



# **Submission to the Independent Pricing and Regulatory Tribunal**

Review of Rural Water Cost Shares Issues Paper



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## 1. Introduction

This document is WaterNSW's submission to the Independent Regulatory and Pricing Tribunal's (IPART) Review of Rural Water Cost Shares Issue Paper, April 2018 ("the Issues Paper").

Under the current regulatory framework, WaterNSW's revenue requirement is met through both customer charges and through "Government" share which represents the balance of the requirement between the total and customer charges<sup>1</sup>.

Under WaterNSW's 2017-2021 Rural Valleys Determination, of the \$411 million revenue requirement over the four years of the Determination, \$276 million or approximately 67% is paid for by water users and 33% by Government.

Under the WAMC 2016-2020 Determination, of the \$229 million revenue requirement over the four years of the Determination, \$166 million or approximately 72% is paid for by water users and 28% is paid for by Government.

If the cost share is amended as between customer and the Government, WaterNSW will still receive its entire revenue requirement. In this sense, WaterNSW is revenue agnostic to the outcomes of this review.

However, WaterNSW is concerned to see that our customers are properly advised and consulted on the rationale and determination of the cost shares and any potential changes arising from this review. Engaging with customers on cost share outcomes and providing our customers with a sound, rationale basis for the cost shares which is firmly based on the factual circumstances of our assets and operations is important to ensure customers receive confidence:

- that they are not paying for services provided to others; and
- in transparency of the calculation of their charges.

As such, our involvement in this review is to ensure that we continue to provide services to our customers which are relevant to them, as reflected in their IPART determined charges. We are also concerned to ensure that any changes to the shares are introduced in such a way as to avoid bill shocks to our customers.

The following sets out our responses to the questions raised by IPART in the Issues Paper.

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<sup>1</sup> And any Customer Service Obligation payment, representing the customer share which cannot be met by customers.

## 2. Cost sharing principles

- 1 Do you agree that WaterNSW and WAMC's costs should be allocated between water customers and the Government (on behalf of the broader community) using the impactor pays principle – ie, those that create the need for the cost to be incurred should pay the cost?**

The majority of WaterNSW assets in the Rural Valley Determination are pre “line in the sand” assets. All major (and nearly all minor) structures were built pre-1997. Therefore, in applying the impactor pays approach, it is important that it is firmly based on the legacy nature of the assets which were constructed by the NSW Government.

It is important in this context to make a distinction between “*creating the need for the cost to be incurred*” and “*creating the cost to generate a need*”. The NSW Government built WaterNSW's dams and associated infrastructure for a number of purposes such as securing urban drinking water, stock and domestic and irrigation water supply, as well as in some instances for flood mitigation. In many locations, there was no pre-existing irrigation industry of the scale facilitated by the infrastructure. In many instances, the NSW Government created the infrastructure with the aim of encouraging economic development, specifically with regard to attracting the irrigation industry to a region. This subsequent “industry” are now “takers” of an infrastructure solution. This infrastructure, due to its scale and long asset lives, has constraints on adaptability (e.g. a dam cannot be moved to another location on the river and cannot be easily augmented without significant capital investment). Further, to meet current dam safety and environmental standards significant capital and operating expenses may be required. This pull and push between creating the need and the cost and the legacy role of the NSW Government in the initial establishment of the assets needs to be acknowledged.

In this context, we are generally supportive of Figure 4.3 “Illustrative example for defining legacy costs”, at page 23 of the Issues Paper, noting that this does not provide a solution for all practical examples. For example, the second example in respect of dam safety guidelines is not clear whether the dam in question is a new dam or a pre-existing dam. In our view, the conclusion would be different if the dam is a pre line-in-the-sand asset (which applies to the majority of our structures) rather than a newly constructed asset.

Once a dam is constructed, it must continue to meet current dam safety requirements, whether it is used or not (the only exception would be a full decommissioning of the asset as a dam). Therefore, where a pre-existing dam needs to be rectified to bring it up to current dam safety standards, this is a legacy cost and, according to the logic applied in the example with respect to environmental damage, these costs should not be recovered from current and future users.

