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Our Ref: DOC12/25933

Mr James Cox
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Independent Pricing and Regulatory Tribunal of NSW
PO Box Q290
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10 July 2012

Dear Mr Cox

IPART Discussion Paper - Review of rural water charging systems

State Water appreciates the opportunity to comment on the above discussion paper. Please find attached State Water's submission to this regard.

If you wish to discuss, please contact Joseph Caruana, Senior Regulatory Economist, on 02 8245 2074, joseph.caruana@statewater.com.au.

Yours sincerely

Brett Tucker
Chief Executive Officer

State water

Taking care of it

Review of Rural Water Charging Systems

State Water Corporation submission to the Independent Pricing and Regulatory Tribunal's discussion paper

10 July 2012

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Review of Rural Water Charging Systems
State Water Corporation submission to IPART

State Water reference: DOC12/25668

July 2012

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1. Executive summary

State Water is supportive of the NSW Government's review into rural bulk water pricing conducted by the Independent Pricing and Regulatory Tribunal (IPART) and appreciates the opportunity to provide comment on the Discussion Paper released 26 June 2012. The IPART review provides a transparent forum for stakeholders to discuss tariff design and Government contributions. The review also removes a potential policy void on NSW Government contributions due to the shift to the Australian Competition and Consumer Commission (ACCC) for future State Water price determinations in the Murray Darling Basin.

1.1. Customer engagement

State Water had commenced customer consultation outside of the IPART review in the lead up to its pricing submission to the ACCC, including:

- Pricing presentation to Customer Service Committees (CSCs) in late 2011
- Pricing forum held in February 2012
- Written updates provided regularly to CSCs and other interested stakeholders

State Water has decided to postpone its formal customer engagement until the completion of the IPART review, to allow stakeholders to engage in the independent process. Due to the review timeframe and limited resources, it is State Water's expectation that the IPART process and subsequent Government decision, will largely conclude tariff design consultation for the State Water submission, excluding new or significant information. Following the review, State Water intends to focus consultation with customers on other areas of the price submission to the ACCC.

1.2. Preliminary comments

Within this submission State Water has provided responses to questions raised by IPART in its discussion paper that we consider relevant to the business. In doing so, we have outlined our concerns, including:

- Consideration of weightings of the proposed assessment criteria
- Revenue risk associated with State Water's new regulatory environment under the ACCC
- Consideration of complexities and risks associated with the choice tariff option
- Issues for consideration in the development and implementation of an appropriate hardship policy
- Support for IPART's cost share approach
- The need for consistency with the outcomes of the coastal valleys review for valleys not at full cost recovery.

1.3. Incorporation of review outcomes in future pricing submissions

State Water will endeavour to incorporate IPART's independent decisions into its 2014-17 pricing submission, if accompanied by a Ministerial direction under section 20D of the *State Owned Corporations Act 1989* and Government commitment to fund any Customer Service Obligations resulting from this review. It is State Water's view that a Ministerial direction provides a higher likelihood the ACCC will accept a tariff design that encompasses volatility risk. However, it must be noted that State Water merely submits its pricing proposals to the ACCC, with the final decision resting with the new regulator.

2. State Water responses to specific questions raised by IPART

2.1. Assessment criteria

Question 1: Are the proposed assessment criteria appropriate?
State Water considers the proposed assessment criteria to be appropriate for the tariff structure, policy and cost share options to be assessed as part of this review. State Water does however seek clarification from IPART on whether it intends to weight each of these assessment criteria equally or whether stronger weightings are to apply to certain criteria. State Water acknowledges that the weightings stakeholders would apply to each of these criteria are likely to differ, however ultimately these criteria must be applied in a manner that leads to a practical and effective outcome that meets the objectives of this review.

Outside financial viability, State Water notes outcomes from the IPART review must be able to be implemented within the bounds of the Commonwealth *Water Act 2007*, *Water Charge (Infrastructure) Rules 2010* and the ACCC's pricing principles[1] to provide the highest possibility that they will be accepted by the ACCC.

2.2. Tariff structure and other policy options to address customer cash flow issues

Question 17: What are your views of the tariff structure options presented? Do you agree with our preliminary view for tariff structure or policy options that best meets the assessment criteria?

Tariff structure and revenue risk
State Water appreciates the work undertaken by IPART to develop the tariff options. However, we are of the view that IPART's proposed tariff options are based on the regulatory framework (financial parameters) implemented by IPART for the 2010 State Water determination, and do not fully reflect the regulatory framework State Water will face for its next pricing determination.

