Submission to the Independent Pricing and Regulatory Tribunal

Draft Report on Rural Water Cost Shares October 2018

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Contents

1. Introduction

This document is WaterNSW's submission to the Independent Regulatory and Pricing Tribunal's (IPART) Draft Report on Rural Water Cost Shares, October 2018 ("the Draft Report").

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[1].

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[2].

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 efficient revenue requirement. In this sense, WaterNSW is revenue agnostic to the outcomes of this review.

However, WaterNSW is keen 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, rational 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 now and in the past; 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 applicable to them, as reflected in their IPART determined charges. We are also wanting 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 response to the Draft Report.

2. WaterNSW approach to this submission

In the Draft Report IPART has taken what we would describe as a very strict interpretation of the "impactor pays" approach to cost share between users and Government. WaterNSW's submission to IPART's issues paper proposed a different approach to the treatment of legacy assets and regulatory changes which affect legacy assets through the lens of the "impactor pays" approach. That approach was not accepted by IPART.

As our views were set out in that submission we will not repeat them here, noting that our suggestions in our submission would have been unlikely to have increased user share to the same extent as set out in the Draft Report. Instead, this submission will focus on those areas of the Draft Report that we see would benefit from further refinement and reconsideration.

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[1] And any Customer Service Obligation payment, representing the customer share which cannot be met by customers.

[2] WaterNSW's costs do not include Murray Darling Basin Authority (MDBA) contributions.

Despite WaterNSW's views on the application of the impactor pays approach differing from that of IPART, we nonetheless commend IPART on the Draft Report as a document which clearly sets out IPART's current thinking on a difficult issue in a concise and clear way. This clarity has been missing from the discussion of user:government share, probably since the inception of the concept for rural water services. We anticipate that the Draft Report and the forthcoming Final Report will continue to provide much needed clarity for our customers in regard to this difficult issue.

3. Principles underlying the cost sharing framework

At page 19 of the Draft Report, IPART notes that in applying the impactor pays principle, the counterfactual starting point is a world without a high consumptive use of water, that is a world without the need for regulated infrastructure and services.

We query whether this is correct. It is possible to have a high consumptive use of water without regulated infrastructure and services. For example, in NSW unregulated rivers, there is still a substantial level of consumptive use of water, it is just that the water is stored in on-farm storages rather than state owned dams and other infrastructure.

Without a dam on the State's rivers, there would undoubtedly be less consumptive use as a system of on dam storages would likely lead to higher losses and not have the benefit of co-ordinated storage/usage as is found under the current arrangements in regulated river systems. However, high consumptive use would still undoubtedly occur.

Therefore, the best that the counterfactual can state for WaterNSW's bulk water services is that there would be a world without a "higher" consumptive use of water and without regulated infrastructure.

In terms of the current WAMC services, we find it more difficult to frame a counterfactual. The existence of the Water Act 1912 (NSW), which pre-dates the State's significant structures, shows that a rules based system for managing water was always inevitable. Customers using solely groundwater or unregulated water sources would still have been subject to a rules based system without substantive infrastructure.

It is not clear from the Draft Report how the counterfactual is used to determine the Government/user share. Nevertheless, a change to the counterfactual would require IPART to reconsider the recommended cost shares in the light of a newly defined counterfactual. This may well cause some adjustment to the recommended shares in the Draft Report. For example, environmental requirements that arise due to the volume of water extracted from a river system may be treated differently from environmental requirements that rise due to the presence of a dam, such as a fishway.

4. Impact of the draft cost share ratios

IPART's Draft Report contains some substantive changes to the cost share ratios for WaterNSW's rural bulk water services. These are set out at pages 46-47 of the Draft Report. IPART conducted analysis on the 2017-2021 Rural Bulk Water Determination and concluded that its proposed changes would increase the aggregate customer share of WaterNSW's efficient costs to 84% from 83%[3]. That is, a 1% increase (see page 46 of the Draft Report).

