



Submission to the Independent Pricing and Regulatory Tribunal

IPART Annual Review of WaterNSW's Rural Bulk Water Prices

2018-2019 – Draft report



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1. Introduction

This document is WaterNSW's submission to the Independent Regulatory and Pricing Tribunal (IPART), "*WaterNSW, Annual Review of regulated charges for 2018-19, Draft Report*" (the Draft Report).

IPART was accredited under Part 9 of *Water Charge (Infrastructure Rules) 2010 (Cth)* (the Rules) in 2016 to determine or approve pricing applications for NSW Murray Darling Basin (MDB) large bulk water providers. Following this accreditation, IPART made the "*WaterNSW, Prices for rural bulk water services from 1 July 2017, June 2021*" (Determination) for the period 2017-2021.

Rule 34 of the Rules requires WaterNSW to submit to the Regulator for approval or determination of its regulated charges in respect of the second year and each subsequent year of the regulatory period. In March 2018, WaterNSW submitted its application in respect of charges for 2018-2019 financial year to IPART.

IPART published its Draft Report in response to WaterNSW's application on 24 April 2018 and this submission responds to that Draft Report.

WaterNSW agrees with the analysis set out in Chapter 3 of the Draft Report which seeks to estimate indicative regulatory charges for 2018-19 using updated water sales volumes and updated customer numbers, however, WaterNSW does not agree with the conclusion that those updated charges should not be applied to customers in the 2018-19 year.

In WaterNSW's view, IPART has incorrectly applied Rule 37(2) of the Rules.

Rule 37(2) provides:

The Regulator must not approve regulated charges under subrule (1) ... in respect of the year to which the application relates except to the extent, if any, that it is reasonably necessary to make variations to those charges having regard to:

(a) the changes in the demand or consumption forecasts set out in the application under rule 34; and

(b) price stability.

A correct application of the Rules would see the application of the updated regulatory charges as IPART has set out in Chapter 3 of the Draft Report.

2. IPART's jurisdiction

2.1 Water Act 2007 and the Water Charge (Infrastructure) Rules

The ability to determine prices for WaterNSW's rural valley customers in the Murray Darling Basin (MDB) is derived from the *Water Act 2007 (Cth)* (the Water Act). Section 92(1) of the Water Act specifies that the Minister may make rules (to be called water charge rules), applying in Basin States ... that relate to regulated water charges.

Under sub-section 92(3)(c) the water charge rules may deal with the determination, or approval, by the Australian Competition and Consumer Commission (ACCC) of regulated water charges and under sub-section 92(3)(e) the accreditation by the ACCC of arrangements under which regulated water charges are determined or approved by agencies of the state (instead of by the ACCC).

Section 93(1) of the Water Act states that the Minister must ask the ACCC for advice about water charge rules the Minister proposes to make, or about proposed amendments or revocations of rules. The Water Act came into effect on 3 March 2008 and thereafter the then Minister for Climate Change and Water, Senator Penny Wong, wrote to the ACCC requesting advice on water charge rules. The development of the ACCC's advice to the Minister took the following form:

- in July 2008, the ACCC published its Issues Paper on Bulk Water Charge Rules and received 17 submissions in response;
- in September 2008, the ACCC published its Water Charge Rules Position Paper and received 17 submissions in response;
- on 6 April 2009, the ACCC published its draft advice to the Minister on the water infrastructure charge rules and on 30 April, conducted a public forum to discuss its draft advice. It received 11 submissions in response;
- in June 2009, the ACCC provided its final advice to the Minister on water charge infrastructure rules (published on 13 July 2011) (the Final Advice);
- on 6 November 2009, the ACCC published its draft advice on accreditation under the Water Infrastructure Charge Rules; and
- in February 2010, the ACCC provided its final advice to the Minister on accreditation under water charge infrastructure rules (published on 15 August 2011).

