Lachlan Valley Water Inc
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Representing and Uniting Lachlan Valley Water Users

Submission to IPART

on WaterNSW Regulated Charges 2017 - 2021

October 2016

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[redacted]

EXECUTIVE SUMMARY

Notional Revenue Requirement

LVW considers that the proposed user share of the notional revenue requirement in relation to the capital components is excessive, and that WaterNSW's approach to calculating the capital component of the NRR does not allow an equitable user cost share.

LVW recommends that IPART 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.

Operating Expenditure and Scope for Further Efficiency Gains

LVW recommends that WaterNSW be required to provide greater detail on what costs are included in Customer Support, Compliance and Other, and to be explicit about the level of service that is to be provided as standard.

LVW supports maintaining the current standard of customer service by WaterNSW, and urges customer consultation in determining whether further efficiency gains are possible.

Capital Expenditure

LVW is unable to form a view on whether the capex program is prudent and efficient because of the lack of detail provided by WaterNSW. LVW is highly concerned at the proposed large increase in the user share of capital expenditure and the lack of information to justify that change.

LVW considers the capital maintenance allowance proposal is not an accurate way to provide for capital expenditure and does not support it being used to set prices.

LVW recommends that IPART should recalculate the WACC adopting a lower beta than 0.7.

LVW recommends IPART review WaterNSW's actual capex for 2014-2017 at the end of the March 2017 quarter and use that information as the basis for setting the opening Regulatory Asset Base (RAB) for the next regulatory period.

Irrigation Corporation Rebates

LVW supports the rebates on the basis that they represent avoided costs and recommends that WaterNSW be asked to provide information on the reduction in their operating costs to substantiate the change in the proposed level of rebate to Irrigation Corporations.

Revenue Volatility

LVW recommends that WaterNSW should be required to quantify the additional costs it faces as a result of revenue volatility.

LVW submits that water users should bear only the actual costs incurred by WaterNSW as a result of revenue volatility, rather than the cost of the risk transfer product.

Lachlan Valley water users would be willing to move to 80:20 pricing if the volatility allowance remains at its current level.

Other Charges

LVW recommends that meter reading charges should be recovered through a separate charge.

LVW believes WaterNSW's proposed environmental gauging station charges are reasonable.

SUBMISSION ON WATERNSW CHARGES - 2017 DETERMINATION

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 response in general, and provides additional responses on the issues from a Lachlan perspective.

We have addressed the key changes proposed in WaterNSW's application and the questions IPART has asked in its issues paper.

2. Notional Revenue Requirement

IPART has asked whether the proposed user share revenue requirement is appropriate.

For the Lachlan the total notional revenue requirement (NRR) over 2017 – 2021 is $44.2 million, of which the user share of revenue is $28.8 million, or 65% of total revenue required for this valley. While the proposed user share of the revenue requirement is lower in absolute terms, at $7.2 million/year average over 2017-2021, compared with $7.6 million/year average over the 2014-2017 determination, we are concerned that the percentage user share is an increase of 2% compared with the shares approved by ACCC for the 2014-2017 determination.

LVW welcomes the savings in operating expenditure that WaterNSW has already made and proposes for 2017 – 2021, and appreciates that these have flowed through to the revenue requirements. However, we are concerned that WaterNSW's proposed structural changes in the capital components of the revenue 'building block' will result in a higher user share for these components, and that both the absolute cost and the % share will continue to increase over time.

Table 1. Notional Revenue Requirement - Lachlan Valley, 2017 – 2021 ($000)

	Total Revenue		**Operating Expenditure**		**Return on Capital, Depreciation, UOM, Tax, ICD Rebates**	
	$'000	**% share**	**$'000**	**% share**	**$'000**	**% share**
User	28,803	65%	18,955	91%	9,848	42%
Government	15,420	35%	1,782	9%	13,638	58%
Total	**$44,223**		**$20,737**		**$23,486**	

2.1 Operating Expenditure

The operating expenditure (opex) comprises 47% of the notional revenue requirement and the user share of that is $18.96 million or 91%, which is a comparable share to previous determinations.

