SUBMISSION PAPER

Submission on

Review of Rural Water Cost Shares

WaterNSW & Water Administration Ministerial Corporation

Prepared for:

The Independent Pricing and Regulatory Tribunal

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PO Box 1657

DUBBO NSW 2830

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[redacted]

www.mrff.com.au

About MRFF

Macquarie River Food and Fibre is a non-profit, non-political organisation representing irrigated food and fibre producers in the Macquarie Valley. Our voluntary membership structure incorporates Water Access Licence holders in the Macquarie regulated river system and aquifer access licence holders in the Lower Macquarie Groundwater Sources. Based on current collection rates, MRFF represent 80% of the total volume of entitlement (excluding government owned licences) in the Macquarie system. MRFF is further supported by a number of associated local businesses and service providers.

MRFF is a member of the NSW Irrigators' Council and the National Irrigators' Council.

MRFF is represented on WaterNSW's Customer Service Committee for the Macquarie-Cudgegong and on the NSW Government's Macquarie-Cudgegong Environmental Flows Reference Group.

About this Submission

This is a formal submission in response to IPART's Review of Rural Water Cost Shares. MRFF commissioned Rod McInnes to prepare the submission and interpretation of the issues paper.

While this submission is provided on behalf of irrigated food and fibre producers in the Macquarie Valley our members reserve the right to provide individual submissions.

1. PURPOSE

1.1 Macquarie River Food and Fibre (MRFF) represents the interests of over 500 irrigated farming families in the Macquarie Valley in central west NSW and is supported by a number of associated local businesses and service providers.

1.2 MRFF has a vision for an efficient, productive and profitable irrigation industry in the Macquarie Valley. Key to achieving this vision is a secure regulatory framework, efficient management and equitable pricing for the region's water storage and delivery services.

1.3 In light of this, MRFF welcomes the opportunity to provide a submission on the Review of Rural Water Cost Shares to the Independent Pricing and Regulatory Tribunal (IPART).

1.4 MRFF understands and generally agrees with the submission that the NSW Irrigators' Council (NSWIC) makes to IPART. In summary, though we see benefits of the proposed service-level approach, particularly in respect to better transparency around environmental or flood mitigation impactors, we are cautious about adopting a new cost-sharing method, given the complexity involved. We are keen to ensure that the existing system is better understood and implemented, and that any change is justified by clear net benefits.

1.5 This submission has therefore been developed to further highlight those points we believe to be of particular importance to MRFF members and, where we can, to provide further information and detail relevant to the Macquarie Valley.

1.6 MRFF's submission is structured to provide:

- Our understanding of the principles of cost sharing and why cost shares matter in particular to Macquarie Valley irrigators;
- Strengths and weaknesses of IPART's proposed cost sharing approach;
- Comments on the implications for customers in the Macquarie Valley.
- Summary of recommendations.

2. COST SHARING PRINCIPLES

2.1 IPART has proposed in its Issues Paper to review the existing activity-based costs shares that are applied to rural bulk water pricing in NSW. Further, it is investigating a new service-based cost sharing methodology for allocating the irrigation system costs of WaterNSW and WAMC (the Water Administration Ministerial Corporation) between government and customers. Some government activities such as water monitoring are done for public policy reasons and would still take place even if there was no irrigation. It would be unfair to force irrigators to pay these costs, so there is a methodology to make sure that they are paid for by Government even though they may be activities that are not separately accounted-for for different types of customers.

2.2 The original decision to have cost shares was in 1998, but the actual cost shares were developed in 2001 by consulting firm ACIL Consulting using an impactor pays cost allocation system allocated at the activity level within the then existing integrated management accounting system. This costing methodology was accepted by IPART and despite a number of reviews by IPART and ACCC, this system has been used with only minor modification until today. The scope of this review assumes that the impactor pays methodology will be retained.

2.3 In the 2017 Rural Water Price Review WaterNSW proposed changing the cost shares. IPART responded by contracting consulting firm Frontier Economics to conduct a review of the cost sharing system. The NSWIC submission has more detail on the history of that and earlier reviews of the system.