The Final Advice explains the rationale behind the adoption of an annual update requirement at page 101 as follows:

"If charges are determined across a number of years and demand is variable and uncertain, there is a risk that the actual level of demand may differ significantly from the forecast level:

- *Where demand is significantly less than anticipated, the operator may experience a revenue shortfall.*

- *Where demand is significantly greater than anticipated, customers may face prices higher than necessary (resulting in surplus revenue for the operator) or may be subject to demand rationing.*

Given the high variability in rainfall in Australia and the limited ability of operators to influence the supply of water, this is a key issue in the rural water sector.

To address revenue stability, the regulator could determine a revenue path for the duration of the regulatory period. In this way, prices would be adjusted to account for fluctuations in demand and there would be greater certainty about future levels of revenue.

However, this could result in annual price shocks, especially where demand is highly variable. Such price shocks are undesirable for customers as they require some price stability in order to make sound investment decisions. In balancing revenue stability against price stability, the ACCC is recommending a hybrid approach.

The annual variation process has been introduced to ensure that operators recover sufficient revenue in the presence of uncertain and highly variable rainfall.

The Final Advice contains the following on the matters the ACCC should consider in making an annual update decision at page 103:

Box 1: ACCC Final Advice on the Rules

The ACCC was concerned that the draft rules that accompanied the draft advice did not sufficiently limit the matters that the ACCC will have regard to in approving or determining charges for subsequent years in a regulatory period. In particular, the ACCC should only be required to consider:

- the maximum charges (and estimated required revenue) determined as part of the approval or determination of charges before the commencement of the regulatory period
- the updated demand or consumption forecasts for the upcoming year
- whether those updated forecasts appear reasonable
- the proposed charges for the upcoming year.

In response to comments from interested parties, the ACCC also sees merit in including an additional criterion that requires the ACCC to have regard to price stability across years in approving or determining charges.

In summary, the ACCC will not approve an operator's proposed regulated charges for the second, third or fourth year of a regulatory period unless the ACCC is satisfied the regulated charges are those approved or determined under the approval or determination process that was undertaken prior to the commencement of the regulatory period for the relevant year, adjusted for any change in demand or consumption forecasts where the updated demand or consumption forecasts are reasonable. In approving or determining these charges the ACCC will also have regard to whether the proposed regulated charges will maintain price stability across years.

The Rules were made by the Hon. Tony Burke, the Minister for Sustainability, Environment, Water, Population and Communities, and commended on 12 January 2011. The Explanatory Statement to the Rules provides as follows:

The purpose of Division 3 is to provide operators with some degree of revenue stability in the presence of variable and uncertain rainfall outcomes. Rainfall variability and uncertainty can lead to significant differences between the actual and forecast level of demand or consumption of water. This can lead to revenue shortfalls or surpluses. The annual review of regulated charges will allow charges to be updated in the second, third and fourth years of a regulatory period to reflect more current estimates of demand or consumption. This measure seeks to limit the scope for the under or over-recovery of revenue due to inaccurate demand or consumption forecasts.

The Minister adopted the ACCC final advice on accreditation when making the Rules, which under Part 9 provides for the accreditation of state agencies to approve or determine regulated charges under the Rules.

2.2 Accreditation

Section 59 of the Rules states that the accreditation of arrangements providing for a State Agency to approve or determine regulated charges of Part 6¹ operators is subject to (amongst others) a condition that the “applied provisions” apply as a law of the State and are in force. The applied provisions include Division 3 (sections 34 through 39) which provides for the annual review of regulated charges for second or subsequent years of a regulatory period.

On 24 June 2015, Peter Boxall the Chairman of IPART wrote to Rod Sims the Chairman of the ACCC applying for accreditation of arrangements for IPART to approve or determine regulated charges of Part 6 and Part 7 operators relating to NSW. The arrangements to be accredited were set out in the Independent Pricing and Regulatory Tribunal Amendment (Accredited State Water Regulator) Act 2015, which received assent on 9 June 2015.