IPART has indicated it will review cost shares for this determination, although WaterNSW has stated that the review should be deferred until after the determination. LVW provides the following comments on reviewing the cost shares on the basis of impactor pays for service levels required by the wider community.

User shares – impactor pays
We propose that the user shares should be reassessed on the basis WaterNSW incurs costs for servicing users who currently do not pay for WaterNSW services. Under the impactor pays principles these whose activities generate the costs should bear such costs.

WaterNSW has two types of service users who currently do not pay

i. Environmental Contingency Allowances, which are volumes set aside for environmental requirements in accordance with the provisions of a Water Sharing Plan, and which require WaterNSW to undertake river flow assessments and operate structures in order to deliver the water, and
ii. Basic landholder rights, which is the right of landholders with a frontage to a body of water to take water without a licence for stock and domestic consumption.

We submit that both these users qualify as impactors because their requirements result in significant costs at times. For example, during severe drought such as was experienced in the Lachlan from 2003 – 2010, ensuring the delivery of water to basic rights holders required significant resources from State Water at that time both in managing the river and in communicating with landholders.

Where community standards require that services such as delivery of basic landholders rights be prioritised or that the delivery of water for environmental purposes is required, then we suggest the community standards are the impactor and those costs should form part of the Government share of costs. The water charging objectives of the Water Act 2007 include a requirement "to give effect to the principle of user-pays…"[1] and clearly these users of WaterNSW services are not paying for them.

LVW recommends that IPART 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.

2.2 Return on Capital, Depreciation, UOM Allowance, Tax and Rebates

The capital and other allowances component of the revenue requirement comprises 53% of the notional revenue requirement and the user share is $9.85 million or 42%, a 5% increase in the share compared with the previous determination.

LVW is concerned at this increase in the user share, in view of WaterNSW's proposed new approach to the provision for capital expenditure (capex) in the building block. WaterNSW's capex program over the next 4 years in the Lachlan totals $21.8 million, of which $19.7 million, is the user share. This compares with a total user share of capex for 2014-2017 of $6.5 million.

The new approach to capital expenditure and WaterNSW's proposal to use a capital maintenance allowance as the basis for calculating the return on capital will result in a significant increase in the user share of the notional revenue requirement which will continue to rise even further over time. We are also concerned that it is not clear from the information provided that this approach will result in efficient capital expenditure and will deliver value for users. Further explanation of our position is included in sections 4.1 and 4.2.

[1] Schedule 2, Part 2, Water Act 2007

LVW considers that the proposed user share of the notional revenue requirement in relation to the capital components is excessive, and that WaterNSW's approach to calculating the capital component of the NRR does not allow an equitable user cost share.

3. Operating Expenditure

IPART has asked for comment on the Operating expenditure (opex) in terms of:
- *prudency and efficiency*
- *what scope there is to achieve further efficiency gains*

3.1 Prudency and Efficiency

The proposed total opex in the Lachlan Valley over 2017 to 2021 averages $5.18 million/year, and is expected to reduce over the 4 years of the determination to $4.54 million in 2020/21, which would be 11.5% lower than the allowed opex for 2016/17[2] . We have found it difficult to compare the costs for the future pricing period with current costs because of differing bases of comparison and lack of valley-specific figures in the WaterNSW submission, but accept IPART's calculation that there is an 11.5% reduction.

We welcome the reduction in costs but are concerned that part of the savings achieved so far may have resulted through reduced customer levels of service. In the case of the Lachlan there are currently no Customer Service field staff based in this valley, with these services instead being provided by staff from the Macquarie or the Southern region. In the past LVW has expressed our concern at the withdrawal of the State Water presence and customer field staff from the valley and the resulting reduction in customer interaction. We also address this in section 3.2.

It is difficult to comment on the prudency and efficiency on a valley basis as WaterNSW has not provided a breakdown of the opex categories on a valley basis. On a statewide basis four major activities account for 71% of the opex:
- Routine Maintenance = 24%
- Customer Support, Compliance and Other = 18%
- Water Delivery and Other Operations = 17%
- Dam Safety Compliance = 13%

We expect that the allocation of costs to these categories would be similar on a valley basis and therefore wish to comment on the increase in the costs of Customer support, Compliance and Other. WaterNSW proposes an increase of approximately $1 million per year statewide on this category but it is not clear what services will increase in cost or what additional services will be provided, so it is difficult to form a view on whether the costs are prudent and efficient.