Overall, it may be that the impactor pays approach is overall ill-suited to determining the cost share issue for regulatory driven expenditure on WaterNSW's pre line-in-the-sand assets and in these circumstances the beneficiary pays approach may be more appropriate. This approach is consistent with IPART's hierarchy in its *Review of funding framework for Local Land Services NSW, Draft Report, September 2013*:

- *Where identifiable, the party causing the adverse impact to which the activity is directed should fund that activity (i.e. the ‘impactor pays’ approach);*
- *Where there is no adverse impact being addressed, or whether the impactors are too difficult to charge, then those benefitting from the activity should pay (i.e. the ‘beneficiary pays’ principle); and*
- *As a last resort, where clearly identifying the impactor or beneficiary is too difficult or where it is administratively inefficient to charge either party, the taxpayer should fund the activity.*

**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 (ie, costs that are unavoidable regardless of the ongoing provision of services to current and future customers), and/or**
- it is not practical or cost-effective to recover costs from other users (ie, impactors other than water customers subject to regulated prices)?**

This logic does not take into account where the Government is also a “customer” or beneficiary (on behalf of communities) of the services. This is a major feature of the operation of our rural dams and is likely unique in the consideration of the allocation of costs between users and Government.

In addition to but separate from the Government being “the customer” in respect of community benefit obtained from WaterNSW's assets and services, both the Commonwealth and NSW Government are large holders of Water Access Licences (WALs) (together, environmental water holders). As such, they have specific requirements with respect to the ordering of water for environmental purposes.

Providing water for environmental purposes is also embedded within the operation of the Water Sharing Plans (WSPs). Between these two mechanisms, the WSPs and through their WALs, the environmental water holders are able have a significant impact on the operation of our structures.

In our view, a review should be conducted on a valley by valley basis to determine to cost impact on our operations and capital requirements between provisions in the WSPs which facilitate environmental flows, servicing environmental WAL holders, servicing other WAL holders and community benefit.

We provide further thoughts on the allocation of environmental costs in response to question 4 below.

### 3. Current cost sharing framework

#### 3 Do you agree with the current cost share ratios (listed in Appendix C)? Should the list of activities and/or cost share ratios be amended? If so, how and why?

The purpose of the review is to determine the outcome of the current cost share ratios. Therefore, we do not feel it is appropriate to make comment on this at this time, noting we believe there is a need for appropriate consultation with customers and, depending on the outcome, a transition to an alternative methodology.

However, we note that the activity group categorisations for the WAMC determination are very granular. WaterNSW will be seeking to streamline the categorisation for the services we deliver which are relevant to the WAMC Determination. This would enable us to introduce simplicity and reduce unnecessary complexity and associated cost and inefficiency from the business. This will also assist our customers to better understand the cost drivers in providing our services. The granularity does not enable this to easily occur at present.

If there are variances in the Government:User cost share between the W-Code sub-groupings, it will inhibit us from being able to introduce this simplicity and associated benefits. Therefore, we strongly urge that there be only one Government:User share for each high level W-Code under the WAMC Determination unless there are compelling reasons otherwise.

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

At page 16, IPART highlights four issues Frontier Economics identified in its 2016 Review of WaterNSW Cost Shares, December 2016 ("**Frontier Report**"). We provide our views on each of the issues below.

##### **Shared or common costs**

The Frontier Report notes that 100 per cent of these costs are currently allocated to water customers even though there may be other users or impactors. This is not correct. Our common costs are allocated across projects which include those to which Government share is applicable.

##### **Dam Safety compliance costs**

- ***Flood mitigation and flood management***

The Frontier Report states that some of our dam safety costs may be driven by flood mitigation services to the broader community. In this respect it is important to distinguish between flood mitigation and flood management.

Only two of our rural dams have a specific flood mitigation purpose (Burrendong and Glenbawn). This means that they have additional capacity to store water in times of flood. However, all our rural dams can be and are managed during times of flood in such a way as to reduce impacts on downstream communities (flood management). Although flood events may only occur sporadically in response to adverse weather conditions, WaterNSW infrastructure and dam operators need to be continuously prepared for their eventuality.

Currently, the cost shares provide for operational and capital expenditure for flood operations to be shared 50:50 between Government and users.

It would be appropriate to determine on a valley by valley basis the appropriate share of capital and operating costs to be allocated to flood mitigation and flood management, to enable sharing of costs between extractive users and flood mitigation/management users/communities.

- ***Pre-1997 dam safety obligations***

WaterNSW has ongoing pre-1997 dam safety obligations, which require significant capital expenditure on certain structures. However, the quantum of the residual of these obligations can be estimated through to their exhaustion, noting that the new dam safety legislation, the Dam Safety Act 2015 (NSW), is yet to become operative.

IPART should carefully examine the history of the line in sand write down of WaterNSW's assets and the amount users were expected to fund in relation to pre-1997 dam safety obligations<sup>2</sup>. We query whether re-opening an issue in respect of which both customers and Government have had a long-standing understanding is appropriate at this stage of the cycle of these obligations.

More broadly, our observations on post-1997 dam safety obligations below are relevant to pre-1997 dam safety obligations.

