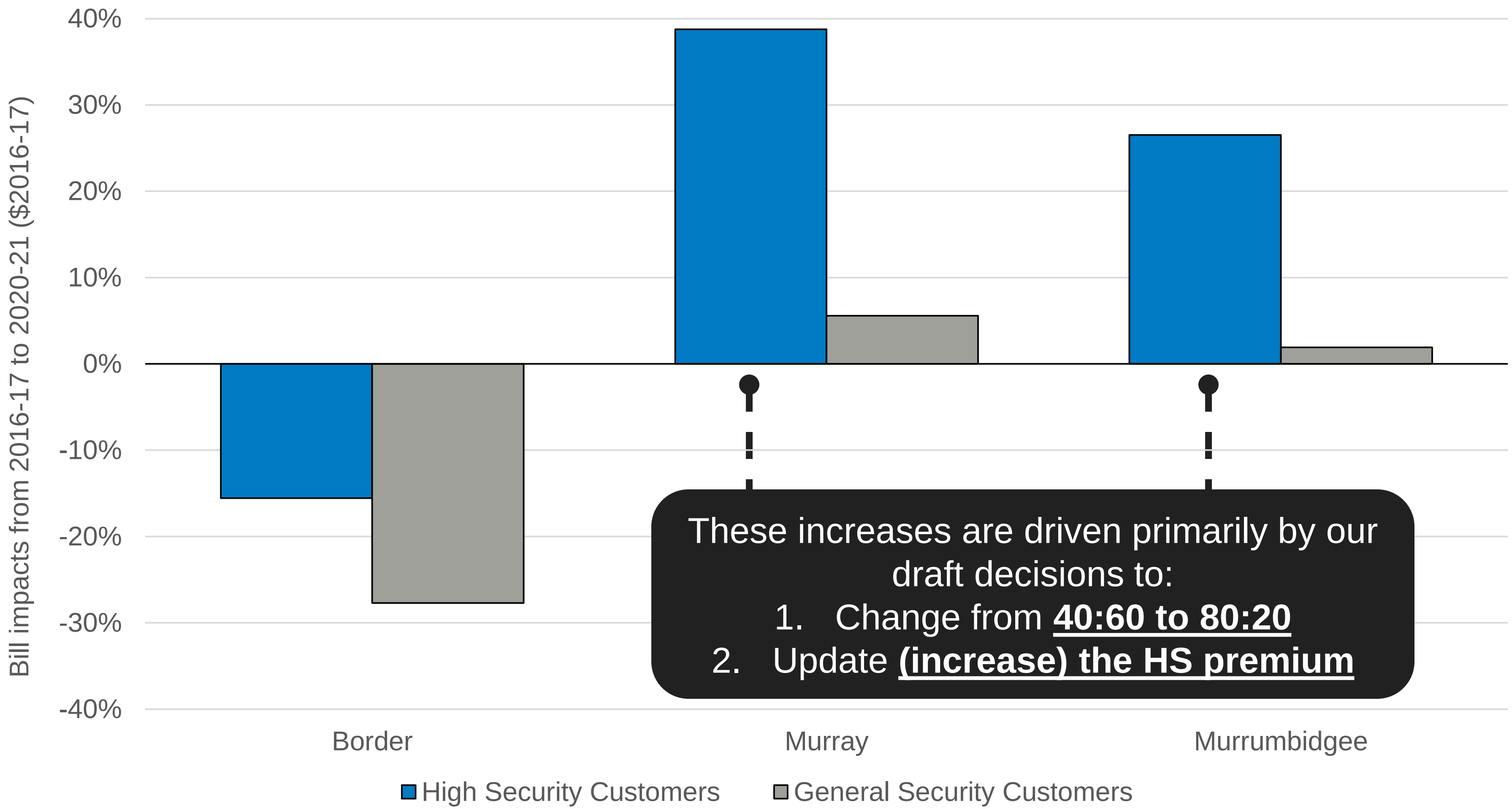
WaterNSW proposed to adjust the BRC/MDBA HS premium



