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Representing and Uniting Lachlan Valley Water Users

Submission to IPART

on Draft Report on WaterNSW Regulated Charges 2017 - 2021

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SUBMISSION ON DRAFT WATERNSW CHARGES, 2017 - 2021

1. Introduction

Lachlan Valley Water (LVW) is the peak valley-based organisation representing 550 individual irrigator members in the Lachlan Valley, including irrigators within Jemalong Irrigation Limited (JIL). This submission has been prepared on behalf of all members and represents an overall valley position, however, our members also reserve their right to make their own independent submissions. Lachlan Valley Water is a member of NSW Irrigators Council (NSWIC) and supports the NSWIC submission in general, and provides a response on the issues from a Lachlan perspective

Our submission addresses the key decisions made by IPART and the issues on which IPART has asked for comment.

2. Length of Determination

LVW supports the 4 year determination period.

3. Form of Regulation

3.1 Annual Price Reviews

LVW considers that in addition to reviewing entitlements and usage, the annual price review should address the timing of capital expenditure (capex) and determine if an adjustment for unearned rate of return on capex is required. This is required in view of WaterNSW's and previously State Water's history of persistent underspending on capex.

We recommend that the annual review incorporate a review of actual capital expenditure compared with budget expenditure and determine the under or over expenditure. Where there is under-expenditure of capital in that year, the Weighted Average Cost of Capital (WACC) can be applied to the under-expenditure to calculate the unearned rate of return received by WaterNSW, and this amount should be offset against either the UOM, volatility allowance or the price adjustment to usage charges.

LVW recommends that the annual review incorporates a review of actual vs budgeted capes, and an adjustment for any unearned rate of return on underspent capex.

3.2 Efficiency Carryover Mechanism

LVW supports the concept of an efficiency carryover mechanism (ECM) and that it should apply to controllable operating expenditure. However, we consider that allowing cost reductions to be retained for 4 years is overly generous to WaterNSW and that it imposes too high a cost on customers, particularly where efficiencies have been achieved by changing the level of service provided to customers.

We are also concerned that customers have so far received no financial benefit as a result of the merger between State Water and the Sydney Catchment Authority, nor from the recent reforms and transfer of DPI Water staff to WaterNSW.

LVW proposes that a 2 year carryover period is more appropriate for the ECM as it shares the benefits of the cost reductions with customers, but also provides an incentive for WaterNSW to make savings.

4. Revenue Requirement

Lachlan Valley Water is concerned that the statewide customer share of the notional revenue requirement (NRR) is set at $285.4 million, or 67% of the total allowed revenue. There has been a trend in recent years for customers to pay an increasing share of the NRR, up from 60% in 2010 to 67% proposed for 2016/17. We are concerned at three components in the 'building block' which have contributed to this trend, namely the return on assets, the repayment of the UOM, and the inclusion of a volatility allowance. Our submission deals with these in detail in 6.2, 8.1 and 8.2 respectively.

5. Operating Expenditure

The proposed total operating expenditure (opex) in the Lachlan Valley over 2017 to 2021 is $17.61 million, or $4.34 million/year, of which the customer share is 89%, at $3.91 million/year. We acknowledge the reduction in opex that WaterNSW has been able to achieve over the past three years, and appreciate that it has flowed through to budgeted opex for 2017-2021, but are wary that efficiency savings have been and will in future be achieved partly by changing the level of service provided to customers.

We consider that further cost reductions may involve changes to levels of service and recommend that WaterNSW should consult with customers regarding minimum requried standards for level of service, and how further efficiencies will be achieved.

6. Capital Expenditure

6.1 Past Capital Expenditure

While LVW agrees that the actual capital expenditure for 2014/15 to 2016/17 should be included in the Regulated Asset Base (RAB), we reiterate that in the past WaterNSW has struggled to spend all budgeted capex. In view of this we request that IPART review the actual capital expenditure for 2016/17 at the end of the third quarter and adjust the figure to be included in the RAB if a shortfall in actual vs budget capex is evident.

6.2 Capital Expenditure 2017-2021

While LVW welcomes IPART's reductions in WaterNSW's forecast capital expenditure, we are still concerned at the level of capital expenditure (capex) allowed over the 2017 determination period for the following reasons:

a. we question whether the increased level of capex is prudent and efficient
b. the timing of capex

We are concerned that the capital allowance approach to be adopted by WaterNSW includes capital expenditure that has not been adequately investigated and verified as necessary by WaterNSW. IPART's consultants, Aither, have also identified that the proposed increase in capital expenditure is not prudent or efficient[1] and that the planning process undertaken by WaterNSW is not sufficiently detailed to justify the proposed level of expenditure.

[1] P58, IPART Draft Report on WaterNSW Review of prices 2017-2021, March 2017

WaterNSW has referred to previous under-investment in capital programs as a reason necessitating their new approach to capital expenditure. However, the IPART draft report notes that there is a significant change in the mix of capital expenditure, with a large increase in the 'maintaining capability' category in the 2017-2021 period compared with the previous determination. WaterNSW and its predecessors have been operating this infrastructure for many years and therefore we conclude that in past determinations the 'maintaining capability' capital projects submitted by WaterNSW have been those it deemed necessary at that time to maintain capability of the assets and meet regulatory compliance requirements.

