Submission to IPART's draft review of prices for rural bulk water services (2017 - 2021 determination period)

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NSW Farmers' Association Background
The NSW Farmers' Association (the Association) is Australia's largest State farmer organisation representing the interests of its farmer members – ranging from broad acre, Livestock, wool and grain producers, to more specialised producers in the horticulture, dairy, egg, poultry, pork, oyster and goat industries.

TABLE OF CONTENTS

TABLE OF CONTENTS ... 2
Executive Summary ... 3
1. WaterNSW's budgeted v actual capital expenditure ... 4
2. Operational expenditure & incentives for further efficiencies ... 4
3. The Murray Darling Basin Authority charges ... 5
4. Government and customer share of revenue requirements ... 6
5. Volatility risk and WaterNSW's cost/price structure ... 7
6. Full cost recovery in the Peel and North & South Coasts ... 7
7. Regulatory asset base in the Peel and North & South Coasts ... 8

Executive Summary

The New South Wales Farmers Association (NSWFA) welcomes the opportunity to provide comment on the draft IPART report on the *Review of prices for rural bulk water services from 1 July 2017 to 30 June 2021*. We support IPART's moderation of WaterNSW's proposal, particularly with respect to overall capital expenditure, and note that usage charges in most valleys have either decreased or stayed below forecast inflation over the determination period. We also welcome IPART's recommendation that the push towards full cost recovery be abandoned in the North and South Coast valleys. This is a win for common-sense.

The NSWFA holds significant concerns with the determination process. The current water market arrangements have seen a rise of more than 250% in water usage charges for high security permit holders in the Peel since 2009, leaving them with the highest usage charges in the state (larger users paying in excess of $90000 p.a.). These increases have been justified by expounding the virtues of a market mechanism and the need for full cost recovery, despite the fact that the exorbitant charges are driving out users and jeopardising the viability of the water market in the region.

Similarly, usage charges for some customers in the Murray Valley have doubled over the two determination periods, in large part due to the passing of the Murray Darling Basin Authority (MDBA) charges onto users. This cost pass through contradicts the 'impactor pays' market principle, given the predominantly ecological and socioeconomic purpose of the MDBA charge. This would suggest that increases in water charges have not been a result of the invisible hand of the market, but deliberate changes to public policy settings.

The NSWFA specific concerns include:

- passing on the bulk of the MDBA/BRC charges to users;
- lack of confidence in the review of WaterNSW's capital expenditure and regulatory asset base;
- the lack of clarity around the apportionment of costs between the NSW Government and users;
- the tendency towards overcompensation of WaterNSW for perceived costs around volatility and passing these perceived costs to users;
- the need to recognise the unviability of full cost recovery in the Peel Valley to ensure that the productive capacity of the region is not further damaged; and
- the inappropriate and bloated regulatory asset base (RAB) in the Peel, North Coast and South Coast valleys, that is increasing usage charges, incentivising users to exit the market, and jeopardising the existence of a functioning water market in the region.

The NSWFA recommends that:

- the NSW Government pay the bulk of the MDBA/BRC charges in accordance with IPART's 'impactor pay principle' and in recognition that the charges are predominantly for ecological and socioeconomic purposes;
- IPART undertake a comprehensive review of the apportionment of revenue requirements between Government and users that specifically addresses why and how MDBA/BRC charges should be apportioned, and the viability of full cost recovery principles in valleys with a diminishing user base;
- IPART move away from full cost recovery in the Peel Valley, in line with the recommendation and reasoning given for the abandonment of full cost recovery in the North and South Coast valleys;
- an allowance not be provided to WaterNSW for volatility risk, given the additional revenues afforded to it via a market risk premium;

- that further incentives not be provided to WaterNSW to promote efficiencies; and
- as a matter of urgency, IPART undertake a review of the viability of the Peel, North and South Coast valleys to more closely align water prices to capacity to pay, recognising the impact of previous price determination in shrinking the user base.

The NSWFA further supports the submission put forward by the NSW Irrigators' Council.

1. WaterNSW's budgeted v actual capital expenditure

NSWFA members hold significant concerns around the process of reviewing and validating WaterNSW's budgeted capital expenditure. Members have raised specific concerns around whether Aither Consulting had, or was able to, gather all information available to determine the prudence and efficiency of WaterNSW budgeted capital expenditure.

WaterNSW's actual capital expenditure is some $30 million below the amount budgeted for in the previous determination process. While this underspend is supposedly returned in future determination processes, WaterNSW has consistently underspent across various determination processes. This creates a financial benefit for WaterNSW and an opportunity cost for users, where the $30 million could have generated $1.47 million p.a. for users[1]. The determination process should have more rigour around aligning WaterNSW's budgeted capital expenditure with actual expenditure or return the $1.47 million p.a. to users.

Given the maturity of the water market and pricing determination process, we are concerned that capital expenditure, and it's prudence and efficiency, is still largely determined via theoretical calculations.