On 30 July 2015, the ACCC published its draft decision on IPART’s accreditation application. This draft decision proposed two further conditions on IPART’s accreditation:

- IPART must apply the pricing principles, as published by the ACCC from time to time. The ACCC states that this ensures that all accredited regulators will apply one set of pricing principles to all determinations under the Rules, helping to achieve consistency where decisions are being made by different regulators in different Basin states;
- IPART must provide to the ACCC information relevant to IPART carrying out its functions under the accredited arrangements upon request. The ACCC states that this ensures that the ACCC can access information to enable it to undertake its monitoring, enforcement and advisory functions under the Water Act.

The ACCC received three submissions in response to its draft decision on accreditation, including from IPART on 26 August 2015, which stated that IPART accepts all of the proposed conditions of accreditation.

On 23 September 2015, the ACCC made its final decision to accredit IPART under Part 9 of the Rules. The accreditation was subject to the two conditions notified in the ACCC’s draft report on accreditation and attached the ACCC’s pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010, dated July 2011 (the Pricing Principles).

¹ Part 6 of the Rules applies to an infrastructure operator that is not a member owned operator if the sum of the maximum volume of water from managed water resources of which the operator provides infrastructure services is more than 250GL. Part 6 of the Rules applies to WaterNSW.

Part 2.2. of the Pricing Principles deal with the annual review process. They state at page 17:

“When assessing whether a change to charges is warranted the regulator will consider the demand/consumption forecasts in the application for the forthcoming regulatory year, along with price stability. Charges can then be updated before the commencement of each year to reflect updated demand forecasts using in determining charges.

*Under Division 3 of Part 6, **the regulator’s function is to adjust charges approved or determined under Division 2 of Part 6 (or as amended under Division 4) for changes in demand or consumption forecasts subject to the condition that those changes must maintain price stability.**”*

After referencing Rule 37(2) the Pricing Principles state at page 17:

*“Where the regulator is not satisfied of the above, it must determine such charges that will satisfy these conditions. In this way, those charges approved or determined prior to the regulatory period commencing could be adjusted for **any subsequent changes** in demand or consumption forecasts.*

An annual review of charges will allow operators to maintain greater revenue stability in the face of changing demand or consumption. However, in approving charges in subsequent years of a regulatory period, the regulator will also consider whether the proposed charges will impact on price stability so as to balance the interests of the operator and its customers.”

3. ACCC's Annual Price Reviews

3.1 2015 Annual Review

The ACCC first conducted an annual price review of WaterNSW's determined prices in 2015. In its application for to the review, WaterNSW applied updates to the consumption forecasts and entitlement numbers but declined to update the "unders and overs" mechanism set out in the ACCC's determination.

On 5 June 2015, the ACCC published its "*WaterNSW, Annual Review of Regulated Charges:2015-16, Final Decision*" (2015 Final Decision) and within it outlined its views on the tests in Rule 37(2) and applied those tests in practice. It noted at page 1 of the 2015 Final Decision:

*"These tests impose a high threshold which must be met before the ACCC is able to depart from the methodology set in its 2014 Determination. This is important as the methodology set in the 2014 Determination is designed to balance the interests of Water NSW's customers, in terms of price stability, and Water NSW itself, in terms of revenue stability, **by basing charges on the most recent usage information.**"*

In the 2015 Final Decision, the ACCC set out a three-step process in making their decision which they summarized through a flow chart set out in Box 2 below.

Box 2: ACCC process to updating charges through an annual review process

Step 1: calculate the 2015-16 charges set according to the 2014 Determination (section 5)

This step involves adjustments to the indicative charges in the 2014 Determination through the application of the unders and overs mechanism with updated CPI movements and water volume data.



Step 2: the 'change in forecasts' test (section 6)

This step involves consideration of additional information that changes the demand or consumption forecasts used in the 2014 Determination.