WaterNSW's approach therefore represents a significant change in practice and LVW is concerned that significant extra costs being loaded onto customers as a result of a new approach by WaterNSW which has not been properly tested and validated.

LVW welcomes IPART's reduction of $3.9 million in the forecast customer share of capex for the Lachlan, but is concerned that the adoption of the capital allowance approach without a more rigorous validation program will increase customer costs unnecessarily.

With regard to timing of capex - as outlined in our submission on WaterNSW's pricing submission, we are concerned that the capital allowance approach has the potential to aggravate the existing problem for customers where WaterNSW customarily budgets for earlier and/or higher capex than is actually spent, and therefore receives an unearned rate of return on unspent capex.

If the capital allowance approach is adopted, then LVW recommends that there must also be an annual adjustment for any unearned rate of return for underspent capital as described in 3.1.

7. Allowance for Return on Assets, Depreciation and Tax Obligations

7.1 Regulatory Asset Base

As mentioned in 6.1, Lachlan Valley Water recommends that IPART review WaterNSW's actual capex to date for 2014-2017 at the end of the March 2017 quarter and adjust the figure to be included in Regulatory Asset Base (RAB) on that basis.

7.2 Depreciation

Lachlan Valley Water remains concerned that by allowing both depreciation and indexing of the value of the RAB as components of the 'building block' WaterNSW is being doubly compensated for the consumption of the asset.

7.3 Return on Assets

As noted in 6.2 above, Lachlan Valley Water recommends that if the capital allowance approach is adopted, it should be accompanied by an annual adjustment for capex underspend as described in 3.1.

7.4 Weighted Average Cost of capital

Lachlan Valley Water supports the NSW Irrigators Council submission that a lower beta value for WaterNSW's WACC calculation should be considered in view of the numerous measures in place to lower the revenue risk faced by WaterNSW.

LVW recommends that a lower beta than 0.7 should be adopted for the WACC calculation.

8. Other Costs

8.1 Unders and Overs Mechanism (UOM)

LVW strongly disagrees with the decision to discontinue the UOM, which has only been in operation for the last 4 years. We consider this is too short a period to accurately test whether the mechanism effectively manages under and over-recovery of revenue, and we request that the UOM be retained.

LVW is also opposed to the proposal to repay the UOM balance in the next pricing period.

LVW supports the UOM on the basis that it reflects actual revenue volatility, both above and below the forecast sales, and because we consider it an equitable method of managing risk for both WaterNSW and customers over time.

The UOM balance is -$19.5 million, which is 14% of the allowed revenue over the 3 year period of the determination. We suggest that an under-recovery of 14% of expected revenue over that period is a relatively low level of risk. We also note that $4.6 million is due to an extraordinary, one-off event in one valley and that normally the UOM would not need to manage for the revenue fluctuation due to the shutdown of one large customer.

We also note that the UOM balance of $19.5 million is more than offset by the $21.7 million underspend on operating expenditure during the pricing period. While we do not suggest that WaterNSW should have to reduce operating expenditure to match a reduction in revenue, we note that this is the type of action that WaterNSW’s customers would take to manage fluctuations in their own income. Reducing operating expenditure is also an action that has an impact on customers, where there may be a different level of service provided, so it is fair to say that in those circumstances customers will contribute to addressing the reduction in revenue.

LVW also submits that when assessing the level of risk faced by an organisation, consideration should be given to the overall risk associated with the profitability of the organisation, not simply the revenue risk.

A benefit of the UOM as opposed to a volatility allowance or risk transfer product is that is reflective of the actual variability in revenue, whereas the proposed volatility allowance is a fixed amount and is based on previous revenue volatility, not actual volatility in the current pricing period.

LVW strongly disagrees with the proposal to discontinue the UOM, and requests that it be retained, and that repayment of the balance occur on the basis incorporated in the original design of the UOM.

8.2 Volatility Allowance

As noted in our initial submission to IPART, our main concern with WaterNSW’s approach to managing revenue volatility is that in arguing that its costs are largely fixed WaterNSW implies that it should be able to pay a dividend to the business owners every year, irrespective of external events.

LVW disagrees strongly that WaterNSW, as a monopoly business, should be insulated from external events to the point where it is able to pay a return to owners each year regardless of the level of sales. We propose that efficient pricing should allow some equitable sharing of external risks between business owners and customers.

LVW does support IPART's proposal that WaterNSW should self-insure and agrees that the organisation has the capacity to do this due to its geographical diversity.

LVW also believes that WaterNSW over-states the financial risk of the 40:60 tariff structure and notes that 60% of total revenue in each year is guaranteed regardless of usage, due to the 33% Government share of revenue and the 40% fixed charge component of the user share. Therefore, even if WaterNSW's sales were to be only 50% of planned sales, the organisation would still receive 80% of planned revenue.