We consider adjusting the BRC/MDBA HS premium inappropriate

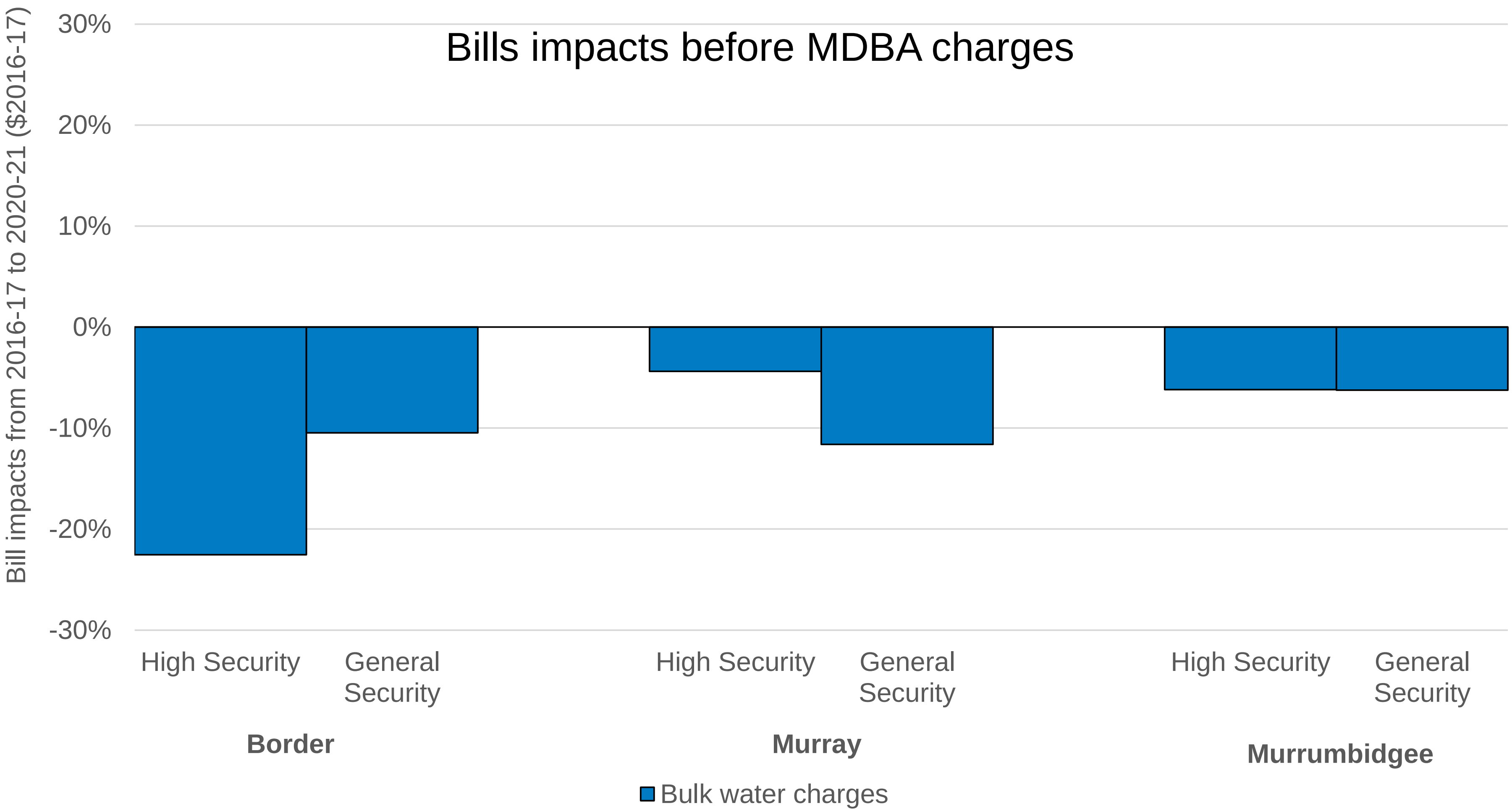


Despite our efficiency factor, our draft decisions would impact bills for HS customers



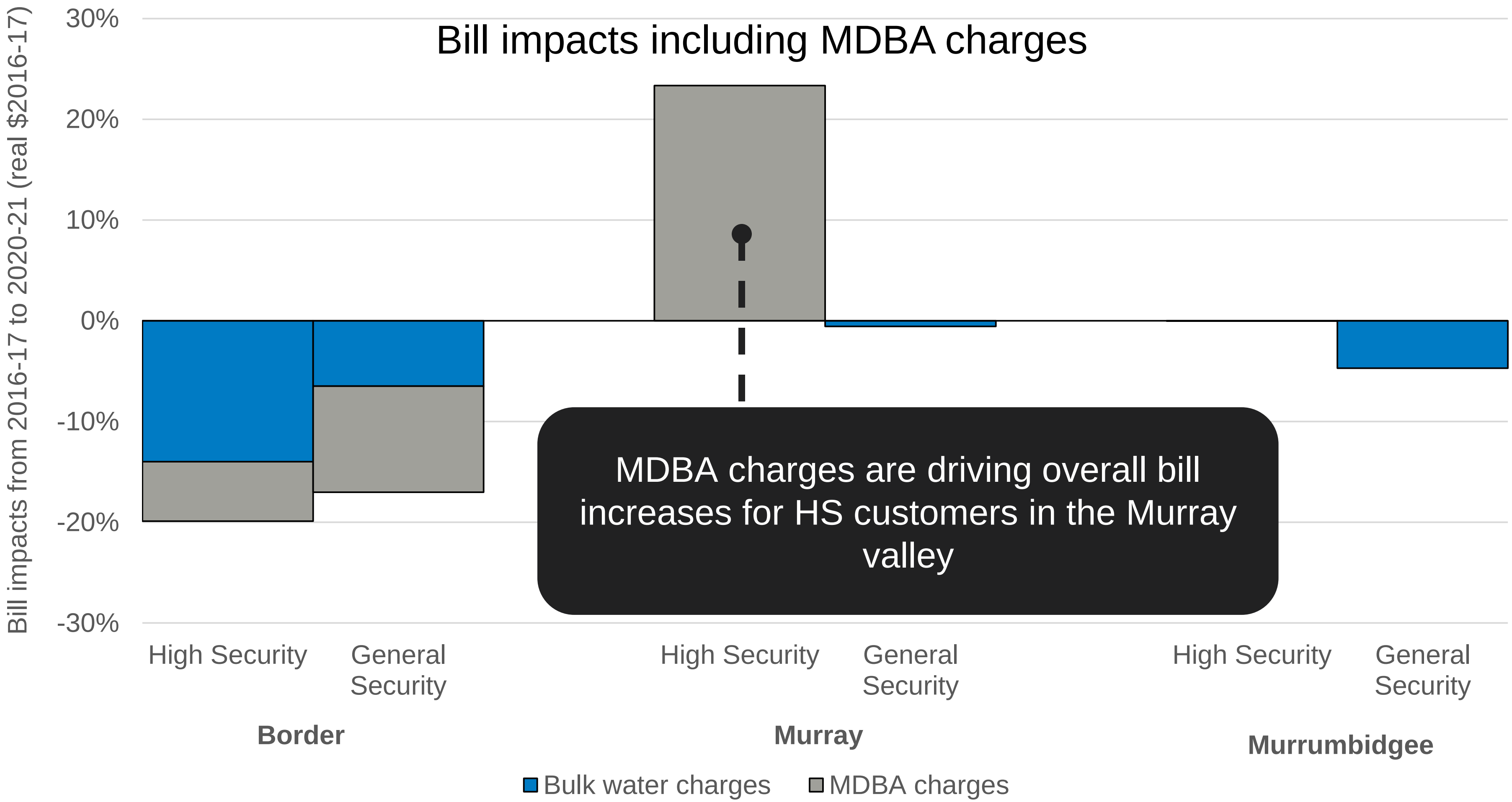
BRC/MDBA bill impacts only. Excludes bulk water charges.

Our draft decisions on BRC/MDBA charges would impact overall bills….



Combined bill impacts (bulk water charges plus BRC/MDBA) presented in real $2016-17

…especially for HS customers in the Murray valley



Combined bill impacts (bulk water charges plus BRC/MDBA) presented in real $2016-17

Questions

1. Is the efficiency factor, 1.25% compounded per annum, applied to WaterNSW's proposed BRC & MDBA costs reasonable & sufficient?
2. What are your views of adopting an 80:20 tariff structure?