Step 3: the 'price stability' test (section 7)

This step involves consideration of the impact of any increases or decreases in charges on Water NSW's customers.

Water NSW's application asks for the ACCC to approve charges that are lower than those which would be calculated according to the 2014 Determination on the grounds of price stability. The ACCC has considered whether it should approve Water NSW's application on these grounds in step three.

Step one automatically includes updating prices for updated CPI **and water volume data**. Only after this is any additional information in respect of change of forecasts considered and then the price stability test. This is consistent with the approach in the Pricing Principles which states the regulator's function is to adjust charges for changes in demand or consumption forecasts subject to the condition that those changes must maintain price stability.

Step two involves “*considering any additional information not included at step one that changed the demand or consumption forecasts adopted in the 2014 determination*”². That is, not the general updating of demand and consumption forecasts which is conducted in step one. In that year, this additional information included considering interstate trade, as this was not factored into the original updated forecasts (unlike IPART’s 2017 determination). That is, the factors considered at step two are exogenous to the standard updating of demand and consumption forecasts.

At step three the ACCC considered price stability. In the circumstances of the 2015 Final Decision, customers were unlikely to experience bill increases of more than 12.2% nominal or 10.7% in real terms³. In response the ACCC noted (after considering increases in the Peel valley):

“The ACCC does not consider the absolute value of those charges in other valleys that will face the largest percentage increases justifies a similar cap on charge increases.

...

*... the ACCC considers that approving Water NSW’s application for charges in 2015-16 would likely result in more significant increases in later years. The ACCC does not consider that the charge increases for 2015-16 are so significant that the ACCC should risk more significant increases in future by approving Water NSW’s application.”*⁴

The ACCC clearly preferences annual updating to risking more significant increases in future years.

3.2 2016 Annual Review

The ACCC conducted its second annual review in 2016. In this review, the ACCC followed the same three step approach as outlined in their 2015 review, while WaterNSW did propose updates to its prices in line with the ACCC’s 2014 determination (including adjustments to demand/consumption and the “unders and overs mechanism”).

The ACCC concluded:

*“The largest increases in expected bills are less than 10 per cent in real terms. The ACCC does not consider that the ‘price stability’ variation test has been satisfied and therefore does not propose to vary WaterNSW’s 2016 charges on these grounds. This is consistent with the approach adopted in the review of 2015-16 charges, when the ACCC decided against capping larger charge increases on price stability grounds.”*⁵

² Page 15 of the 2015 Final Decision.

³ Page 19 of the 2015 Final Decision.

⁴ Page 20 of the 2015 Final Decision.

⁵ ACCC, “WaterNSW, Annual Review of regulated charges: 2016-17, Final Decision, May 2016”, page 4.

4. IPART's Draft Report

4.1 Introduction

IPART's approach to determining whether to update prices based on changes to forecast demand and customer numbers (as submitted by WaterNSW to IPART in its application for the price adjustment) varies significantly to:

- the approach set out in the Pricing Principles which IPART is required to follow; and
- the approach of the ACCC in applying the Pricing Principles and Rule 37 (noting the ACCC drafted the Pricing Principles and designed the Rules through its advice to the Minister).

It is our submission that IPART is not at liberty to depart from the framework set out in the Pricing Principles (as correctly applied by the ACCC in its two annual review decisions of WaterNSW's prices).

Apart from being inconsistent with the conditions of the accreditation regime, such a departure would undermine the rationale of the accreditation regime which is to provide consistency of approach to applying the Rules. Although such consistency was deemed necessary between state-based regulators, WaterNSW submits that such consistency is just as important between different regulators within a state (in this case between the ACCC and IPART) to enable consistent decision making and regulatory certainty to both WaterNSW and its customers.

4.2 IPART's approach

IPART's approach in its Draft Report to determine if it is necessary to vary charges, was to consider:

- whether varying charges would be necessary to mitigate WaterNSW's revenue volatility in 2018-19;
- whether updated usage volumes, water allocation ratios and/or entitlement volumes are likely to reflect a sustained shift in demand, and the size of any such change; and
- the potential impact on customer bills and price stability⁶.

