



**SUBMISSION TO THE IPART REVIEW OF
BULK WATER CHARGES FOR STATE WATER CORPORATION (SWC)
1 July 2010 to 30 June 2014, IN RESPONSE TO THE
DRAFT DETERMINATION AND DRAFT REPORT March 2010**

By MURRUMBIDGEE IRRIGATION (16 April 2010)

INTRODUCTION

Murrumbidgee Irrigation Ltd (MI) is an unlisted public company providing water supply, drainage and environmental services to approximately 3,200 landholdings (2,700 licences) in the MIA. The Company employs 170 staff and manages \$500 million of infrastructure assets servicing over \$2.5 billion in water entitlements.

The Murrumbidgee Irrigation Area (MIA) is one of the most diverse and productive regions in Australia contributing over \$5 billion annually to the national economy. The MIA was first established in 1912 following the commissioning of Burrinjuck Dam. Further expansion occurred in the 1970's with the completion of the Snowy Mountains Scheme and construction of Blowering Dam. The region has played a significant role in fostering cultural diversity with over 50 different nationalities now resident in the region. The region also played a significant role during and after WW1 and WW2 in terms of national security and repatriation.

In making this submission to IPART, Murrumbidgee Irrigation Ltd (MI) continues to recognise its regional and national responsibilities to assist in meeting water reform objectives for water supply services, while maintaining regional production and welfare of shareholders and other stakeholders.

Some facts on MIA value adding

Chickens - \$120 million/year, 450,000 chickens/wk and 950 jobs,
Feedlots - \$450 million/year, 75,000 cattle (150,000 through abattoir) and 800 jobs,
Wine grapes - \$147 million/year (farmgate), 300,000 mt, 430 growers, #
Wineries - \$1,000 million/year, 13 wineries, 300,000 tonnes, 60 containers exported/day, 1,500 jobs.
Citrus - \$250 million/year 185,000 tonnes, 1500 jobs including juicing and packing,
Rice - \$360 million/year (farmgate), (normal year) #
Sunrice - \$800 million /year, high export orientation, 1,100 jobs (normal year),
Walnuts - \$35 million/year expected to expand to \$400 million in 10 years, #
Vegetables - \$79 million/year (farm gate). #
Livestock (non-feedlot) - \$350 million/year, 650,000 head #
Crops (excluding rice) - \$568 million/year #

Employment data is not available

SUMMARY

The draft IPART determination recommends a further 28% real increase in SWC's bulk water charges to rural water users in NSW driven by:

- A 13% increase - \$7.3m (\$2010) - in user costs mainly as a result of:
 - ⇒ The introduction of a revenue volatility allowance of \$2.9m.
 - ⇒ An increase of \$3.7m in the return on capital due to the expected increase in the RAB of \$57m,
 - ⇒ An increase of about \$2.1m due to an increase in the real rate of return from 6.5% to 7.4% per year.
 - ⇒ A real increase in the cost of depreciating assets of \$0.8m.
- A real increase in the level of charges of 15% due to a consumption forecasts.

MI is very concerned at the impacts on rural water users and wider communities. It rejects the comparison of costs with total farm costs as a fair measure of impacts while ignoring comparison with farm incomes. We recommend:

1. *The cost estimates of revenue volatility be qualified by an estimate of the probability of the event occurring. For example a probability of the worst case event occurring over the next four years might reasonably be set at, say, 60% - and this factor could be applied to the estimated cost of the revenue volatility allowance for the worst case scenario.*
2. *That returns to equity should be removed from the cost of capital used to estimate the costs of borrowing to enable SWC to cope with revenue volatility.*
3. *That the cost shares of regulatory and environmental services be acknowledged in driving the costs of revenue volatility.*
4. *That SWC be directed to support all future investments that have impacts on charges to paying customers with a cost-benefit analysis showing the share of all drivers in costs and the share of all beneficiaries in benefits to avoid potential for explosive growth in the RAB.*
5. *That the impacts on investment incentives of differential rates of depreciation should be evaluated with a view to removing any incentive to make unnecessary investments in future.*
6. *That the real WACC of 6.5% be maintained for the next four years unless evidence is available that Australia will sustain an increase in the real WACC over that time.*
7. *The continued use of long run IQQM data for consumption forecasts, and that data be used as the benchmark for estimating the costs of annual revenue volatility (rather than moving to the moving average approach). If this is not possible then reductions in the consumption forecasts should be capped.*
8. *That improving SWC's credit rating should be achieved through either:*
 - a. *An increase in equity funding, and*
 - b. *Deferral of SWC's capex program*

DETAILED COMMENTS

The draft IPART determination recommends a further 28% real increase in SWC's bulk water charges to rural water users in NSW. This continues the trend of significant real increases for all IPART determinations on bulk water prices over the last two decades.