2.4 In December 2016 IPART received a final report from Frontier Economics, recommending that IPART retain its impactor pays framework, but move to a costing system within that based on service-based costing rather that activity-based costing. Frontier Economics referred in its report to some comments on cost sharing from MRFF's submission to the WaterNSW Pricing Review.

2.5 Cost shares matter self-evidently to MRFF because they drive the cost impact on irrigators once total costs have been determined. They matter in particular to Macquarie Valley irrigators because Burrendong Dam is, arguably, designed for and used for significant flood mitigation which on the impactor pays principle, should reduce the share of total water utility and water resource management cost that Macquarie Valley irrigators bear. Frontier Economics recognises that there is logically a share of flood mitigation in its report (Frontier Economics, 2017, Pg. 70)

2.6 As such, MRFF wishes to comment on some of the above points identified by IPART in its Issues Paper.

2.7 Frontier Economics proposed some changes to definitions or interpretation that is relevant in principle to application of cost shares in the Macquarie Valley. IPART highlighted some of these on page 16 of the Issues Paper.

2.8 The first of these issues is that shared or common costs are allocated 100% to water customers under the current system. In the original accounting for cost shares, administration costs were reallocated across the activity cost groups (See ACIL Consulting, 2001, Pg. A4-8) using the integrated management accounts between the operator, regulator and resource manager functions using COAG standardised categories. This may not be the technique currently employed, but there is nothing to stop this happening in a transparent manner. Indeed, it's an increasingly important role for regulators in ensuring cost transparency, by for instance, ensuring that regulated utilities have management accounting systems in place that meet their regulatory obligations (eg. The Ofwat Regulatory accounts working group - RAWG in the UK). This is particularly important for valleys like Macquarie where there are multiple functions (flood mitigation, environmental management) occurring, and MRFF, given the relatively small number of businesses (c. 500), cannot have the resources to critique the particular allocation of costs either in the current (activity-based) or alternative (service-based) systems.

2.9 There are other issues listed such as dam-safety liabilities which are connected to the issue of dealing with legacy costs (Issue No. 2 on Pg 14 of IPART's Issues Paper). These will be dealt with in the next section.

3. STRENGTHS AND WEAKNESSES OF IPART'S PROPOSED APPROACH

3.1 Fundamentally, the economic justification of cost sharing that is being considered is unchanged. Despite arguments by NSWIC and MRFF that domestic water right users and others should share in costs as beneficiaries, the proposed cost share system continues to be based on impactor pays principle. This leads to beneficiaries being left out of the cost share while irrigators as the primary service from dam infrastructure and delivery services pay for these services and Government should bear a fair share of environmental and flood mitigation services provided from the dam.

3.2 The new approach from IPART is in the costing detail. The original methodology developed by ACIL in 2001 used activity costing available in the Land and Water Conservation and State Water accounting databases. The proposal is to lift the cost sharing allocation process to a higher level, by using the services that the dams and operators provide. For instance, irrigation and flood mitigation are services, made up of, in accounting terms of many activities. This is intuitively sensible, as it's at the service level that impacts are seen. Thus, overall, the approach has some intuitive strengths for customers in the Macquarie Valley.

3.3 However, the approach's key weakness is that it may be practically difficult, particularly without transparent co-operation from the service providers. We support NSWIC in seeking more justification before this is progressed.

3.4 In particular, there are weaknesses in the definitional details that MRFF, based on our experience in the Macquarie Valley, believes will require more attention. These issues are the definition of flood mitigation and environmental services and of legacy costs. These are covered in more detail in the following section from the viewpoint of Macquarie Valley customers.

4. IMPLICATIONS FOR MACQUARIE VALLEY CUSTOMERS

4.1 Starting with legacy costs, while we believe the principles being applied by Frontier Economics are correct, there is difficulty with their interpretation of what legacy costs currently include, which leads to a false conclusion. Frontier Economics, (2017, Pg. 16-17) critiques the ACCC Review of Cost Shares, stating that legacy costs should not include changes to regulatory standards. This is correct, in principle, but ignores the interaction with another component of legacy costs, the write-off of past inefficient expenditure. This is of importance for Macquarie Valley because of the multi-function nature of Burrendong Dam. A dam sized efficiently to meet irrigator needs would likely be very different with different costs.