In particular, the tariff options put forward do not acknowledge the lower risk profile (equity beta) put forward by the ACCC in its pricing principles document and the negative impact this will have on State Water's revenue requirement, via a lower weighted average cost of capital (WACC). This is evident in the discussion paper's explanation of the initial assessment of the preferred tariff option of 40:60 fixed to variable combined with a revenue volatility allowance,

[1] ACCC 2011, *Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010* July 2011

> *"Given the alternative of a largely fixed but cost reflective tariff, this option achieves a middle ground between the interests of businesses' cash flows and State Water's financial viability, including its need to be compensated for the revenue risk that this [variable] tariff structure creates[2]."*

It is precisely this risk that the ACCC asserts our shareholders can diversify away from and the reason for stipulating a lower equity beta and ultimately a lower WACC.

> *"The equity beta in the WACC only compensates an operator for bearing risk that is by nature systematic. That is, risk that a firm cannot efficiently address through other means. Revenue volatility on the other hand mainly arises for water infrastructure operators because variable charges have been levied. This form of volatility can be addressed by altering the tariff structure or through other mechanisms available to the regulator[3]."*
>
> *"… charges must promote the economically efficient use of water infrastructure assets. In practice, this can be best achieved where the fixed and variable components of charge recover the fixed and variable costs of providing services[4]."*
>
> *"… regulated revenue streams must be based on costs assessed as prudent and efficient, and it must be likely from the charges levied by an operator that there will be enough revenue available to provide the infrastructure services. There is a risk that a business will not have sufficient revenue to recover its costs where it imposes a charge structure that is misaligned with the underlying cost structure of the operations of its business. This might arise where the costs of operating a water business are largely fixed but a high proportion of revenue is to be recovered through charges that vary in water consumed or delivered[5]."*

Consequently, State Water suggests higher fixed charges reflecting the business's fixed cost base, is the most effective way to ensure State Water's financial viability, given the ACCC's assessment of volatility risk.

Nevertheless, State Water acknowledges the terms of reference for the review require IPART to take into account business [customer] cash flows[6]. In light of this and

[2] IPART 2012, *Review of Rural Water Charging Systems Discussion Paper* June 2012, p 3

[3] ACCC 2011, *Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010* July 2011, 71

[4] Ibid, p 51

[5] Ibid, pp 70-71

[6] Minister K. Hodgkinson, *untitled* May 2012

subject to the above points, IPART's proposed 40:60 fixed to variable tariff design, in conjunction with an appropriate revenue volatility allowance, could potentially meet State Water's financial viability objective, as well as achieving broad customer support.

It appears the ACCC is open to a revenue volatility allowance as an "other mechanism" to compensate revenue volatility, subject to it complying with Schedule 2 of the *Water Act 2007.*

> *"Other mechanisms would need to be assessed by a regulator on a case by case basis. For instance a regulator will also have the flexibility to apply any other mechanisms to address forecast revenue volatility where it considers that applying those mechanisms would contribute to achieving the Basin water charging objectives and principles in Schedule 2 of the Water Act. For instance, a regulator could apply a revenue volatility allowance subject to this assessment[7]."*

The treatment of risk is the key issue for State Water in the next Determination. Revenue volatility risk was recognised by IPART in its 2010 Determination, and explicitly addressed through a revenue volatility allowance which links the holding cost of extraction volatility risk to the WACC.

The Commonwealth's Water Charge (Infrastructure) Rules 2010, in conjunction with the ACCC's pricing principles have introduced a new jurisdictional risk for State Water as a result of the ACCC's views of risk diversification strategies available to State Water outlined above. State Water anticipates a lower equity beta and therefore a lower WACC (holding cost allowance), even if the Government mandates a variable tariff design as a result of IPART's review.

Applying the ACCC's determined lower WACC would result in a lower volatility allowance than that determined by IPART, for the same level of risk, over the same period. In addition, the overall lower revenue requirement that arises under the ACCC framework compared to IPART's is due to the ACCC's view that State Water can diversify away from volatility risk via higher fixed charges. However, IPART's proposed tariff design does not allow State Water to diversify away from this risk.

State Water believes that IPART must be cognisant of this new jurisdictional risk and redesign the revenue volatility allowance from the 2010 Determination to accommodate the ACCC's assumed diversification strategy. State Water is keen to work with IPART to produce solutions to the indentified issues above and will put forward a proposed new methodology in its response to the Executive Summary.

[7] ACCC 2011, *Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010* July 2011, p 71

Consideration of the tariff choice option

In February 2012, State Water held a customer pricing forum, which was attended by representatives from each of the customer service committees and State Water's top 20 customers by revenue. The forum was a valuable opportunity for State Water and customers to reach a common understanding of ACCC rules and how the move to the ACCC as State Water's pricing regulator would impact future determinations. During this forum, the top three objectives voted by customers for the next determination were:

a) To achieve a clear and transparent pricing process, including both costs and consultation

b) To consider price choices based on the customers risk profile (i.e. willingness to accept risk)

c) To maintain the 40:60 fixed to variable tariff structure.

