Lachlan
Valley
Water Inc

Submission to IPART

Review of Prices

for NSW Office of Water
2010-2014

by Lachlan Valley Water

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EXECUTIVE SUMMARY

We have had extreme difficulty in developing a response to the NSW Office of Water (NOW) submission due to the lack of useful information provided in their submission, and in particular, the lack of detailed reports of previous expenditure on a valley basis and activity basis. We found the PricewaterhouseCoopers (PWC) report very useful in providing greater detail and explanation of NOW's costs.

As a result of NOW's delay in providing its submission to IPART for this determination, we recommend that no adjustment to charges be made during the year and that NOW's water management charges should remain at the 2009/10 levels for the 2010/11 year.

Key features:

LVW does not consider NOW's 2006-2010 expenditure represented an efficient level of operating costs, with significant under-delivery in some areas and a lack of clarity about the linkages between the level of resources and the achievement of outcomes.

Nor does LVW consider the proposed operating costs to 2014/15 represent an efficient level of costs. The PWC report states that the method used to estimate forward costs created a disconnect between historical and future costs. LVW believes NOW has not developed a business case for the forecast additional staff numbers that are proposed, and recommends that IPART not make any allowance for increases in staff numbers until NOW has made a satisfactory business case for the additional resources.

LVW recommends that NOW's "Scenario 2" proposal for the cost of Commonwealth reforms to be recovered from licence holders if not funded by the Commonwealth, be rejected.

We concur with PWC's recommendations regarding both past capital expenditure and the future program.

We submit that a rate of return on capital for NOW is not justified.

LVW recommends NOW's reporting requirements to IPART should be extended to providing that same information to stakeholders on an annual basis, with particular emphasis on providing valley based financial reports.

LVW submits that the cost-sharing ratios used in the 2006 determination be maintained.

LVW supports valley specific pricing for regulated, unregulated and groundwater sources, and opposes the proposal for uniform groundwater charges across all inland valleys.

LVW supports the retention of the long run average consumption forecast with the addition of recent years' data to more accurately reflect current conditions.

LVW supports retention of the current split between fixed charges and variable charges.

LVW recommends adoption of a glide path approach to mitigate the impact of extreme price increases.

LVW supports a 4 year determination period.

SUBMISSION ON NSW OFFICE OF WATER PRICES - 2010 DETERMINATION

1. Introduction

Lachlan Valley Water (LVW) is the peak valley-based organisation representing 650 surface water and groundwater irrigator members in the Lachlan Valley, including irrigators within Jemalong Irrigation Limited (JIL). This submission has been prepared on behalf of all members and represents a 'whole of valley' position, however, members have also reserved their right to make a separate submission. Our organisation is a member of NSW Irrigators Council (NSWIC) and supports the NSWIC submission.

We have had difficulty in developing a response to the NSW Office of Water (NOW) submission due to the lack of useful information provided in their original submission, and in particular, the lack of detailed reports of previous expenditure on a valley basis and activity basis. The PricewaterhouseCoopers (PWC) report was extremely useful in providing a greater level of detail and explanation of NOW's costs.

2. Establishing Efficient Costs

2.1 Historical and Forecast Operating Expenditure

IPART has requested comment on

- *The efficiency of NSW Office of Water's operating costs over the 2006 determination period and the efficiency of its proposed operating costs over 2010/11 – 2014/15*
- *Whether there is scope for NSW Office of Water to achieve efficiency gains over the upcoming determination period.*

2.1.1 Historical Operating Costs 2006-2010

LVW believes that NOW's operating costs over 2006-2010 were clearly not efficient. While NOW's total overall operating expenditure for the 4 years was close to the total forecast of $177.4 million (NOW's original submission claims a minor underspend of $428,000 over the 4 years[1], while the PWC report indicates an overspend of $220,000), the outcomes delivered by NOW in critical areas were far less than forecast.