4.2 ACIL Consulting in the original cost share review, did not deal with these legacy costs specifically, only stating that it thought their treatment by IPART's "line in the sand" was likely to be adequate. The issue arises however, as to whether future changes in regulatory standards would change the amount of "write-off", if you were to revisit the size of the contingent liability embedded in past inefficient investment decisions. ACIL Consulting did not have to assess this issue, since there was a clear IPART ruling through the "line in the sand" writing off of expenditure prior to 1997.

4.3 It's important to remember that the rural water system was built for social, not economic, reasons such as increasing immigration and population, decentralising settlement patterns and providing domestically grown produce across a broad range of commodities and seasons. Although the irrigation industry supports full cost recovery, the quantum of that full cost is arguable given the known inefficiencies in investment.

4.4 The quantum of that legacy cost is unclear in another sense. The program to meet changed dam safety standards for instance, was delayed for many years. IPART provided a chart in its Issues Paper for the most recent Bulk Water Price Review (Figure C.1 Trend in NSW Government's cost shares ($2010-11) (IPART, 2017, Pg. 151) which showed that the NSW Government's cost share as a total of WaterNSW's efficient costs had increased substantially since 2006-07. The reported conclusion was that this "primarily relates to WaterNSW's increased capital expenditure to undertake dam safety upgrades and related environmental measures". It's important to recognise that this may not be an indicator of future cost shares, let alone that this is inefficient. If these works had proceeded according to State Water's capital programs, the cost shares would have most likely have been flat or declining over time. The increase largely reflects a timing shift.

4.5 For a valley such as the Macquarie with an asset such as Burrendong Dam which is designed to serve a range of services not related to irrigation, it's most important that the treatment of legacy costs is rigorous if the "line in the sand" is relaxed. IPART does not suggest this, but Frontier says (Frontier Economics, 2016, Pg. 28):

- "… in our view assigning costs attributable to changes in standards to government would undermine the cost signalling intention of an impactor pays approach and is also inconsistent with general regulatory practice."

4.6 If the "line in the sand" is to be relaxed, particular attention needs to be taken to acquitting all agreed expenditure committed to by the Government under this arrangement, and to a proper assessment of the impact of the contingent liability caused by changes in regulatory standards on remaining asset value.

4.7 Again, IPART will have an important role in assuring a fair assessment of these issues is undertaken.

4.8 A major issue in the Macquarie Valley is environmental services. The valley contains the Macquarie Marshes system and there are significant environmental water allocations and management issues. The NSWIC and MRFF have stressed the importance of properly accounting for these environmental impactors on water costs and environmental management. In addition, the changes in the environment in the Macquarie Marshes are not due entirely to changes in water releases since development of the valley for irrigation. Environmental changes have occurred through grazing and vegetation clearing both within the marshes and elsewhere in the catchment.

To some extent, the dam may mitigate the upstream causes of these impacts. A holistic approach to this evaluation needs to be undertaken, without a simplistic view that all effects are due to water diversion.

4.9 A related issue is flood mitigation. We note that Frontier Economics quoted the ACCC Review of Cost Shares on this point:

- "In NSW, Burrendong Dam is the only dam of a material size which provides flood mitigation as a primary or secondary purpose. For the average or typical dam, flood mitigation is not an important service. " (Frontier Economics, 2016, Pg. 29) and later;
- "… the dam also has a significant flood mitigation role, in addition to irrigation and the provision of stock and domestic supplies, with almost one third (489,00 ML) of the dam's total storage capacity (1,678,000 ML) designated and operated solely for flood mitigation, and the remaining 1,189,000 ML designated for irrigation, stock, domestic and environmental purposes). " *ibid.* Pg. 70

4.10 MRFF asks that these functions be taken into account properly in the measurement of service, or through adjustments to the activity-share.