Members have also expressed their frustration around the transparency and accountability of WaterNSW for the delivery of projects. The specific example given is the significant under-delivery of proposed metering infrastructure for the Southern Basin Metering project while still passing on the cost of the full project to users. Members have noted that it is not the role of users to carry the financial burden of poorly scoped and delivered projects.

2. Operational expenditure & incentives for further efficiencies

NSWFA opposes any further incentives that supposedly incentivise WaterNSW to undertake cost efficiency measures in relation to its operational expenditure. As a matter of principle, WaterNSW should be doing this as a core business activity. If WaterNSW has not been doing this, then it puts the whole determination process into question.

It should also be noted that over the previous determination period, the difference between WaterNSW's budgeted and actual spend was $21.7 million. This is more than enough incentive to promote efficiencies. In other regulated markets, such as electricity, the regulator generally makes arrangement that some of the benefits of this underspend is shared with customers.

[1] Based on a rate of return of 4.9%

3. The Murray Darling Basin Authority charges

NSWFA members are concerned at the significant price increases in the bulk water charges by valleys affected by the MDBA/BRC charges. As an example high security holders in the Murray Valley will see a 35.5% increase in their charges over the determination period, equating to a $4000 p.a. increase in charges for farmers with larger water entitlements. This price increase comes on top of the 35-45% price increase in the previous price determination period. Over the two determination periods the cost of water will double from around $8200 to around $15500 for larger high security water users. Most of this increase can be attributed to the MDBA charges.

The pass through of the MDBA/BRC charges to customers undermines the impactor pays principle governing the water market, and distorts price signals within the water market. The fixed nature of the proposed cost recovery of the charges amplifies and exaggerates this market distortion. As such, it is incumbent on the NSW Government to cover the majority of these charges.

In its draft determination, IPART states that a guiding principle for apportioning costs between customers and the NSW Government is the impactor pays principle: "*those that create the need to incur the costs should pay the costs"*. This suggests that costs created for wider community benefits, such as preserving the environment or promoting socioeconomic development, should not be part of the market determination of prices and be borne by the Government on behalf of the wider community.

Clearly the MDBA charges' predominant purpose is ecological and socioeconomic, and thus incumbent on the NSW Government to cover. Section three of *The Water Act 2007 (Cth),* dealing with the objectives of the Murray Darling basin Authority, states that the purpose of the Act is:

"(i) to ensure the return to environmentally sustainable levels of extraction for water resources that are overallocated or overused; and

(ii) to protect, restore and provide for the ecological values and ecosystem services of the Murray‑Darling Basin (taking into account, in particular, the impact that the taking of water has on the watercourses, lakes, wetlands, ground water and water‑dependent ecosystems that are part of the Basin water resources and on associated biodiversity)"

Other states, such as South Australia, do not place the burden of MDBA charges onto bulk water users alone. In NSW, not only have farmers been forced by the MDBA Plan to significantly reduce the amount of water they use, but are being asked to pay for the mechanism that restricts their water usage.

This situation is unfair on NSW farmers and creates a myriad of unintended consequences that undermines the water market mechanism and the efficacy of price signals within this market. It creates an incentive to sell water rights above and beyond what is economically efficient, by amplifying the impact of price signals when the price of water and water permits are high. During such periods permit holders are not only incentivised to sell their water allocation through higher market prices, but also through the ability to avoid the significant charges associated with the MDBA. This is not the purpose of the MDBA charges.

The fixed nature of the MDBA/BRC charge further contributes to the distortion of price signals, as the cost is incurred by permit holders regardless of usage.

The NSWFA seeks that at a minimum IPART apportion MDBA costs between users and Government at a 60:40 ratio (as opposed to the 80:20), which is more in line with the impactor pay principle.

Transparency around the MDBA charges

NSWFA members are also deeply concerned around the lack of transparency in how MDBA charges have been applied to the affected valleys, and whether the investments necessitating these charges are efficient and necessary. Given the long-term nature of the determination, IPART must make more effort to review these charges and communicate the underpinnings for the charges to users as a part of this process.

4. Government and customer share of revenue requirements

Any changes to the share of revenue extracted from customers will have significant impact on water users. Every 1% of the notional revenue requirements attributed to users will increase their cost by $4.26 million over the determination period. We note that a review of cost allocations were due prior to this determination period, and are concerned at the delay in this review, particularly as the user share of costs has risen from 60% to 67% over two determination periods. This translates into an additional $30 million that users are expected to pay over the determination period.

The NSWFA recommends that any extensive review of the cost share framework should be all-encompassing and specifically include reference to:

- apportionment of MDBA/BRC charges between the NSW Government and users (see section 1 for more details); and
- the need for Government contribution where viability of the full cost recovery is not viable , particularly in the Peel, North Coast and South Coast valleys.

NSWFA members have raised specific concerns around irrigators picking up the bulk of costs regardless of the impact of the investment. The farming community has been told of the virtues and necessity of a market system for water, particularly in justifying the continuing regime of sizeable increases in usage charges. At the same time farmers are being asked to arbitrarily pick-up the bill for exceptions that betray these principles (such as the abandonment of impactor pay principle for the recovery of the MDBA/BRC charges). It is the role of the Government to facilitate and fund activities that fall outside of market considerations or address market failure.