- **Post-1997 dam safety obligations**

As noted in our response to question 1, above, we see that ongoing dam safety obligations may be a legacy cost issue. Upon construction a dam must continue to meet current dam safety requirements, whether it is used or not. Therefore, where a pre-existing dam needs to be rectified to bring it up to current dam safety standards, could be a legacy cost issue.

Another feature of dam safety, in addition to evolving regulatory requirements, are the parameters against which those regulatory requirements are measured. For example, certain measures must be implemented based on the possibility of harm to a certain number of people located downstream of the dam. If, over time, more people are located downstream of the dam, then an additional requirements and costs arise. In this sense, users of dam do not create the need for the cost to be incurred. Instead, the people creating residences downstream of the dam have created the need for the cost to be incurred. Alternatively, it can be said Governmental authorities who provided planning permission for those residences to be located downstream of the dam created the need for the cost to be incurred.

Another example of parameters against which dam safety requirements are measured are the likelihood of extreme weather events. If changing climate modelling determines greater consequences for extreme weather events, then additional dam safety requirements will need to be added to the existing structures. This exogenous impact on the dam creates the need for the cost to be incurred, rather than just the regulation itself.

Further dam safety costs are incurred by WaterNSW through emergency preparedness requirements. These requirements are aimed at protecting the communities who live in the areas that are potentially inundated due to dam failure.

### **Work, Health and Safety (WH&S)**

WH&S practices are integral to the safe operating environment of our infrastructure.

From an operating cost perspective, we are required, and think it is vitally important, to carry out our operations in strict compliance with WH&S requirements. We do not see these costs as separate from our operating costs. Working safely is the way in which we operate our infrastructure and, as such, these costs should be allocated between users and Government in a way that is consistent with the underlying share of the activity in question.

However, due to the legacy nature of our assets, to bring these assets up to modern WH&S requirements, capital expenditure is required. In some cases this will be significant. In many cases, this expenditure has to be carried out whether or not the assets are used to supply services to end users. Just having assets in situ requires them to be accessed, inspected and monitored, which all must be done in a safe environment. Even the cost of decommissioning an asset may exceed the costs of upgrading it to modern WH&S requirements.

### **Environmental Planning and Protection**

We understand from our customers that provision of services to the environmental water holders is a major concern in relation to cost shares, that is, that they are paying for services provided to the environmental water holders. As such, whether these costs should be paid for by Government or extractive users or environmental users is a major issue for this review. As noted in response to question 2 above, we consider that a review should be conducted on a valley by valley basis to determine the cost impact on our operations and capital requirements between provisions in the WSPs which facilitate environmental flows, servicing environmental

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<sup>2</sup> That is, why users are not bearing the costs of these obligations.



WAL holders, servicing other WAL holders and providing community benefits. However, this exercise of itself will not determine the cost share and, therefore, we provide some additional perspectives on this issue below, noting that IPART's Figure 4.3 sought to highlight the legacy costs issue in terms of environmental damage.

- **Legacy costs**

Many of the structures that comprise our infrastructure portfolio were put in place at time when their impact on the environment was not understood or when community expectations on environmental outcomes were different to those which exist today. For example, they were constructed without fish passages or cold water pollution regulators. At the time of construction of these structures, there may have been a lack of awareness on the impact on the environment or, even if there was awareness (obviously a fish can't swim through a dam), there may have been a lack of technology to enable these issues to be rectified.

Noting that the structures were initially designed and erected by the NSW Government (and not by water users), meeting current environmental standards is imposing considerable operational and capital costs on WaterNSW. WaterNSW queries whether there may be some instances where the NSW Government would be willing to assume these costs to facilitate expedient outcomes.

- **Managed environment**

An important aspect in considering environmental impacts of WaterNSW infrastructure is the transformation of NSW waterways from a natural environment to a managed environment. Irrespective of the merits or otherwise of this transformation, it is now an established fact. Without this management and the associated infrastructure, many local communities would be negatively affected in terms of access to drinking water and for stock and domestic purposes through periods of long term drought (putting aside the impact to irrigation).

Moreover, the Murray Darling Basin (MDB) is an interconnected system. This means that removing infrastructure in one part of the MDB would negatively affect other parts of the system. Therefore, the concept that the infrastructure would not be needed without the particular set of current or future users is not correct, as the operation of a valley impacts the others. Moreover, environmental management is now seeing water being "shepherded" through valleys<sup>3</sup>.

- **MDB Plan**

A significant proportion of environmental requirements are driven by the MDB Plan between the Commonwealth, NSW, Victoria, Queensland, South Australia and the Australian Capital Territory. This further complicates the attribution of cost in the MDB. Through the Plan, Commonwealth funding is used to pursue certain initiatives towards certain environmental standards and outcomes. These standards may be for the benefit of the scheme as a whole and may be directed at benefitting the environment in locations outside of NSW.