The 28% real increase in charges over the next four years is estimated to be necessary to meet an expected increase in user costs of 13% - or \$7.3m (\$2010) - over the next four years. The main factors are:

- A real increase of 2% (\$0.7m) in user operating costs resulting from:
 - ⇒ A real increase in operating costs (including the cost of revenue volatility) of 8% or \$2.8m (\$2010) largely due to:
 - The introduction of a revenue volatility allowance of \$2.9m (\$2010).
 - ⇒ A real decrease in MDBA and BRC costs of 22% or \$2.1m (\$2010).
- A real increase of 48% (\$6.6m) in capital costs. The main features being:
 - ⇒ A real increase in the cost of depreciating assets of 50% or \$0.8m (\$2010) due to:
 - An increase of about \$0.5m (\$2010) due to an expected \$57m (\$2010) increase in the RAB, and
 - An increase of about \$0.3m (\$2010) due to a higher rate of depreciation on new assets.
 - ⇒ A real increase in the return on assets of 48% or \$5.8m (\$2010) due to:
 - An increase of \$3.7m (\$2010) due to the expected increase in the RAB of \$57m (\$2010), and
 - An increase of about \$2.1m (\$2010) due to an increase in the real rate of return from 6.5% to 7.4% per year.
- A real increase in the level of charges required to meet a given level of costs by 15% due to a corresponding reduction in the level of expected water sales. This explains the increase in charges of 28% to meet a cost increase of only 13%.

The businesses served by SWC are most unlikely to experience a real increase in prices received for their goods and services of 28% over the next four years. On that basis alone MI requests a reconsideration of the key drivers of the increases in bulk water prices.

In this context IPART's assessment of the impact of its decisions on customers is inappropriate because total farm costs have been increasing rapidly over the last few years. The correct comparison is farm incomes which have fallen over the same period.

The introduction of a revenue volatility allowance

The revenue volatility allowance adds \$3m to fixed charge costs for general security (GS) users.¹ It is estimated as the revenue needed to meet the costs of borrowing to enable SWC to conduct its business in years of revenue shortfalls. The method of calculation is to estimate the revenue shortfalls for user charges in a 'worst case' 4 year sales scenario and apply the WACC to that value to estimate the holding charge. There are a few areas where this method should be reviewed.

First, the worst case scenario is the upper limit of estimates of the costs to SWC of managing cash shortfalls. It quantifies the financial risk of a worst case event but it does not provide any information about the probability of the event. It is equivalent to an insurer calculating premiums based on the event (loss of asset, say a house) multiplied by the market WACC. Home insurance would sky-rocket if such an approach were applied in that sector.

- 1. MI recommends that the cost estimates of revenue volatility should be qualified by an estimate of the probability of the event occurring. The probability of the worst-case drought event re-occurring over 2010-2014 may be much higher than historical data might suggest, however, it is also likely to be much lower than 100%. For example a probability of the worst case event occurring over the next four years might reasonably be set at, say, 60% - and this factor could be applied to the estimated cost of the revenue volatility allowance for the worst case scenario.*

Second, the use of the WACC to value holding costs in this instance seems inappropriate because the cost is of borrowing rather than the costs of equity. Excluding equity costs from the WACC would reduce the estimated costs of managing revenue volatility.

- 2. MI recommends that returns to equity should be removed from the cost of capital used to estimate the costs of borrowing to enable SWC to cope with revenue volatility.*

Third, it is questionable that GS users are the sole drivers of the costs of revenue volatility "because it is revenue from these customers that is volatile". It is GS users who are most exposed to the vagaries of climate and in turn suffer water availability volatility and flow on impacts to their businesses. It would therefore appear to be a perverse outcome should GS users be asked to shoulder the costs of dealing with revenue volatility.

Revenue volatility is actually 'financial volatility' that is driven by two factors. First there is drought that reduces SWC sales revenue to people with no water. Second there is an inability by SWC to adjust costs in the face of drought.

IPART notes in section 4.4.4 (when discussing the option of SWC reducing costs as a response to drought) that "much of the [SWC's] proposed expenditure is driven by regulatory and environmental drivers which are beyond State Water's control." On this basis the regulatory and environmental drivers (that are presumably still receiving valuable services) are likely to be significant impactors on the costs of "revenue volatility". Like HS water users, regulatory and environmental services may drive a higher proportion of SWC costs during drought than in average climatic conditions.

¹ The volatility allowance is broadly equivalent in cost to users of a 1.4% increase in the WACC according to table 4.8 of the draft determination.