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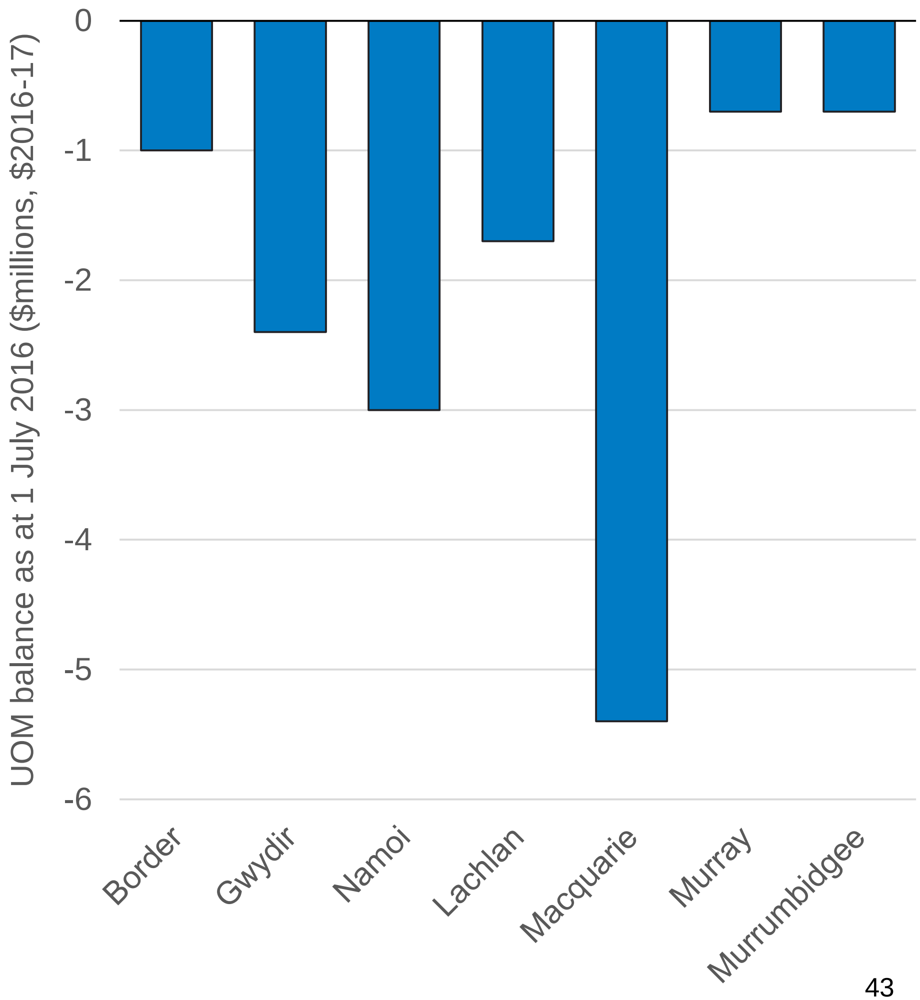
Our draft decisions on managing volatility

Our draft decision is to discontinue the UOM

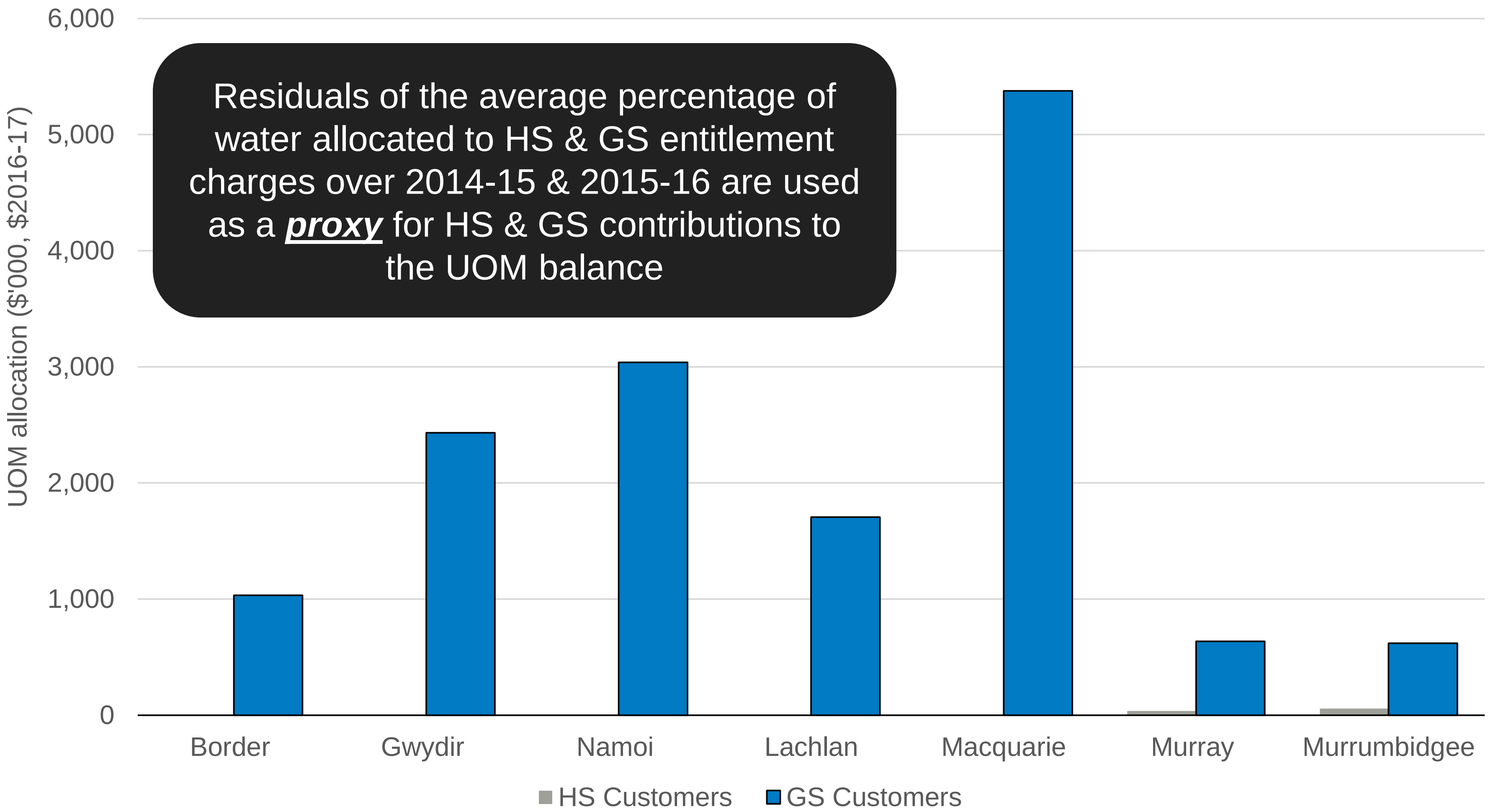
1. The UOM was introduced in the ACCC's 2014 Decision to address WaterNSW's revenue volatility risk

2. However, we consider that the **UOM does not materially ameliorate volatility**

3. Total UOM balance is currently about -$19.5 million
   - But we would review/update this balance for the Final Determination