The overall design of the MDB Plan means that these standards become embedded within the WSPs and make their way into WaterNSW's cost base. The standard to which our infrastructure is embedded is the standard recognised at the inter-Governmental level for the benefit of the environment within and outside of NSW. As such, the community standard is determined by a collective of the Commonwealth and other States and Territories.

Commonwealth/NSW Government funding enables the Commonwealth/NSW Government to purchase WALs and subsequently use those WALs for environmental outcomes, impacting WaterNSW's costs in providing services to the environmental water holders, to the point where the environmental water holders are WaterNSW's largest "customer". This is a fundamental realignment of the concept of "impactor" in terms of the characteristic of "water user" and needs careful consideration as part of this review. Noting the costs of serving this class of customer may differ to the cost of serving other customers.

Both the Commonwealth and the NSW Government play all of the roles of:

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<sup>3</sup> In conjunction with an order under section 324 of the Water Management Act (NSW).

- the rule maker
- water user
- sovereign (taxation power).

A recognition of these features is important in determining who a “water user” is and what a “water user” should pay for environmental outcomes.

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

The cost of securing our assets is likely to increase with increased regulatory requirements. We can provide IPART with greater details on these requirements and their costs throughout the review process.

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

We suggest that, to the extent possible, updating of the current cost share ratios should have a factual basis on the proportion of costs incurred between impactors/users if there are multiple impactors/users to one activity/code.

## 4. Service-based cost sharing framework

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

Moving to a service based approach solely for the purposes of splitting costs between the Government and users does not necessarily assist in resolving the underlying issue of which services should be paid for by customers and which by the Government.

For example, as per the categorisations in Table 4.1, across water storage services, water transportation services and environmental services, the question remains how much should be paid for by the Government in respect of providing environmental services and how much by customers. Each of those categorisations has some relevance to providing environmental services.

Then taking one of those categorisations, “water storage services”, it is also relevant to how much dam safety expenditure is allocated between Government and users. Therefore, one categorisation will have two different allocations for different cost that make up that service. It would just be easier to quantify the dam safety expense as an expense that will be split, the same for environmental management expenses.

Moreover, it would lead to arbitrary allocations between the services. For example, “routine maintenance” on a dam would support each of the three categorisations noted above, which would need to be allocated across the services. We still need to start with costs and then build up a “price” for each service.

We consider that including such categorisations into our accounting systems only for the purposes of the cost share split is excessive. Our business needs to allocate costs for a variety of purposes. We need to be able to determine how to do this in the least obtrusive and most cost effective way which meets a number of stakeholder objectives. Mandating such an overlay for one purpose, costs shares between users and Government may increase costs disproportionately to any potential benefits.

The costs in contention, that are within scope to be shared, are well understood and are easily captured by WaterNSW’s existing systems to allocate the costs as per the determined cost share split. If there is to be a further splitting of costs, e.g. for the environment, then we can split those specifically, rather than completely re-arranging our internal systems for this purpose.

### 8 Are the benefits of moving to a service-based approach likely to exceed the costs?

As noted above, without a full understanding of the requirements it is not possible to determine at this stage, however, the costs may well exceed the benefits.

### 9 Would there be merit in transitioning to the service-based approach over time?

WaterNSW is very much interested in moving to a service-based approach for providing services to our customers. However, we see this as something that would arise from a discussion between WaterNSW and our customers.

. Driving such an outcome merely for the purposes of allocating costs between users and Government is not appropriate at this stage, particularly when the outcomes of the cost share review are unknown at this stage.

In our view, the results of the cost share review should be articulated first. Then WaterNSW can consider, in consultation with its customers, how this would feed into a broader service based approach, for example, involving our levels of service program and how such changes would affect customer tariff structures.

### 10 Are there alternative cost sharing frameworks that could better achieve our objectives or could achieve them at a lower cost? If so, how would they operate?

As long as the method proposed is simple to implement and understood by customers we would not object to alternative methods. We see little merit in seeking alternatives for the sake of it.

## 5. Key information requirements

**11 Is there any other information we should consider in our review and assessment of the current activity-based cost sharing framework?**

As noted above, we have reservations on the merits on the service-based cost sharing framework. It will be time consuming and costly to implement and we do not see that it will add value to the process.

In our view, the existing splits should be carefully considered on a factual basis, together with areas where customers and other stakeholders have indicated that the current cost sharing is not satisfactory.

As noted in question 2 above, we consider that a valley by valley review be conducted to determine the cost impact on our operations and capital requirements between provisions in the WSPs which facilitate environmental flows, servicing environmental WAL holders and servicing other WAL holders.

**12 Is there any other information we should consider in our review and assessment of the proposed service-based cost sharing framework?**

Not at this stage.