LVW recommends that WaterNSW be required to provide greater detail on what costs are included in Customer Support, Compliance and Other, and to be explicit about the level of service that is to be provided as standard.

3.2 Scope for Further Efficiency gains

WaterNSW has also flagged, both in this submission and in the review of their Operating Licence, that they intend to adopt a new customer level of service framework[3].

[2] Table 5.3, p 5, IPART Issues Paper, September 2016
[3] p93, WaterNSW Pricing Proposal to IPART, June 2016

We understand that there is a trade-off between level of service and cost, but our concern would be if WaterNSW were to propose a lower base level of customer service and that more of the services previously considered as standard may now be treated as additional or discretionary services for which an additional cost will be charged.   As noted in 3.1, many customers value the engagement with WaterNSW staff and see it as important part of the customer service.

LVW supports maintaining the current standard of customer service by WaterNSW, and urges customer consultation in determining whether further efficiency gains are possible.

4. Capital Expenditure

IPART has asked for comment on WaterNSW's forecast capital expenditure (capex) in terms of:

- *whether it is prudent and efficient*
- *whether the proposal for a capital maintenance allowance in addition to depreciation is reasonable*
- *what is an appropriate rate of return for WaterNSW assets*
- *is there any reason to depart from a straight-line depreciation method*
- *Are WaterNSW's proposed lives for new and existing assets appropriate*

4.1 Prudency and Efficiency of Capital Expenditure

It is impossible to comment on the prudency and efficiency of the forecast capex at a valley level because of the lack of valley-specific detail and the new approach taken by WaterNSW to capital expenditure. WaterNSW proposes a split of expenditure into four categories: maintaining capability, augmenting capability, new capability and regulatory compliance, instead of the previous practice of supplying an itemised capex program. WaterNSW has derived a total capex figure for each valley but has not provided information on the allocation of expenditure to each category on a valley basis. The table below shows proposed capex information for the Lachlan[4].

Table 2. Proposed Capital Expenditure, Lachlan Valley 2017 – 2021 ($'000)

	2017/18	2018/19	2019/20	2020/21	Total
User	5,802	5,547	4,566	3,843	19,759
Government	882	417	382	340	2,021
Total	**$6,685**	**$5,965**	**$4,948**	**$4,183**	**$21,780**

Note: numbers may not add due to rounding.

Maintaining capability is the largest expenditure category, accounting for 60% of capex statewide, but rather than identifying specific projects in this category WaterNSW proposes to adopt a capital allowance approach, with the calculation of the allowance based on WaterNSW's analysis of the value and condition of the assets in each valley, the risk associated with each asset and the cost of maintaining existing capability and meeting regulatory compliance requirements.

LVW is concerned about the lack of transparency and accountability in this approach. We understand that for smaller capital projects there is an advantage in the flexibility that a capital maintenance allowance would provide. However, for all larger projects which require detailed planning to deliver effectively we expect that WaterNSW would have a good knowledge of the condition of their assets and the expenditure required to maintain

[4] Tables 78, 79 and 80, p 82 – 84, WaterNSW Pricing Proposal to IPART, June 2016

capability, and that it would have identified the projects it expects to undertake during the pricing determination period. We believe this is a significant deficiency in the WaterNSW capex proposal, and it prevents an assessment of whether the expenditure is prudent and efficient. We submit that IPART should review WaterNSW's capex program in detail to determine whether the proposed expenditure levels are justified.

LVW is unable to form a view on whether the capex program is prudent and efficient because of the lack of detail provided by WaterNSW. However, we are highly concerned at the proposed large increase in the user share of capital expenditure and the lack of information to justify that change.

4.2 Proposed Capital Maintenance Allowance

Lachlan Valley Water opposes WaterNSW's proposal to introduce a capital maintenance allowance in addition to depreciation, not only because of the lack of transparency but because State Water, now WaterNSW, has a long history of under-spending on capex, and delays where the spending occurs much later than budgeted.