Any change to the cost share ratios will have a different impact on each pricing determination depending on the nature of the costs to be included in the specific determination. It is true that many costs are generally in the same order, year on year, or over a number of determinations. Although WaterNSW generally seeks to smooth costs over time, some lumpiness cannot be avoided, particularly when major projects need to completed within the price path.

[3] With MDBA costs included.

In addition, there are other costs which are particularly driven by regulatory factors which are outside the complete control of WaterNSW. WaterNSW notes that these cost share categories have been selected by IPART for substantive adjustment, for example dam safety compliance and environmental planning and protection (from 50% user share to 80% user share). These items did not feature prominently in WaterNSW's proposal for the 2017-2021 Rural Bulk Water Determination as WaterNSW was working, and is still working, with Government on a way forward on fish passage compliance and the new Dam Safety Act 2015 (NSW) still not having commenced with supporting regulations yet to be finalised.

In addition to impacts which affect the cost allocation for each determination, it should be noted that impacts vary significantly on a valley by valley basis depending on the requirements within each valley. Asset conditions and upgrades vary depending on the particular asset in question and regulatory requirements also vary depending on local factors.

Using WaterNSW's high level capex planning for the next 10 years, noting dam safety requirements are still not resolved and thus not included, our analysis shows:

- when fish passage compliance is excluded, the impact is an increase of up to 11.5% for the Lachlan and 8.6% for the Border valley;
- when fish passage compliance is included, the impact is an increase of up to 16.1% for the Lachlan and 15.4% for the Gwydir.

Most of the other valleys have increases between 2 and 5%. These impacts are before other factors that can cause bills to increase such as any required operating expenditure increases.

Based on the high level capex planning assumption, such increases will lead to bill shock for our customers, particularly in the current drought environment. IPART has in the past introduced a community service obligation, paid for by Government, to deal with bill shock. This seems a circular resolution of the issue.

5. Opportunities for further improvement

The Draft Report raises some issues where it sought to implement improvements at the next pricing determination. This included valley-specific cost share ratios as set out in Table 6.1 of page 52 of the Draft Report. WaterNSW does not foresee difficulties in applying these specific valley by valley cost share ratios and would be in favour of adopting these ratios.

WaterNSW further supports removing activities from the framework that represent cost categories (rather than actual activities required to be undertaken) and allocating the associated costs across the remaining activities. The examples provided in the Draft Report with respect to WAMC include W08-04 Water Consent Overhead and W10-02 Business and Governance Support, which WaterNSW supports.

The Draft Report also raises the issue of the Corporate Systems code in the WaterNSW Bulk Water Determination. This code is under review by WaterNSW and may be used for IT or other specific project costs. WaterNSW will finalise its position on this cost code as part of the its pricing proposal for the next rural bulk water determination.

WaterNSW supports the comment on page 54 of Draft Report: "*Irrigators considered that there were too many activities in the current cost share framework for both WAMC and WaterNSW. In their view, this reduces the ability for stakeholders to understand how the cost sharing framework impacts the prices IPART regulates*."

WaterNSW is seeking to ensure that customers have a better understanding of the services provided by WaterNSW under the WAMC Determination and considers the complexity of the W-codes as an impediment to this understanding. WaterNSW is pleased to see the comment above which reinforces this view. To this end, WaterNSW will be seeking to consolidate some of these codes where it is relevant to do so. However, the Draft Report has produced more granular shares between W-codes which impedes this process.

WaterNSW submits that it is difficult to achieve simplification and clearer customers communications of these services and their costs, whilst maintaining the current prescriptive activity codes. It is likely WaterNSW will propose a consolidation of cost codes as part of its pricing proposal for the services it provides under the current WAMC Determination.

WaterNSW's preference is to avoid the need to calculate a weighted average of the shares for any of its consolidated activities. A weighted average calculation would increase WaterNSW's regulatory burden, we would need to maintain the current cost codes to calculate the weighted average for a consolidated activity.

WaterNSW requests that IPART align the cost share ratios for those activities codes which relate to a common function. In particular, the W01 activity codes are carried out by the same business unit within WaterNSW and there is no need for four distinct activity codes with four distinct cost shares.