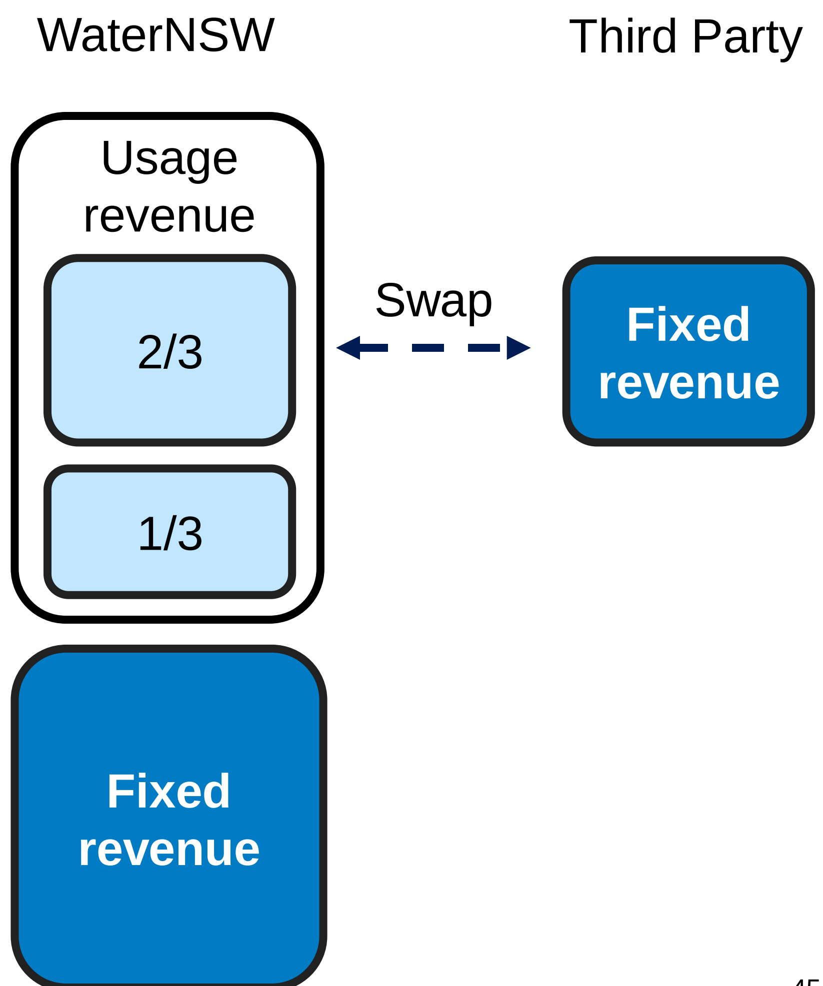
The outstanding UOM balance would be returned to WaterNSW



WaterNSW proposed an RTP of $3.6 million per year

1. WaterNSW argued that its current tariff structures exposes it to an unreasonable amount of revenue volatility risk

2. It has proposed inclusion of a Risk Transfer Product (RTP) of $3.6 million per year ($2016-17)
   - This would allow it to guarantee 2/3 of its usage revenue & hence effectively replicate an 80:20 fixed to variable tariff structure (as 80% of its pricing revenue would be fixed).



Self-insurance is more efficient than an RTP

1. We agree with WaterNSW that it is exposed to revenue volatility & hence some financial risk
2. However, our calculations indicate that "self-insurance" would be more cost-effective than purchasing an RTP
3. Hence, we are introducing a volatility allowance, which is a premium included in prices to reflect WaterNSW's exposure to undue revenue volatility risk (or its costs of self-insurance)
4. This premium is for valleys that are at cost recovery & have a fixed to variable price ratio less than 80:20