This approach obviously departs from the three-step process described by the ACCC in Box 2 above.

The first of the IPART's points above should really be considered as part of the third point, the impact on price stability. However, when considering the third point, price stability, IPART notes "*IPART must not vary charges for 2018-19 except to the extent that IPART considers it reasonably necessary having regard to changes in demand and price stability*"⁷. This is the polar opposite of the ACCC's approach. The ACCC's sees varying demand incrementally in line with changes in forecast demand and customer numbers as maintaining price stability, that is stability over the term of the entire determination – rather than large one off changes which would otherwise occur if the annual changes in forecast demand and customer numbers are not implemented.

IPART should only consider not implementing the annual update to the extent that the update would cause significant price volatility (that is, prices would not be stable). In the ACCC's examples, they did not see price changes of up to 10.7% in real terms as affecting price stability.

⁶ Page 24 of the Draft Report.

⁷ Page 26 of the Draft Report.

From Chapter 3 of the Draft Report, we note that the highest increases in customer bills would be 5.47% for filtered water minor customers in the Fish River scheme, well below the level deemed acceptable by the ACCC.

In respect of revenue volatility, the annual update approach was designed to minimise such volatility, as expressed by the ACCC in its 2015 Decision and quoted above at 3.1:

*“the methodology set in the 2014 Determination is designed to balance the interests of Water NSW’s customers, in terms of price stability, and Water NSW itself, in terms of revenue stability, **by basing charges on the most recent usage information**”*

Providing an annual update which is based on the most recent usage information not only provides our customers with price stability but provides WaterNSW with the flip-side which is revenue stability. IPART’s approach at page 24 of the Draft Report seems to conclude that as the change to revenue would be small, there is no merit in updating prices. This approach is self-defeating as changes not made during one annual update would therefore accrue for the next update which risks volatile price and revenue changes being made during subsequent reviews and subsequent determinations – the very thing the annual review process is trying to avoid.

The final consideration by IPART as listed above was in relation to where there is a sustained or structural shift in demand. In our view, the way that IPART has approached this consideration is the again the polar opposite of the methodology in the Pricing Principles and the ACCC approach.

This consideration aligns with Step 2 in the ACCC’s three step approach. It requires consideration whether there is additional information to inform the demand and usage forecasts – over and above the general approach to updating for more recent information. If there were such factors, then the proposed prices should be considered in that light.

IPART’s Draft Report states that there is nothing to indicate a sustained or structural shift⁸, therefore there is nothing to trigger a further review or change of the prices and on that basis and the updated prices as outlined in Chapter 3 of IPART’s Draft Report should be implemented.

However, as set out in section 4.3 below, a sustained and structural shift has indeed occurred in relation to the usage forecast. As is explained below, this sustained and structural shift, when considered at Step 2 of the ACCC’s three step approach, further reinforces the need to apply the updated prices as outlined in Chapter 3 of IPART’s Draft Report⁹.

4.3 IPART’s comments on sustained/structural shifts and price stability

In considering whether a ‘sustained or structural’ shift has occurred in assessing whether it is reasonable necessary to update the 20-year rolling average of actual water sales, IPART’s Draft Report states at page 25:

“Where there is a sustained or structural shift in demand (eg, a significant change in water entitlements), there may be a strong case to vary charges in the Annual Review.

...

We have assessed on whether the water usage and entitlement data for 2016-17 reflects a sustained or structural shift in demand and/or water availability. We concluded that there is not sufficient evidence to suggest that the data for 2016-17 reflects a sustained shift in water demand or availability.

⁸ Page 25 of the Draft Report.

⁹ As well as under IPART’s own methodology.

...