This occurred in the 2014-2017 pricing period, where capex was $20 million underspent in 2014/15 and is forecast to be $20.7 million underspent at 30/06/17. In their submission WaterNSW argue this was a result of ACCC approving only $111 million of the requested $196 million capex program for 2014 - 2017, necessitating a realignment of the capital program, which contributed to the underspend.

In reality, much of the non-allowed expenditure was for specific programs where new policy approaches were adopted after State Water lodged their initial submission, or where there was a specific reason not to approve the project. $38 million of the non-allowed expenditure was for Environmental Planning and Protection, and was excluded largely due to a review of policy regarding the proposed fish passage projects[5]. A further $14 million was due to pre-1997 dam safety projects being re-phased. When the allowed and actual capex[6] for 2014-2017 are reviewed, it is clear that the two categories that account for the underspending are environmental planning and protection and dam safety compliance for pre-1997 assets.

LVW does not believe it is correct that underfunding of the capital expenditure program is contributing to WaterNSW consuming assets[7] at a much faster rate than they are able to re-invest. We suggest that State Water's project management systems have not been able to support the proposed capex programs.

One of the concerns that customers have with chronic underspending is that the budgeted capital expenditure is added to the Regulatory Asset Base (RAB) in the year in which it is planned and a return on capital is charged from that time. This means that WaterNSW is receiving an unearned return on capital, until the next pricing determination when the RAB is adjusted for actual capital expenditure.

The capital allowance proposal therefore appears to us to be a methodology that will add to the existing problem of WaterNSW loading capex into the early years of a pricing determination but undertaking the projects during the latter years of the period, or deferring to the next period.

While we acknowledge there are benefits in the flexibility afforded by a capital maintenance allowance structure, LVW believes that these are outweighed by the disadvantages for

[5] P33, ACCC Final Decision on State Water Pricing Application 2014/15 – 2016/17, June 2014.
[6] Table 102, p 128, WaterNSW Pricing Proposal to IPART, June 2016
[7] P89, WaterNSW Pricing Proposal to IPART, June 2016

customers, particularly in view of the history of under-spending in the past, and WaterNSW's reluctance to address this issue in this determination.

LVW also considers there is a degree of double-dipping in WaterNSW's calculation of the capital maintenance allowance on the basis of an annual rate of consumption focused on depreciation[8], as well as calculating depreciation, which recognises the cost of using that asset during that period.

LVW considers the capital maintenance allowance proposal is not an accurate way to provide for capital expenditure and does not support it being used to set prices.

4.3 Rate of Return on Assets

The ACCC Pricing Principles require that the Weighted Average Cost of Capital (WACC) should be set at a level commensurate with the commercial risk of the business and should allow the business to recover its efficient costs.

We agree that WaterNSW needs long term financial sustainability, which includes being able to meet operating and maintenance costs, repay its debt and provide a return to owners. In view of the mechanisms that are already included in the pricing, and that WaterNSW has proposed to reduce the revenue volatility risk even further, we suggest that WaterNSW will have a significantly reduced revenue risk, and that the WACC should also be reduced.

Beta – WaterNSW proposes a beta of 0.7. LVW supports the NSW Irrigators Council submission that a lower beta value for WaterNSW's WACC calculation should be considered.

LVW recommends that IPART should recalculate the WACC adopting a lower beta than 0.7.

4.4 Depreciation Method

IPART has asked whether there are reasons to depart from the straight-line depreciation method for calculating regulatory depreciation.

LVW does not consider there is a reason to depart from the straight line methodology.

4.5 Regulatory Asset Base

Lachlan Valley Water also supports the NSWIC position on the roll forward of the Regulatory Asset Base, in view of the delays in spending capex. We recommend that IPART review WaterNSW's actual capex to date for 2014-2017 in the March 2017 quarter to determine their progress and use the capex to that date to set the actual opening Regulatory Asset Base (RAB) for the next regulatory period.

LVW recommends IPART review WaterNSW's actual capex for 2014-2017 at the end of the March 2017 quarter and use that information as the basis for setting the opening Regulatory Asset Base (RAB) for the next regulatory period.