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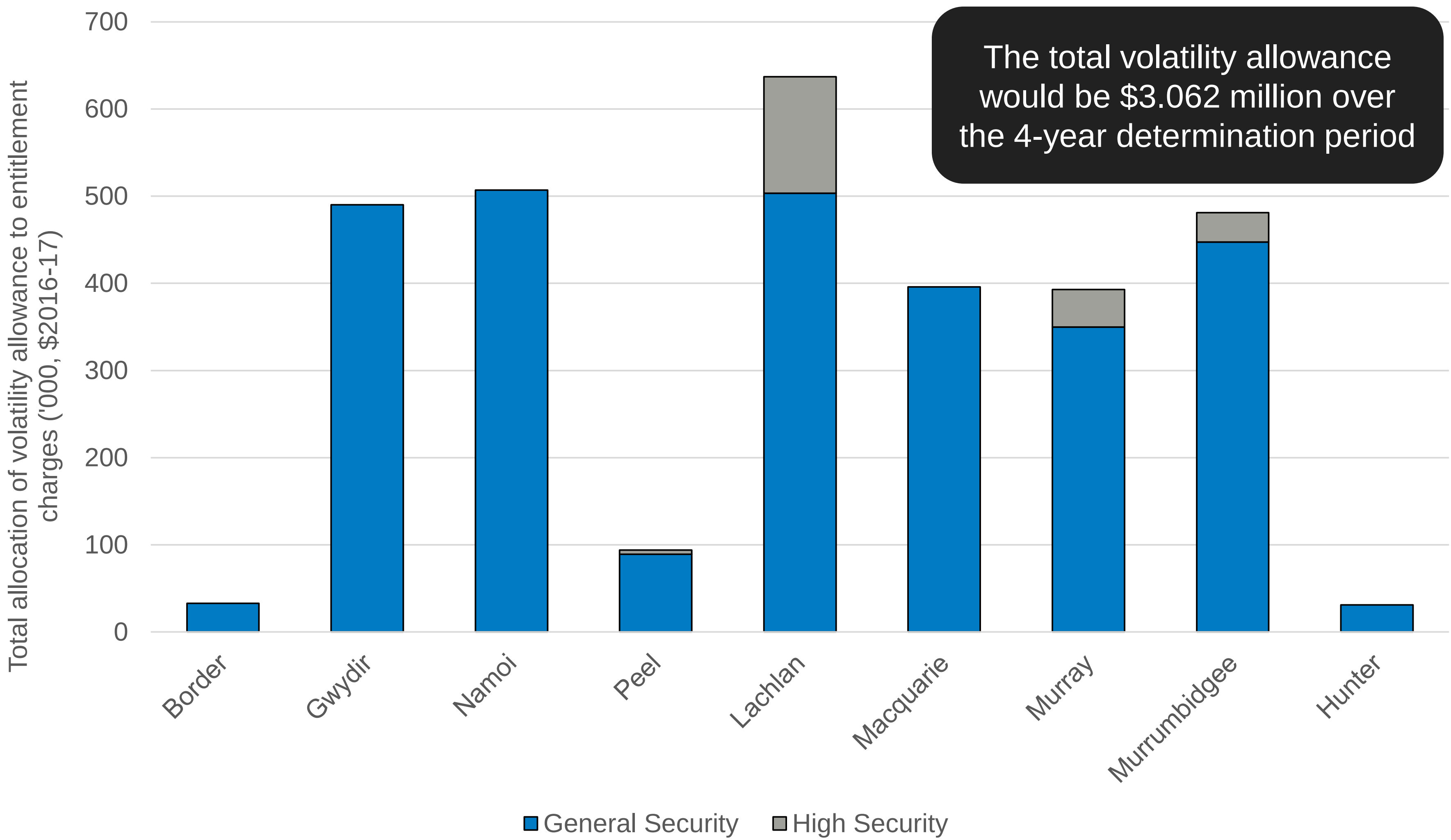
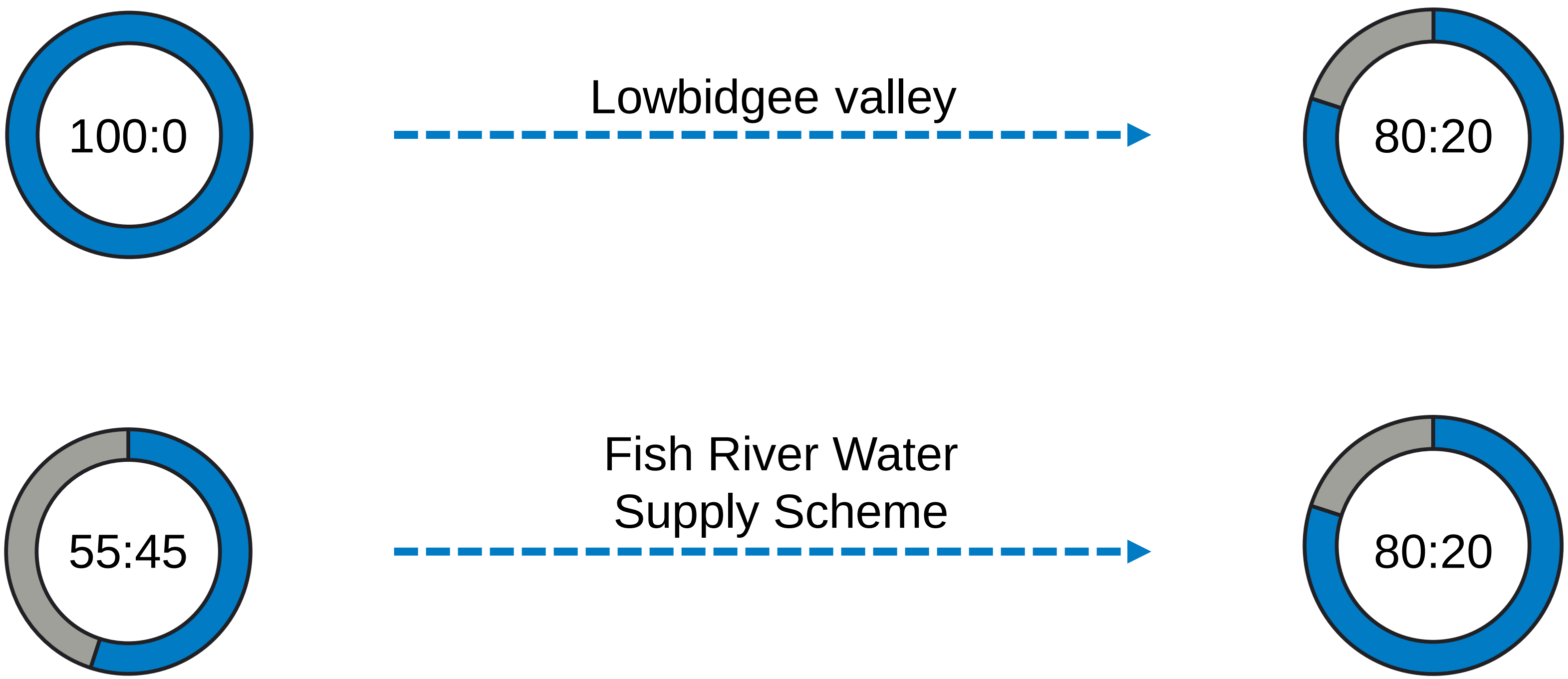
3. Hence, we are introducing a volatility allowance, which is a premium included in prices to reflect WaterNSW's exposure to undue revenue volatility risk (or its costs of self-insurance)
4. This premium is for valleys that are at cost recovery & have a fixed to variable price ratio less than 80:20

We have included a volatility allowance of $0.765 million per year



Our draft decisions on price structures

We are maintaining tariff structures for valleys, except for…



This would achieve a balance between matching WaterNSW's cost structure & distributing risk between WaterNSW & its customers