State Water has given consideration to these objectives when assessing the tariff structure options presented and forming views on the most appropriate option.

Whilst State Water recognises that a number of stakeholders expressed an interest in further consideration of the tariff choice option, we note that this option was originally discussed in the context of a likely move to 90:10 fixed to variable charging arrangement under the ACCC and developing options to maintain the status quo of 40:60 fixed to variable.

State Water shares the concerns expressed by IPART about the complexity of a tariff choice option and considers the complexities and risks associated with this option may outweigh the benefits, particularly if the objectives of this option can be met through an alternative option, such as the Government mandating the current 40:60 tariff structure and providing compensation for the associated risk.

Some of the potential complexities and risks are discussed below, however it should be noted that this is not an exhaustive list and detailed scenario analysis has not been possible due to the timeframes of this review.

Pricing determination process and revenue risk

The tariff choice option would create new complexities and risks for State Water as part of the determination process. Neither State Water nor the ACCC would be capable of predetermining the uptake of each tariff option, and so modelling to determine revenue requirements and prices would require significant and untested assumptions to be made. The extent of assumptions required would increase the risk of pricing each option incorrectly, which could result in unfair distribution of revenue between customer groups and under recovery of revenue. Price modelling for this option raises circular reasoning issues, as accurate price modelling could not be undertaken without knowing how many customers would choose each option, but customers would not have adequate information to make a decision on which option to choose without prices being modelled.

Billing and customer support complexities

State Water's current customer billing system cannot accommodate this tariff option. Whilst it would be possible to upgrade the billing system to allow for this option, it would come at significant expense, which would in turn be passed through to customers in bulk water prices. This option would also add significant complexity to billing and customer support administration, and extra resourcing would be required to meet the additional workload created by this option without reducing the service level State Water provides its customers. For example, additional workload would be created as customers would need to notify State Water of their chosen option and it is likely that advice and information would be sought from State Water to make this decision. A minimum uptake would be necessary to create economies of scale.

Trading complexities and gaming potential

A further consideration of this option relates to trading arrangements and potential arbitrage opportunities. Currently, licence holders can trade allocations in water markets to intrastate and interstate buyers, as well as between their own licences. Given the tight timeframe of this review, and as the rules of this option have not yet been considered, State Water has not fully examined the complete suite of possible arbitrage scenarios. However, one obvious opportunity would be for water allocations to be traded from a 60/40 tariff licence to a 10/90 tariff licence to avoid higher usage charges.

State Water acknowledges that this issue would require further consideration if this was to be considered to be the preferred option. State Water is willing to work through these scenarios with IPART at future stages of this review process if it considers this necessary.

Tariff option selection considerations

As noted in IPART's discussion paper[8], one consideration requiring resolution of this option is the length of the period for which the tariff choice would apply. It is likely that customers would be required to nominate their tariff option at the start of a determination period, which is generally four years. If a large number of customers opted to change from one option to the other at the end of a determination period it is possible that the change in State Water's revenue structure would cause price shocks at the start of the new determination period, which would not be acceptable to customers or the ACCC.

In addition, a legal framework would need to be developed to bind customers to their tariff choice.

[8] IPART 2012, *Review of Rural Water Charging Systems Discussion Paper* June 2012, p. 84

Question 19: Are there any other implementation issues that should be considered for the tariff structures or other policy options outlined? Are there any implementation issues for tariff structure or other policy options at a local level (eg, within irrigation corporations) that we should be aware of?

State Water understands the payment difficulties faced by customers and supports the need to have hardship policies in place to provide payment assistance during difficult times. State Water's current hardship policy allows payment plans to be negotiated if customers are experiencing genuine hardship, which is assessed against a number of eligibility conditions as outlined in Appendix B of IPART's discussion paper[9].

In times of exceptional circumstances additional payment assistance, payment deferral and/or waiving of charges are policy decisions that must be made by Government. Such policies would need to comprehensively specify the terms and conditions of hardship eligibility and assistance to ensure transparent and efficient administration of the policy. Failure to have a clear policy in place has created costly administrative complexities in the past. Whilst State Water can accommodate these exceptional circumstance assistance measures, it would be beneficial to have in place predetermined conditions and triggers, such as those proposed in IPART's discussion paper, to reduce the administrative burden for State Water and uncertainty for customers.