LVW also supports the NSWIC request that IPART investigate WaterNSW's past capex and the rate of return on unspent capital that has been charged to their customers.

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[8] P89, WaterNSW Pricing Proposal to IPART, June 2016

5. Irrigation Corporation Discounts

IPART has asked whether Irrigation Corporations should receive rebates to reflect the avoided costs of the services they provide to their members and whether the levels of rebates proposed by WaterNSW are reasonable.

Irrigation Corporations receive rebates on the basis that WaterNSW avoids incurring costs for billing, metering and compliance for the Irrigation Corporation members, and because the monitoring of diversions by Corporations provides a system wide benefit to WaterNSW. The rebate is collected from other users and paid to the Corporation.

For 2017-2021 WaterNSW states that the value of the avoided costs has decreased because their operating costs have decreased, and consequently they propose to reduce the rebates. The proposed rebates for Jemalong Irrigation Ltd are:

Table 5. Jemalong Irrigation Ltd Proposed Rebates

	2016/17	2017/18	2018/19	2019/20	2020/21
Rebate	63,032	\$39,268	\$37,134	\$37,101	\$36,368

LVW supports the Irrigation Corporation rebates on the basis that they represent costs avoided for WaterNSW. The calculation of the avoided costs must be transparent and any proposed reduction in the rebate should be justified by WaterNSW providing information to substantiate the reduction in their costs for billing, metering and compliance activities.

LVW recommends that WaterNSW be asked to provide information on the reduction in their costs to substantiate the proposed level of rebate to Irrigation Corporations based on avoided costs.

6. Revenue Volatility

IPART has asked

- *Under current price structures, what measures should be used to manage risk to WaterNSW*
- *What implications should WaterNSWs proposed risk transfer product have for the UOM and the annual adjustment to prices*
- *Should water users pay for WaterNSW's purchase of a risk transfer product*
- *Would water users be willing to move to 80:20 if they saved the costs of a risk transfer product*

6.1 Measures for risk management

LVW suggests the first step is to quantify the level of risk faced by WaterNSW, then to consider appropriate management methods. WaterNSW maintains that the majority of its costs are fixed and that a cost reflective tariff would be close to 100% fixed. This infers that WaterNSW should be able to earn a level of revenue sufficient to pay a dividend to the business owners every year.

LVW accepts that WaterNSW is largely a fixed cost business in terms of operating costs but believes it is not an efficient pricing outcome that WaterNSW, as a monopoly business whose customers have no option but to use its services, should have a pricing structure than enables it to earn a profit and pay dividends to owners, regardless of how little water is delivered. We propose that efficient pricing should allow some equitable sharing of external risks between business owners and customers.

LVW also believes that WaterNSW over-states the financial risk of the 40:60 tariff structure and notes that 61% of total revenue in each year is guaranteed regardless of usage, due to the Government share of revenue and the 40% fixed charge component of the user share. If actual water usage fell to only 25% of planned usage, as it did in 2007/08 during the worst year of the drought, then WaterNSW would still receive 75% of their allowed revenue. Many of WaterNSW's customers would like to be in that position.

The Annual Reports for State Water and WaterNSW show that in 2013/14 State Water had revenue of $171.6 million, produced a net profit after tax of $42 million and paid a dividend of $24.3 million. In 2014/15 WaterNSW produced a net profit after tax of $25.5 million and paid a dividend of $20.3 million.

There is already significant risk management built into the pricing structure through the Unders and over Mechanism (UOM) which ensures that over time WaterNSW receives its total allowable revenue, plus interest on under-recoveries.

WaterNSW states that it may bear extra costs as a result of revenue volatility due to the additional interest margin (over and above the interest rate on the UOM balance) that it may be required to pay when it needs to borrow to cover a shortfall in revenue, and due to the additional interest margin that may be payable on a positive Under and Overs Mechanism (UOM) balance for an indeterminate time. However, it has made no attempt to quantify the costs that may be incurred. We suggest that the additional interest costs incurred would not be as expensive as the purchase of a risk transfer product.