We are updating both parameters in the HS premium

Update to the latest 20-year period*

HS Premium = Security Factor × Reliability Ratio

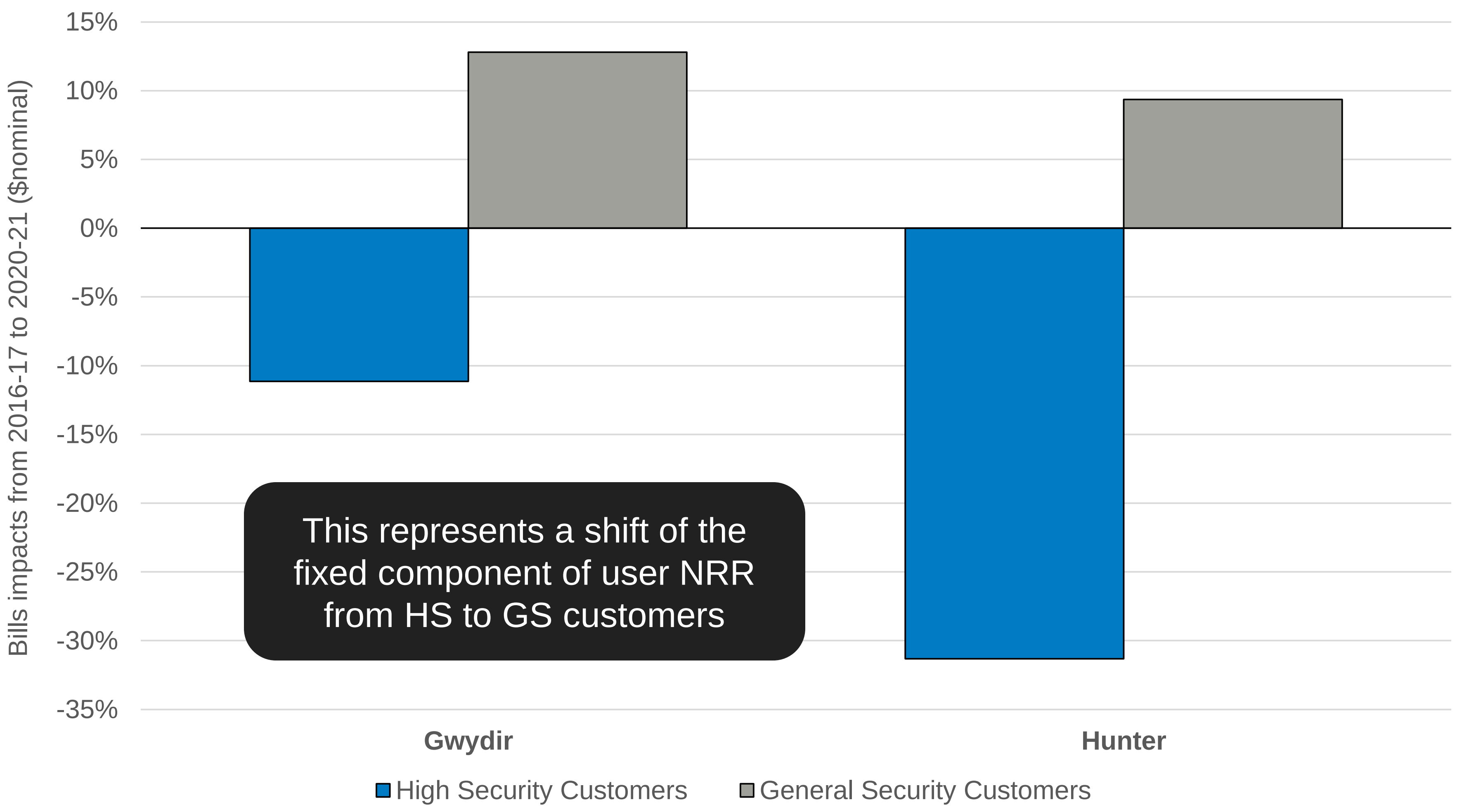
The old security (conversion) factors have not been updated since 2006 & <u>new/updated WSPs have since been developed</u>

GS customers in the Hunter would be affected

1. Most valleys would experience a modest reduction in the HS premium
2. This reduction would be particularly pronounced in the **Hunter valley** & to a smaller degree, the **Gwydir valley**

1. In contrast, the HS premium in the **Murray valley** would increase

Updated HS premiums would increase GS customer bills in the Hunter & Gwydir

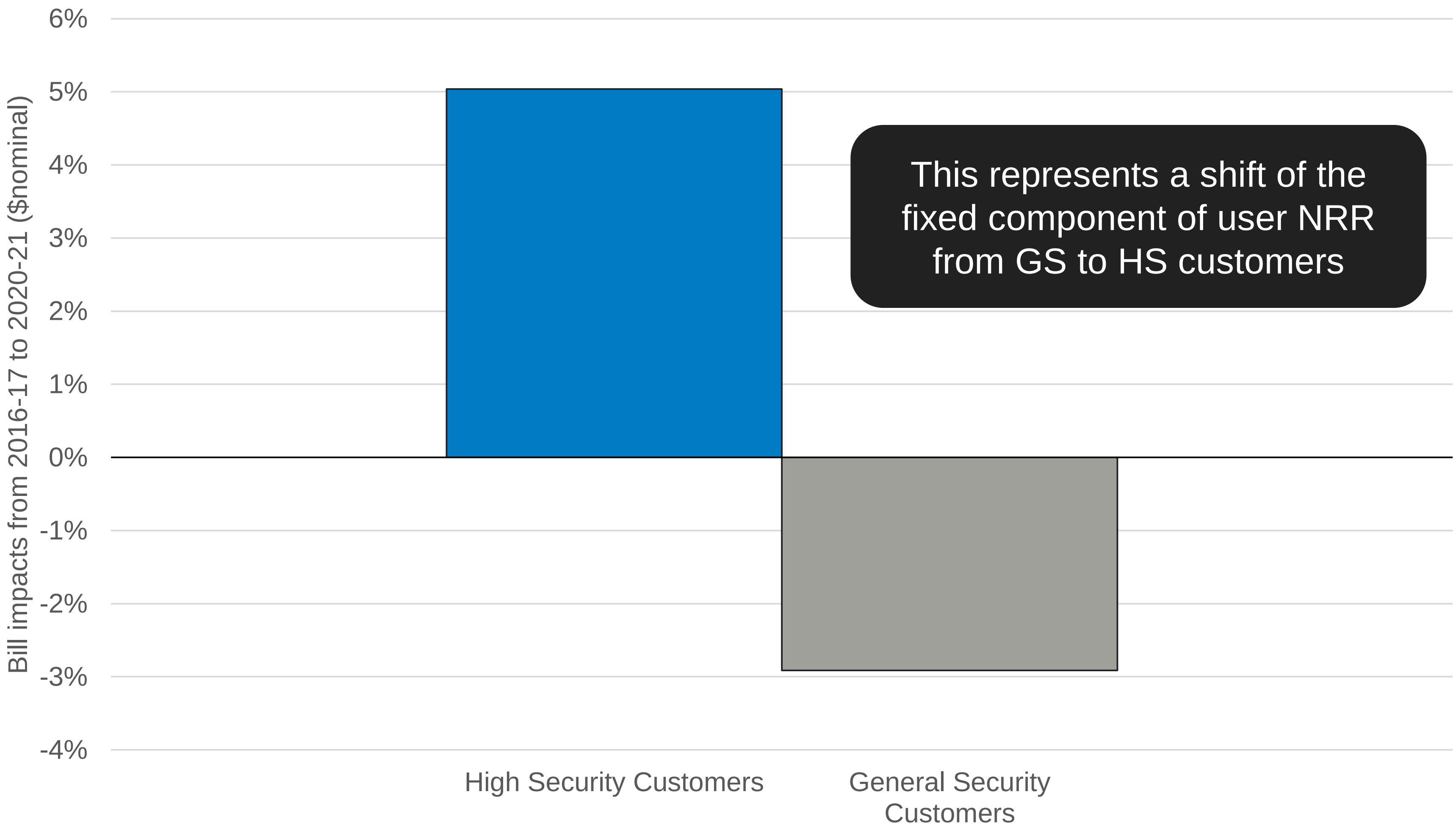


HS customers in the Murray would be affected

1. Most valleys would experience a modest reduction in the HS premium
2. This reduction would be pronounced in the **Hunter valley** & to a smaller degree, the **Gwydir valley**

1. In contrast, the HS premium in the **Murray valley** would increase

This would put upward pressure on HS customer bills in the Murray valley



Note: Bill impacts exclude MDBA charges

Questions

1. What are your views on discontinuing the UOM & recovering the outstanding balance directly from entitlement charges?
2. Is it reasonable for WaterNSW to face 20% business risk?
3. What are your views on the introduction of the volatility allowance for WaterNSW to engage in ‘self-insurance’?
4. Are there other ways WaterNSW can manage its revenue volatility risk efficiently?
5. Are the changes in tariff structures for Lowbidgee valley & FRWS reasonable?
6. What are your views on updating the parameters in the HS premium?