Therefore, changes to water sharing plans could lead to a structural shift in demand. Although there were small changes to the Murrumbidgee, NSW Murray and Lower Darling, Lachlan and Macquarie regulated river water sharing plans, we understand that these changes did not affect usage volumes or allocations of entitlement data for 2016-17, nor do we anticipate that there would be material structural changes in demand due to these changes."

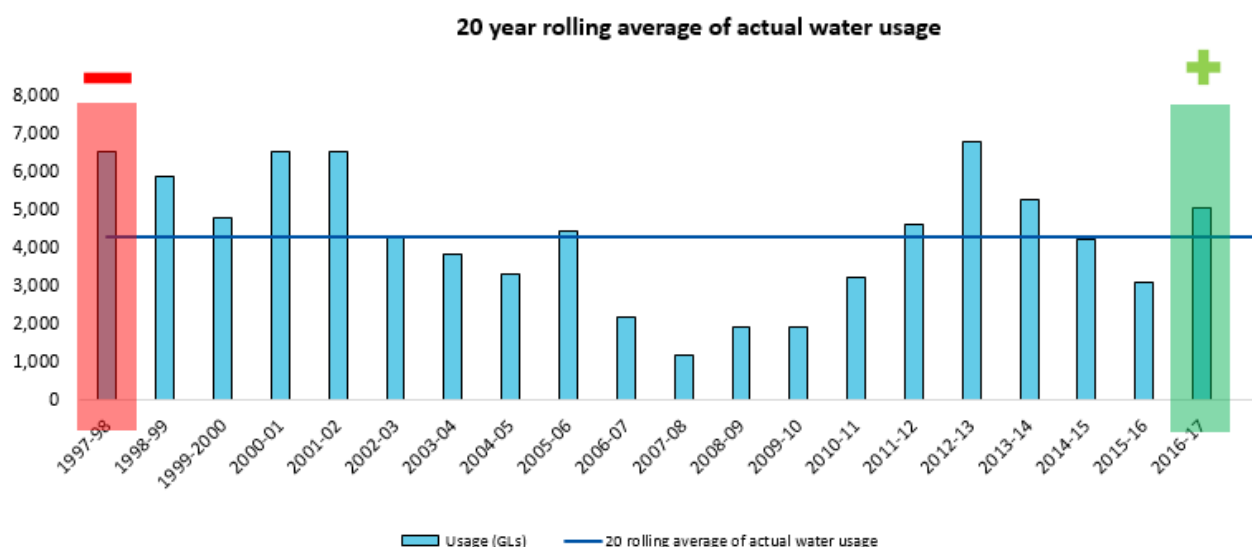
IPART also commented that the updated 20 year rolling average would not provide a materially better estimate actual demand in the next year:

*"it is difficult to establish whether the most recent year of data (in this case demand data for 2016-17) would be more representative of the level of demand expected in the next year (in this case 2018-19) compared with the 20-year average used to set prices in the price determination. In this case, we do not consider there to be strong evidence to suggest that demand data for 2016-17 provides a materially better estimate of forecast demand for 2018-19 compared with the 20-year average used to set prices in the 2017 Determination"*¹⁰

WaterNSW disagrees with IPART's conclusion that an updated 20 year rolling average would not provide a materially better estimate of actual demand in the next year.

The chart below in Figure 1 shows the year which would be 'rolled off' the 20-year rolling average and the year which would be been added on, as per WaterNSW's proposal.

Figure 1 WaterNSW's proposed changes to the 20-year rolling average



IPART should assess whether the data which is added onto the rolling average, is more reflective of forecast demand than the data which has 'rolled off'.

Prior to the commencement of the Water Sharing Plans (WSPs), water extractions in most regulated valleys was considered excessive (i.e. overused or over-allocated). As a result, the MDB Governments¹¹ decided to strengthen the rules around diversion limits to restore the health

¹⁰ Page 26 of the Draft Report.