We also submit that because of its geographical spread, WaterNSW has some internal capacity to manage risk because a shortfall in income in some valleys may be mitigated to some extent by higher usage and income from other valleys, meaning that the overall cost to the business of income volatility would be reduced.

LVW recommends that WaterNSW should be required to quantify the additional costs it faces as a result of revenue volatility.

6.2 Volatility Allowance and Risk Transfer Product

LVW believes that purchasing a risk transfer product to manage the revenue volatility risk is an expensive way to manage this and that WaterNSW is exercising their monopoly power by proposing a risk transfer product rather than considering other ways to manage risk. If WaterNSW chooses the most expensive method to manage risk, then LVW proposes that it should bear the additional cost of that product over and above the actual additional interest cost that would have been incurred.

We are also concerned that by including the cost of the revenue volatility in prices before the volatility occurs, WaterNSW is adding costs to its customers before the risk is even realised, whereas the UOM addresses the impact of risk that has eventuated.

LVW submits that water users should bear only the actual costs incurred by WaterNSW as a result of revenue volatility, rather than the cost of the risk transfer product.

6.3 Would water users be prepared to move to 80:20 pricing

Our comments on this section refer specifically to the Lachlan, because on this issue the Lachlan differs from most other valleys and from the NSWIC position.

The impact of WaterNSW's proposal to use a risk transfer product is that the volatility allowance is very high for the Lachlan. It accounts for 11.6% of user share of revenue, which is the highest of any valley in NSW, and more than twice the state average. We understand that this reflects the very large drop in usage that occurred in the Lachlan as a result of the 2002 – 2010 drought.

The cost of the volatility allowance strongly preferences the pricing in the Lachlan in favour of 80:20. The Lachlan has reached the decision to support the 80:20 pricing on the basis of the information provided by WaterNSW on proposed prices.

This is a very difficult decision because water users are also, rightly, concerned about the risk to their business viability of paying higher fixed charges during a repeat of a severe drought similar to 2002-2010 when they have no water and little income. However, the impact of the proposed volatility allowance is extreme. LVW has consulted members and received support for a move to 80:20 but it is also fair to say that views vary, depending on the usage profile of the user.

Should the volatility allowance not be approved at the levels requested by WaterNSW, water users in the Lachlan Valley may review their decision.

Lachlan Valley water users would be willing to move to 80:20 pricing if the volatility allowance remains at its current level.

7. <u>Form of regulation and price structures</u>

IPART has asked whether there is any reason to depart from the current approach to setting high security and general security entitlement charges.

Lachlan Valley Water supports the current approach to setting HS and GS charges. In view of the Lachlan experience during the 2002 – 2010 drought, when there several years with zero GS water availability we believe the proposed HS premium of 4.03 is an appropriate reflection of the relative availability.

IPART has raised the possibility of applying an Efficiency Carryover Mechanism to WaterNSW's charges.

LVW agrees the principle of an incentive to achieve efficiencies is sound but suggests that there should be greater sharing of the benefit of permanent cost efficiencies within a pricing period. LVW recommends that permanent cost decreases should be retained by the business for no more than 2 years, to find a balance between the incentive to achieve cost savings and the perverse incentive to delay them to the start of a new determination, if the retention period were 4 years as proposed.

8. <u>Other Charges</u>

8.1 Metering Service Charges

Should WaterNSW recover meter reading charges through a separate charge rather than being included in the bulk water charge.

DPI Water is developing a Water Take Measurement Strategy including a policy on cost-effective metering. WaterNSW has indicated this may result in different frequency of meter readings for different categories of users.

Lachlan Valley Water supports this approach and that meter reading charges should be recovered through a separate charge, which can be tailored to the number of meter reads performed per year.

LVW recommends that meter reading charges should be recovered through a separate charge.

8.2 Environmental Gauging Stations

IPART has asked whether WaterNSW's proposed environmental gauging station charge is reasonable.

LVW supports all licenced water users being required to meet the same standards for metering, particularly where large volumes of water are being used. WaterNSW proposes to upgrade gauging stations to enable accurate measurement of environmental water and LVW supports that action.

LVW believes WaterNSW's proposed environmental gauging station charges are reasonable.