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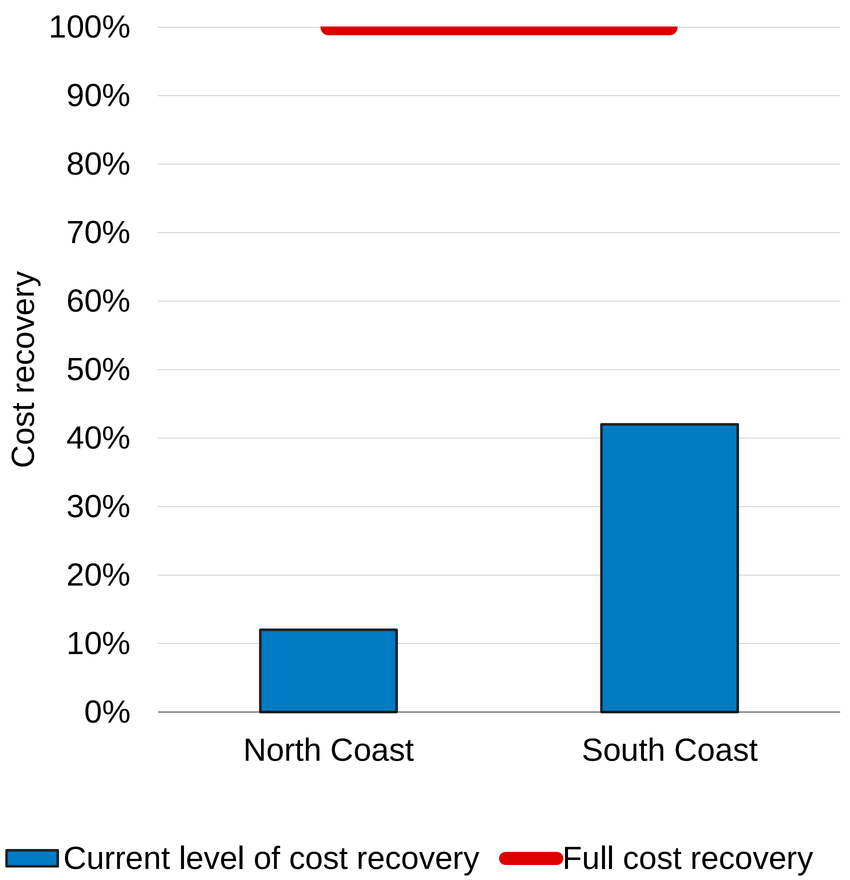
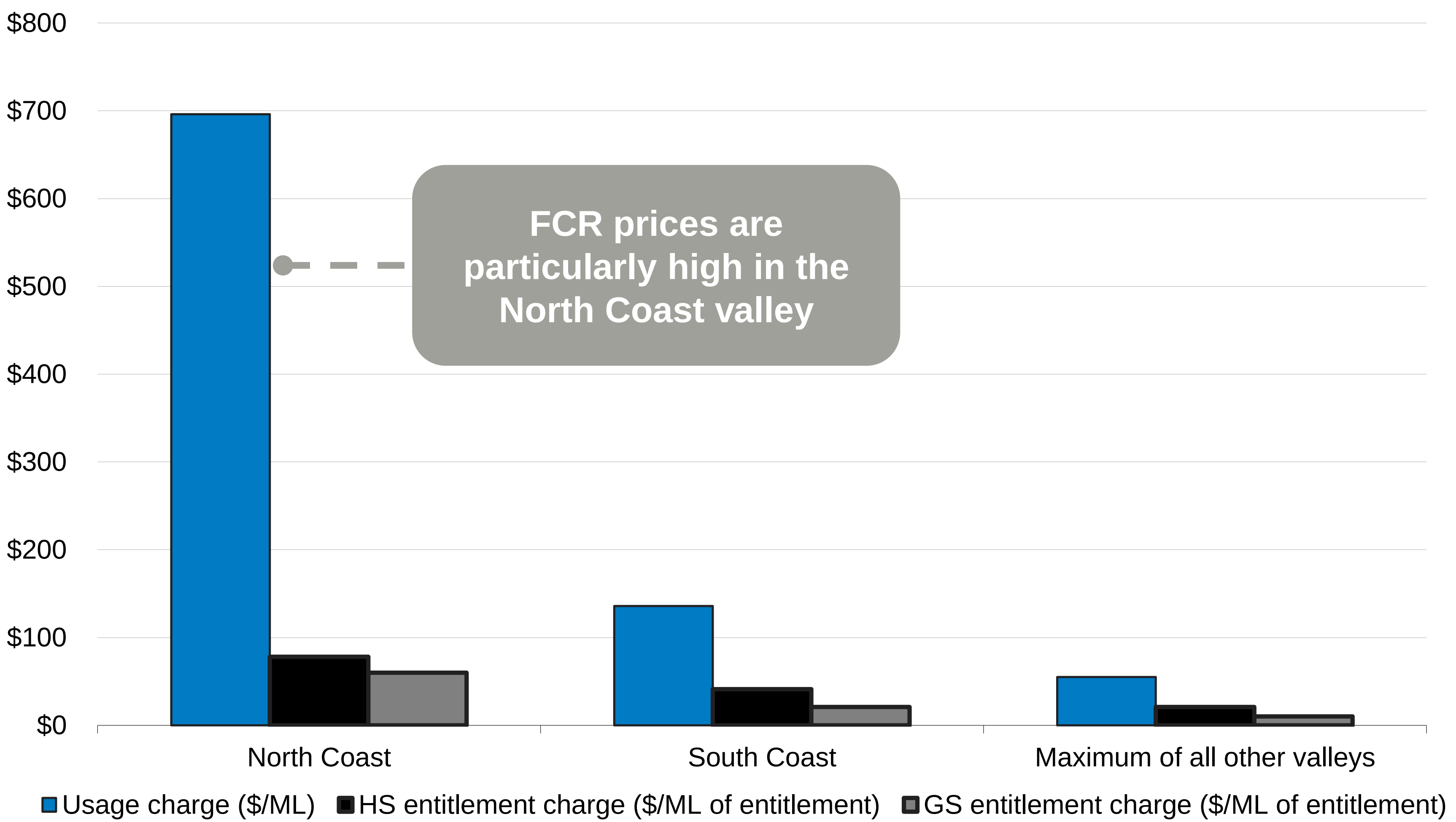
FCR likely to be unattainable in some valleys