5. RECOMMENDATIONS

5.1 In conclusion, for MRFF the following are the key recommendations. The MRFF:

- Supports NSW Irrigators' Council views in their submission, and particularly;
- Does not support redefining of legacy costs and the line in the sand, unless a full revaluation of the contingent liability from inefficient investment is undertaken, including for impacts on forward regulatory costs such as dam safety;
- Supports a case for flood mitigation services for Burrendong Dam being better accounted for;
- Suggests that better evaluation of environmental impacts of water assets and operations is required;
- Suggests care be taken in assuming changes in actual cost shares imply anything more than underspends on capital programs.
- Warns of the risks with implementation of a new system in terms of transparency. IPART has a key role in ensuring that the regulated bodies have adequate management accounting systems for tagging and recognising costs for input to any cost share model; and
- Continues MRFF's long term advocacy on these issues for its members.

References:

ACIL Consulting, 2001, Review of Water Resource Management Expenditure in the NSW Department of Land and Water Conservation and State Water Business: A Report to IPART, 31 July. http://www.ipart.nsw.gov.au:80/pdf/ACIL_Main.pdf & ACIL_Attachments.pdf Accessed 14th November 2001 via http://www.ipart.nsw.gov.au/whatsnew.htm.

Frontier Economics, 2016, *Review of WaterNSW Cost Shares*, December, Melbourne.

IPART, 2017, WaterNSW: Review of prices for rural bulk water services from 1 July 2017 to 30 June 2021, June.

6. APPENDIX: RESPONSE TO IPART ISSUES PAPER QUESTIONS

1. *Do you agree that Water NSW and WAMC's costs should be allocated between water customers and the Government (on behalf of the broader community) using the impactor pays principle – i.e. those that create the need for the cost to be incurred should pay the cost.*

MRFF strongly supports the continuation of a cost share framework which allocates WaterNSW's and WAMC's costs between water customers and the NSW Government. For why this is especially important in the Macquarie Valley, see Section 4 above.

On the topic of the 'impactor pays' vs. 'beneficiary pays' principle, see the NSWIC submission.

2. *Do you agree that the NSW Government's share of WaterNSW and WAMC's regulated costs should be limited to where:*

- there are genuine legacy costs and/or

- is not practical or cost-effective to recover costs from other users?

MRFF, in supporting NSWIC's view that there needs to be a more sophisticated approach to legacy costs. Specific suggestions are provided in Section 4, namely to value contingent liabilities created by past inefficient investments for new regulation.

3. *Do you agree with the current cost share ratios? Should the list of activities and/or cost share ratios be amended? If so, how and why?*

In supporting NSWIC's suggestion that IPART review the cost databases being used by the participating utility and regulators, MRFF made specific suggestions for improvement, such as overseas regulatory accounting consultation bodies.

4. *Do you agree with the issues identified with the current cost sharing framework?*

MRFF suggests that in assessing impactors, that particular examples of environmental impacts can be case studied in the Macquarie Valley, and address this in principle above.

5. *Are there any other issues with the current sharing framework that should be considered in this review?*

See above.

6. *Do you agree with our proposed approach to reviewing the current cost sharing framework?*

MRFF have provided suggestions for improvement, particularly with regard to auditing the management accounting tools used, and ensuring that the consistency of the original Acil Consulting regime is confirmed across operators, regulators and resource managers.

7. *What are the potential challenges and barriers to moving to a service-based approach?*

Transparency is the key, as noted above in suggestions for accounting and evaluation improvements.

8. *What are the benefits of moving to a service-based approach?*

MRFF does see theoretical benefits for a valley where other services are significant, but we share NSWIC's concerns about practical implementation.

9. *Are the benefits of moving to a service-based approach likely to exceed the cost?*

See NSWIC's suggestion that the answer to this question depends on the assessment of Questions 7 and 8.

10. *Would there be merit in transitioning to the service-based approach over time?*

See NSWIC response. Not addressed above.

11. *Are there alternative cost sharing frameworks that could better achieve our objectives or could achieve them at lower costs? If so, how would they operate?*

Please refer to NSWIC's answer to question

12. *Is there any other information we should consider in our review and assessment of the current activity- based cost sharing approach.*

MRFF suggested above that a better understanding of the detailed implementation of the original ACIL Consulting model, particularly accounting aspects and consistency across agencies will be valuable with either approach.