- 3. MI recommends that the cost shares of regulatory and environmental services be acknowledged in driving the costs of revenue volatility. In future these services should be reviewed to ensure that they drive the same level of costs in average climatic conditions and in drought. If it is found that the costs of these services increase in periods of water scarcity it would seem appropriate that those drivers be treated in a similar manner to HS users.*

The very rapid expansion of the regulatory asset base (RAB)

The fear of a galloping RAB was one of the main concerns that users expressed in opposition to IPART using an RAB approach for capital pricing. The total RAB has already reached a level where simple inflation adjustment (at just 3% per year) will add over \$20m per year (\$2010) by 2014. Of this about \$7m will be ascribed to users.

MI is very concerned that the current system creates strong incentives for SWC to invest with little regard for paying customers, and with little or no realistic checks and balances. In this respect the proposed doubling of capital expenditure (investment) for user services from \$32.5m (\$2010) in 2007-2010 to over \$65m (\$2010) in 2011-2014 is somewhat frightening – not least because this is a period when water delivery services to users are expected by both SWC and IPART to decline.

The current system of line item capex budgeting every four years by SWC followed by independent expert review is failing to protect taxpayers and customers. It shifts the onus of proof that investment is justified away from the investor to an independent agent (who must prove that the investment is not justified), and excludes key stakeholders from meaningful input (including paying customers). It is also most unusual that such high levels of capex are not vetted (using standard tools such as cost-benefit analysis).

- 4. MI recommends that SWC be directed to support all future investments that have impacts on charges to paying customers with a cost-benefit analysis showing the share of all drivers in costs and the share of all beneficiaries in benefits to avoid potential for explosive growth in the RAB. The cost-benefit analysis should be made available to all stakeholders prior to inclusion in future capex plans that are part of pricing determinations. A post capex audit should be conducted by an independent group and these results as well as the cost-benefit analysis should be published to the CSC's.*

The higher rate of depreciation applicable to new investment

This more rapid depreciation of newer assets means that the 'service capacity' of assets are expected to decline more rapidly now than in the past. This may provide an incentive for SWC to invest unnecessarily (given a predisposition to 'maintain' service capacity at levels which mean rapid increases in the RAB).

- 5. MI recommends that the impacts on investment incentives of differential rates of depreciation should be evaluated with a view to removing any incentive to make unnecessary investments in future.*

The data on IPART's decision on regulatory depreciation in table 7.1 is different from that presented in table 7.5.

The increase in the WACC from 6.5% to 7.4%

IPART recommends an increase in the WACC from 6.5% to 7.4%. This change is entirely due to observed changes in estimates of the nominal risk free rate, expected inflation, and debt margins based on market data sampled over 20 days to 18 January 2010.

The decision seems likely to increase user costs by about \$2m per year over the next four years.

MI – and many other users – are very concerned that a structural decision on the WACC over the next four years (about 1,460 days) starting from July 1 can be made with reference to 20 days of data taken from the current financial year (either now or closer to the start of the determination period).

The real WACC is generally very stable over the medium and long term because the market adjusts quite rapidly to temporary changes.

A 0.9% increase in the real average WACC for the Australian economy over the next four years would be a major shock and have severe implications for economic performance.

Unless IPART is predicting such an outcome for the whole economy it becomes highly questionable to deliberately apply that shock to the rural water supply sector on the basis of data drawn from a twenty day period. In this context an increase in the real WACC would simply be a tax on SWC's paying customers.

6. MI recommends that the real WACC of 6.5% be maintained for the next four years unless evidence is available that Australia will sustain an increase in the real WACC over that time.

The increase in charges due to a 15% reduction in the level of expected water sales

MI is very concerned at the differential impacts of applying a "one-size-fits-all" approach to changing what had been a quite consistent and well accepted approach based on 100 years of IQQM modeled data.

Also, the draft determination uses multiple instruments suggested by either SWC or IPART to address the problem of revenue volatility, all of which impact significantly on price, namely:

- SWC asked for a 1.4% increase in the real WACC to combat revenue volatility (the draft determination allows a 0.9% increase),
- SWC asked for a 20% reduction in forecast consumption and increase in use prices (the draft determination allows 15%), and
- The draft determination, suggested by IPART, allows for a \$3m fixed charge to meet the costs of revenue volatility.

Given a revenue volatility allowance, the need for making other changes to address volatility becomes unnecessary. They are also potentially costly in that they have indirect impacts on matters other than SWC's volatility such as regional economic performance. On this basis, MI recommends that:

7. The continued use of long run IQQM data for consumption forecasts, and that data be used as the benchmark for estimating the costs of annual revenue volatility (rather than moving to the moving average approach). If this is not possible then reductions in the consumption forecasts should be capped.

The impact on SWC's financial position

It is unclear why SWC must achieve and maintain an over-all BBB investment grade credit rating over the 2010 determination. It appears to be a NSW Government performance target. MI does not believe that this performance target is more important than the economic health of SWC's customers and related communities.

8. MI therefore recommends that improving SWC's credit rating should be achieved through either:
- a. *An increase in equity funding, and*
 - b. *Deferral of SWC's capex program*

[ENDS]