1. We aim to set prices that fully recover users' share of WaterNSW's efficient costs
2. Two valleys currently well below full cost recovery (FCR)
3. FCR is likely to be unattainable in these valleys over 2017 Determination period & beyond



Current FCR prices in North & South Coast



We have decided to use a new approach to set prices in valleys below FCR

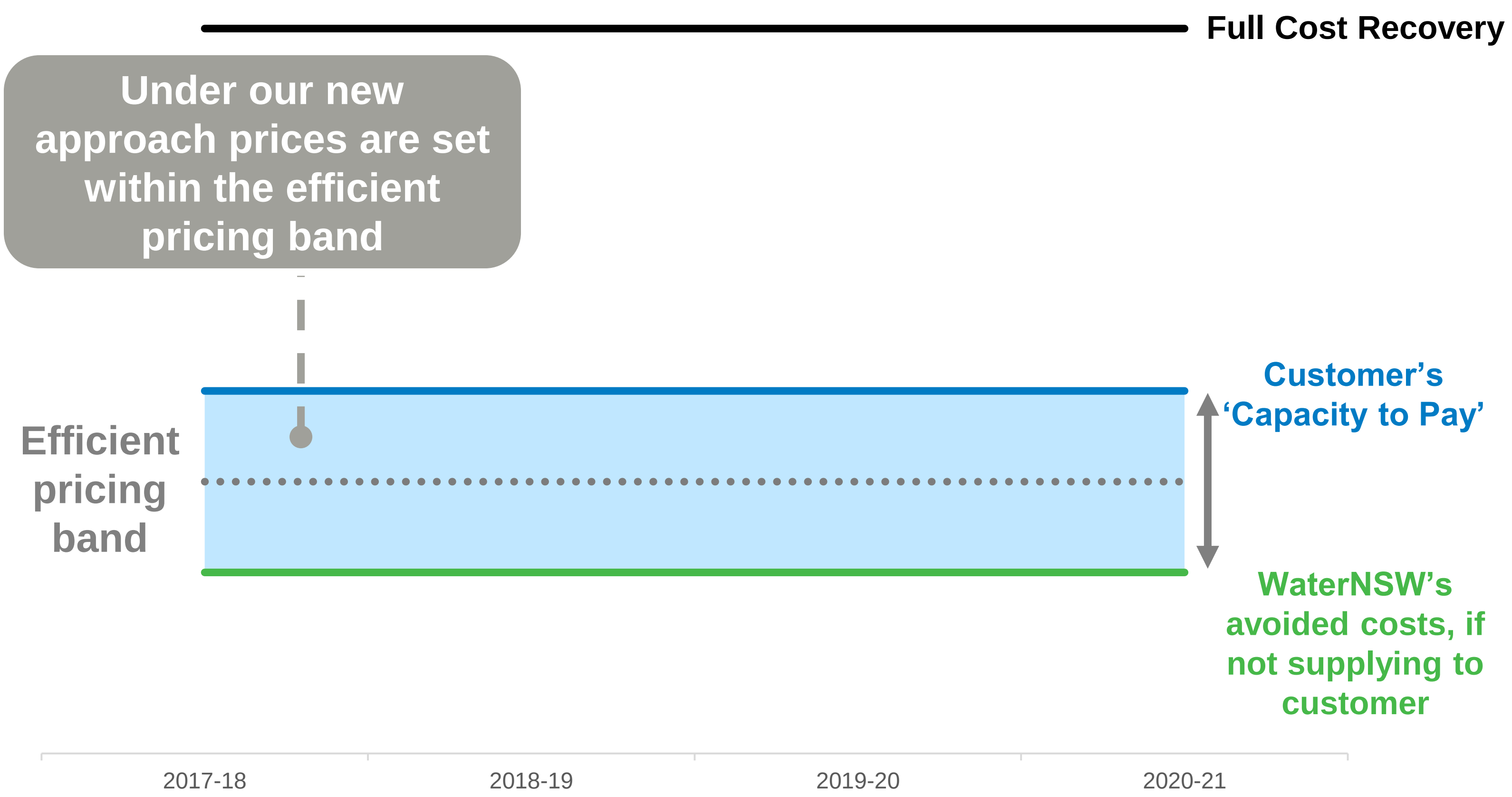
1. Rather than continue 10% glide path towards FCR, set prices using a **new approach**

2. Set prices within an **efficient pricing band** with an:
   a) **Upper limit**: WaterNSW's customers' 'capacity to pay'
   b) **Lower limit**: WaterNSW's avoided costs (costs it would avoid if it did not supply)

3. Set prices for:
   a) **North Coast**
      - Slightly below estimated mid-point of efficient pricing band, by **freezing prices** in real terms

   b) **South Coast**
      - At estimated **mid-point** of efficient pricing band

Our new approach for valleys below FCR sets prices within the efficient pricing band



We have estimated the efficient pricing band based on …

1. **Upper limit**
   a) Our consultants investigated capacity to pay for rural bulk water services in North Coast & South Coast valleys
   b) We estimated the bulk water prices at which:

   Cost of irrigation pasture production = Cost of bought-in feed

2. **Lower limit**
   a) 1% of WaterNSW's costs of supplying bulk water services

We recognise that refinement of these limits is required over time

Why are we using this new approach?

1. **Declining** customer numbers & average water sales in North Coast & South Coast valleys
2. Indicates that prices may be approaching customers' **capacity to pay** in these valleys
3. Above a customer's capacity to pay:

→ Demand for rural bulk water services would decline

→ Lower customer numbers, usage & entitlement volumes, revenue & level of cost recovery

→ Further FCR price increases to recover costs

Impact of our draft decision

1. Applying this approach should provide:
   a) Price stability & certainty for customers
   b) Signal to WaterNSW & the NSW Government that:
      - Transitioning to FCR in these valleys is unattainable

Questions

1. What are your views on how we have set draft prices in the North Coast & South Coast valleys?
2. How could this new approach be refined?
3. Are there other ways that prices could be set in these valleys?

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Questions for discussion

- Any other comments on IPART's Draft Report & Draft Determination?

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Submissions are due 17 April 2017

We prefer submissions via our online form, go to

www.ipart.nsw.gov.au

You can also send comments by fax to (02) 9290 2061, or by mail to:

WaterNSW rural price review 2017
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop, NSW 1240

Our Final Report & Final Determination are due for release in June 2017