It is this ad-hoc approach that has seen water usage prices in the Peel Valley increase by more than 250% in less than six years, with larger water users having to pay in excess of $90000 p.a. for water, putting further pressure on the diminishing user base within the region.

5. Volatility risk and WaterNSW's cost/price structure

The NSWFA believes that the draft determination overemphasises the impact and need to compensate WaterNSW for risks associated with volatility relating to forecasting, and the mismatch between the fixed nature of WaterNSW's costs and the variable nature of usage/revenues. As such we do not believe there is any need or reason for a volatility allowance that is to be paid for by customers, nor do we believe that this allowance is inherently superior in handling these risks compared to the unders and over mechanism (UOM) that IPART has sought to dismantle.

The mismatch between the fixed nature of WaterNSW's cost structure and the variable nature of usage/revenues is not an argument for further allowances for risk. This mismatch is common in many competitive markets, and where it arises, prices tend towards marginal cost (i.e. prices go down), they are not a justification for a price premium. Furthermore, it is not the role of IPART to ensure that WaterNSW a risk-free

NSW Farmers questions whether WaterNSW actually has highly variable revenue structures, with more than 70% of WaterNSW's revenues being fixed. Furthermore, claims of a fixed cost structure is highly dubious. WaterNSW has significantly underspent its capital and operational budget, a combined $51.7 million, around 11% of WaterNSW's NRR. This suggests that WaterNSW has significant leeway around costs and expenditures.

The generous compensation for risk afforded to WaterNSW is further highlighted by its high actual return on assets (ROA)[2] compared to other regulated monopoly infrastructure, such as rail infrastructure[3]. Presumably this difference arises from the different risk profiles of the two markets, given that the methodologies for revenues are largely the same.

In any case, NSWFA believes that a UOM better reflects the cost of this volatility, acknowledging that the volatility risk can be a cost and a source of additional revenue. WaterNSW's arguments around the inability to secure market returns for investing these additional revenues will only have a marginal bearing on the discussion around the merits of a UOM.

6. Full cost recovery in the Peel and North & South Coasts

The NSWFA welcomes IPART's determination to move away from a full cost recovery model for the North and South Coast Valleys. The North Coast and South Coast valleys are already paying some of the highest charges for their water in the state at $59958 and $66272 respectively (for larger high security water users).

Currently, cost recovery in the North Coast Valley stands at 12% and 45% for the South Coast Valley. At full cost recovery, larger high security water users would pay $499000 and $147000 in each respective valley in usage charges. IPART has correctly identified that full cost recovery is unviable in these valleys. NSWFA recommends that the NSW Government explicitly abandon the policy imperative for full cost recovery in the North Coast and South Coast valleys.

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[2] WaterNSW's ROA was 5.12% based on their 2015-16 Annual Report

[3] ARTC's ROA was 2.43% based on their 2015-16 Annual Report

It should be noted that these valley water markets are in danger of failure, due to the self-perpetuating problem of increasing water prices that drive users out of these valleys, which in turn increases water prices for remaining users. Remaining users do not have the luxury of waiting another four years for a policy response on this matter.

The NSWFA further recommends that the principles applied in the North and South Coast valleys also be applied to the Peel Valley, who pay the highest usage charges in the state. Inappropriate usage charges and a bloated RAB, has contributed to the thinning out of the user base in the valley, and will continue to drive users out of the Peel unless water usage charges are aligned to the customer's capacity to pay. This is essentially a failed market, and is putting into risk any productive activity within the region.

Any determination should make it clear that the shortfall in revenue from abandoning full cost recovery in these valleys be covered by the Government not other bulk water users within the system.

Other alternatives include changing the boundaries of these valleys to increase the user base to more evenly spread the significant infrastructure costs. However, this option is not without its economic and political challenges.

7. Regulatory asset base in the Peel and North & South Coasts

Even with IPART's concession around the unworkability of full cost recovery, usage charges in these valleys are making productive activity in the region unviable. The high usage charges in these valleys has contributed to the reduction in the user base, increasing the burden of paying for water infrastructure on remaining users, which in turn further reduces the user base.

This clearly points to a significant mismatch between the user base and the determination of what is a viable regulatory asset base within these valleys. In its draft determination IPART states that:

"*The low level of extractions relative to the volume of entitlements suggests there is a significant under-utilisation of entitlements by licence holders in the North Coast valley in particular"*

Under market competitive conditions, when there is an oversupply the usual response is a price decrease and/or a reduction in investment on maintaining future capacity. It is incumbent on WaterNSW and IPART to review the appropriateness of the existing regulatory asset base, particularly for the Peel Valley, and write down or write off assets that do not contribute to the efficient and appropriate provision of water to existing users now and into the future. As a part of this process, adequate compensation should be provided to entitlement holders (in consultation with users) that may be affected.

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