¹¹ New South Wales, Victoria, ACT, South Australia, the Commonwealth.

of the river system. The MDB cap was agreed by the MDB Governments, and subsequently, the *Water Management Act NSW 2000 (NSW)* (WM Act) was enacted to provide for the protection, conservation and ecologically sustainable development of the water sources of NSW. The WM Act enabled the Minister to create WSPs consistent with the objects of the WM Act.

The WSPs were introduced for most regulated river systems from 2004 with a reduction in long term diversions in mind. It is understood that the Government set a range of up to 10% reduction in diversions through the changes introduced via the new regulatory regime.

Therefore, actual usage sustained prior to 2003-04 (particularly 1997-98) could not be said to be more representative of expected demand. The 2016-17 year is more reflective of the 2018-19 year, where Water Sharing Plans have been enacted in all regulated valleys, with strengthened rules around diversion limits, compared to the 1990s.

WaterNSW notes that around 6,500 GLs of extractions were recorded in the years 1997-98, 2000-01 and 2001-02, and 5,900 GLs recorded in 1998-99 (including Coastal valleys)

This level of demand has not been experienced in the post WSP environment until 2012-13. It is inevitable that the data for these years (1997-98, 1998-99 to 2000-01) will drop off the 20-year rolling average in the next price review, and they are unlikely to be replaced by a similar level of demand in the 2017-21 regulatory period (that is, approximately **6,000 GLs of demand in 3 years of a 4-year regulatory period**).

WaterNSW has forecast actual usage of approximately 4,757 GLs in 2017-18 (a wet year – including Coastal valleys), which is well below the 6,000GLs of demand experienced in the 1990s.

Under the Water Act and the *Basin Plan 2012 (Cth)*, NSW water resources plans must be accredited by the Murray Darling Basin Authority, and must (amongst other things) demonstrate compliance with the sustainable diversion limit in the plan. Accreditation is expected to occur in 2018-19. Once the resources plans are accredited and in force (post 2018-19), there is expected to be even further downward pressure on water usage to meet the requirements of the plan.

Therefore, it is in the interest of price stability for IPART to annually update the 20-year rolling to avoid significant bill shocks resulting from pro-longed changes to the 20-year rolling average.

To demonstrate the proposed bill impact, WaterNSW has modelled the potential step change in the usage charge resulting from sudden (4 yearly) changes in the 20-year rolling average

In this example, WaterNSW has applied to the 2018-21 years an average of water usage from the period 2011-12 to 2016-17. The results are shown in Table 1 below:

Table 1: Percentage in change in 2018-21 price using an average from 2011-12 to 2016-17

Valley (\$ 16-17)	Current Usage Charge	Updated Usage Charge in next price review	% difference
Border	5.44	5.57	2.39%
Gwydir	11.87	13.59	14.49%
Namoi	19.98	22.39	12.06%
Peel	18.36	17.81	-3.00%
Lachlan	19.04	22.63	18.86%
Macquarie	13.78	15.83	14.88%
Murray	1.91	2.01	5.24%
Murrumbidgee	3.31	3.53	6.65%

WaterNSW is unlikely to experience 6,000 GLs of demand over the next 3 years (of a 4-year regulatory period). It is likely that the 20-year rolling average will decline as the average is updated with recent demand figures reflecting the current regulatory environment. WaterNSW submits that it is necessary having regard to price stability and changes in demand and consumption forecast to adjust the 20-year rolling average with 2016-17 actual water sales.

4.4 Conclusion

Applying the methodology set out in Rule 37 and the Pricing Principles, noting the practical examples of implementation in the ACCC's 2015 and 2016 annual reviews, would see an implementation of the price changes as outlined in Chapter 3 of IPART's Draft Report. By not doing so, WaterNSW submits that IPART will be inconsistent with its accreditation conditions.

This aside, even on IPART's own application of Rule 37, it is necessary having regard to sustained or structural shifts and price stability to make the changes as outlined in Chapter 3 of IPART's Draft Report.