For a conditional long term deferral of payment option (say, 1-2 years) as presented by IPART, consideration must be given to the costs to State Water to defer revenue recovery for this period. At this time, and without knowing the actual take up rate of this option, State Water considers IPART's suggested rate of the Supreme Court of NSW rate plus 2.5 per cent to be reasonable compensation for State Water's costs to hold this debt.

However, it is most likely that the implementation of this option will not occur in normal circumstances and will be beyond the normal business practise expected of a commercial entity. This is due to State Water's debt increasing as more customers defer charges and the increase in holding costs associated with higher debt levels. State Water also expects it will incur material increases in administration costs to implement a deferral scheme across the majority of its customer base. State Water will internally explore these issues further and is keen to work with IPART to implement a fair and responsible outcome.

It is also noted that NSW Treasurer approval is required to increase State Water's borrowings in the case of a payment deferral policy being offered to and taken up by a large number of customers.

[9] Ibid p. 46

2.3. NSW Government's costs share for ACCC determined bulk water charges

Question 20: What are your views on the cost share options presented? Do you agree with our preferred option on determining cost shares?

State Water acknowledges the 'impactor pays' principle upon which IPART's cost shares system is based. We consider the list of options for cost share arrangements presented by IPART in its discussion paper is considered to be suitably extensive to allow for thorough evaluation of the most appropriate method.

State Water does not have any concerns with IPART's preliminary view that option 3 (apply cost sharing ratios with reviews of methodology at every second determination period) is the most appropriate method. This option appears to provide a suitable balance between ensuring the cost sharing arrangements remain appropriate and the additional costs imposed by the need to undertake additional reviews.

State Water notes that any future decisions on cost share arrangements made by NSW Government based on IPART's recommendations would need to be communicated to State Water in adequate time to incorporate into State Water's pricing submission to the ACCC.

2.4. Valleys not at full cost recovery and the government contribution

Question 23: Is there a case for ongoing subsidy of the Peel Valley users?
State Water believes the current Community Service Obligation (CSO) arrangement in the Peel valley is consistent with section 66(v) of the Intergovernmental Agreement on a National Water Initiative.[10] That is where full cost recovery is economically unviable where a CSO is deemed necessary, the subsidy should be reported publicly.

State Water will need advance notice of any future decisions by NSW Government to adopt IPART's recommendations on CSOs for valleys not at full cost recovery, so that these decisions may be incorporated into customer pricing decisions.

Question 26: Are there other issues that we should consider regarding the under recovery of the users' share of costs in the Peel Valley?
State Water notes that the Minister for Primary Industries has commissioned a concurrent review of bulk water pricing in small valleys outside the Murray Darling Basin (coastal valleys - North Coast, South Coast and Hunter). State Water considers it appropriate that decisions on government contributions for valleys not at full cost recovery within the Murray Darling Basin as recommended by IPART are broadly consistent with the outcomes of the coastal valleys review.

[10] Council of Australian Governments 2004, *Intergovernmental Agreement on a National Water Initiative Between the Commonwealth of Australia and the Governments of New South Wales, Victoria, Queensland, South Australia, the Australian Capital Territory and the Northern Territory*, 24 June 2004, pp 14

3. Other comments

Irrigation corporation customers and revenue risk

In its discussion paper, IPART contends that because State Water's irrigation corporation customers on-sell water to their customers and have different tariff structures to State Water, some of State Water's risk is mitigated because irrigation corporations will pay bills regardless of water availability[11]. Whilst State Water acknowledges that this comment is made in the context of farm cash flows and customer hardship assistance, it should be clarified that any reduction in the risk borne by State Water due to irrigation corporation customers is minimal and confined to risks associated with payment assistance.

Although it is true that irrigation corporations generally pay bills regardless of water availability, the risks previously identified relating to tariff structure apply equally to this customer type. That is, irrigation corporations pay usage charges to State Water on extracted allocations, and so under the current tariff structure of 60 per cent variable charges, in periods of low extractions State Water will under-recover revenue from this customer type as it would any other customer type.

It is also noted that irrigation corporations receive wholesale rebates arising from the view that State Water incurs lower service delivery costs to provide water to these schemes and the system-wide benefits that the schemes provide[12]. These rebates are independent of water extraction volumes.

4. Concluding remarks

State Water appreciates IPART's consideration of its comments in making final recommendations as part of this review process. We look forward to working with IPART to ensure adequate analysis of the relevant issues can be undertaken throughout the remainder of this process.

[11] IPART 2012, *Review of Rural Water Charging Systems Discussion Paper* June 2012, p. 29

[12] IPART 2010, *Review of bulk water charges for State Water Corporation From 1 July 2010 to 30 June 2014 – Water Final Report* pp. 151-154