While Lachlan Valley Water welcomes IPART's proposal for a much reduced volatility allowance, we are opposed to the reintroduction of a volatility allowance to manage revenue risk.

Our concern with the volatility allowance is that it is a fixed cost based on previous usage volatility and is not reflective of the actual volatility, and therefore the risk to WaterNSW, in the current pricing period.

In addition, by including the cost of the revenue volatility in prices before the volatility occurs, this adds costs to WaterNSW customers before the risk is even realised, whereas the UOM addresses the impact of risk that has actually occurred. LVW considers that the volatility allowance is an inefficient means of managing the revenue risk.

Lachlan Valley Water opposes the reintroduction of the volatility allowance on the basis that it does not reflect actual volatility in the current pricing period, and supports the retention of the Unders and Over Mechanism.

9 Cost Shares

Lachlan Valley Water supports the NSW Irrigators Council submission that a separate review of the current cost share framework must be undertaken on the basis of the Frontier Economics Report.

Currently WaterNSW incurs costs for servicing users who do not pay for WaterNSW services. Under the impactor pays principles those whose activities generate the costs should bear such costs.

Consequently LVW also agrees with the NSW Irrigators Council submission that provisions must be made to capture all beneficiaries of WaterNSW's infrastructure and services who currently do not pay for those services.

We believe there have been significant changes in community standards and expectations over time, and as noted in our initial submission to IPART, when community standards require that services such as delivery of basic landholders rights or the delivery of water for environmental purposes are required, then the community standards should be considered as the impactor and those costs should form part of the Government share of costs.

LVW recommends that the cost share review must identify the costs of servicing impactors who currently do not pay for services, in particular basic landholder rights and the delivery of environmental contingency allowances, and that these costs are removed from the user share of the revenue requirement and instead attributed to the Government share.

10 Forecast entitlement and usage volumes

The 20 year moving average of actual, historical usage for MDB valleys incorporates the drought years of 2003-2010 and the impact of these years will remain in the forecast usage volumes for the next 10 years, leading to usage forecasts well below the long term modelled usage under IQQM and the usage allowed under the Water Sharing Plans.

Potentially this may result in a period where actual usage exceeds forecast usage volumes significantly, and there is significant over-recovery of revenue by WaterNSW.

LVW urges that IPART must be aware of this possibility and be prepared to review the usage volumes where actual usage consistently exceeds the forecast usage by a significant margin.

11 Tariff Structures

11.1 Fixed vs Variable Charges

Lachlan Valley Water notes that our response on this issue is specific only to the Lachlan.

While understanding the approach taken by IPART to adopt 40:60 pricing, LVW supports consideration of the 80:20 pricing ratio in the Lachlan Valley.

One of the drivers for our consideration of the 80:20 fixed to variable price structure is that the Lachlan is, in effect, still paying for the impact of past extreme variability in usage through the impact that a volatility allowance would have on prices.

Our position on 80:20 pricing is informed by our comparison between 40:60 pricing and 80:20 pricing at different usage profiles. We therefore request that WaterNSW be asked to provide the updated 80:20 prices incorporating IPART's changes to opex and capex to enable an updated comparison to be prepared.

LVW supports consideration of 80:20 fixed to variable price structure in the Lachlan.

IPART has sought comment on whether 100% of customers in a valley need to express written support for a change to an 80:20 fixed to variable price structure, or would a majority suffice. Also, whether it would be reasonable to apply 80:20 pricing if all of the Customer Service Committee members for the valley were in support, or whether majority support would be sufficient.

LVW considers that it is not realistic to expect 100% of customers anywhere to support any pricing proposal. When preparing our initial submission to IPART we advised our members of the proposed prices in both hard copy and electronic newsletters, and invited feedback, but had limited response. We presented the proposed prices at our 2016 AGM and received endorsement of our position in support of 80:20 pricing. However, we suggest that it may be difficult to get sufficient response from customers to provide majority support based on the number of customers unless 'voting' is compulsory.

We therefore propose that a manageable way to make such a decision would be via the Customer Service Committee (CSC), where members represent the valley as a whole and are well informed on the impact of prices, the long term average annual availability of water and the variability in supply.

LVW recommends that a majority decision by the CSC should be acceptable, particularly if the changes to the Customer Advisory Group (CAG) proposed in the draft Operating Licence for WaterNSW are accepted, as the membership of the CAG would change, and would incorporate members who do not represent paying customers.

LVW recommends it would be reasonable to apply an 80:20 fixed to variable price structure if there was majority support by the CSC.

LVW agrees that all customers in a valley would need to be informed of the potential change.

13 Miscellaneous Charges

13.1 Trade Processing Charge

Lachlan Valley Water supports the proposal to set a single, fixed charge for processing trades, rather than a two-part tariff.

13.2 ICD Rebates

LVW welcomes the retention of the ICD rebates on the basis that they accurately represent costs avoided for WaterNSW, and accepts that IPART has recalculated the avoided costs and determined higher rebates than those proposed by WaterNSW.