NOW has massively underperformed on the completion of water sharing plans. In 2006 DNR stated that 60 water sharing plans were currently under development and scheduled to commence by 2009.[2] However, by 2009 only 14 of the outstanding plans had been completed and a further 38 were still to be finalised.[3]

NOW claims the delay was due to the need for clarification on how the Basin Plan and state water sharing plans would align. As PWC has pointed out, in that case it would be expected that if the staff were not working on water sharing plans, there should have been a saving in this area and a reallocation of resources elsewhere. There is no evidence of this occurring and Table 5.4 in PWC's report shows the cost of water sharing plan development rising over 2007-2009. Not only did costs rise but PWC found that water sharing plan development was the activity code with the greatest over-expenditure during that period[4].

[1] p22, NOW 2009
[2] p16, DNR 2006
[3] section 3.6.4 and section 5.3 C07, NOW 2009.
[4] p95 PWC 2010

The PWC report reveals other large variations between the forecast and actual 2006-2010 expenditure across activity codes, water sources and between valleys. For example, Figure 6.1 in the PWC report shows there was a considerable underspend on compliance activities during the current regulatory period, a result at odds with NOW's claim that increased compliance is one of the factors that causes an increase in water management activities during drought periods.[5]

PWC states it is not possible to determine whether these variations are due to a variation in the work undertaken or to the adoption of a different allocation approach. Furthermore, PWC makes it very clear how difficult it is to determine whether NOW is operating efficiently.[6] It notes that the methodology used by NOW to produce the historical accounts made it difficult to assess efficient levels of costs, refers to "evidence lacking about tangible efficiency gains having been made over 2006-2009" and that the performance indicators and output measures proposed by NOW don't enable assessment of how efficiently it is delivering services.

It is also difficult, using the information provided by NOW, to identify the links between level of resources and outputs and understand whether NOW is actually making efficiency gains, despite selective claims of improvements in hydrometrics and transaction processing. NOW's January 2010 submission provides information showing improvements in the timeliness of processing two types of transactions, however, these represent only 35% of the total number of transactions in 2008/09 and it would have been useful had NOW provided more complete information.

NOW has provided a list of water management activities in sections 3.6.1 to 3.6.14 that is comprehensive but adds little value to the price determination process because it does not clarify whether the activities are IPART or non-IPART, nor whether these represent the required service level, a higher level of service, or additional activities not previously identified.

Overall the information provided by NOW does not indicate that its 2006-2010 expenditure has been efficient, and NOW has not shown how it links the level of resources required with the achievement of outcomes or that it has coherent planning and strategies to deal with changing conditions.

2.1.2 Efficiency of proposed operating costs over 2010/11 – 2014/15

LVW considers NOW's proposed operating costs do not represent an efficient level of costs. Our view is based on the concerns described in 2.1.1 above regarding the efficiency of the historical operating costs and the fact that NOW seems to have added no rigour to the way it has estimated future costs.

NOW has estimated its forward costs based on the forecast 2009/10 costs plus the divisional Directors' estimate of the full time equivalents (FTE) required to undertake the forecast activities, in effect the Directors "wish list", with that staff level then reduced by an arbitrary 20%. As PWC points out, this is an unusual approach which creates a disconnect between historical and future costs, and the more effective method would be to use the actual 2008/09 costs as a base level and then include an allowance for new obligations in the next determination period.

In order to arrive at a more efficient cost PWC has suggested firstly, a revised base year of 2009/10 expenditure and FTE, and secondly, several changes to NOW's forecast

[5] p5 NOW 2009
[6] p7 & 8, PWC 2010

expenditure to allow for an annual 0.5% efficiency improvement, adjust the overhead rates, remove the Metro Water costs and remove the costs of unallocated FTE's.

These are sound recommendations and LVW supports them. However, when it comes to the forecast additional staff numbers that NOW proposes, LVW recommends that NOW's methodology is so weak and the business case for any increase in resources so lacking that IPART should not make any allowance for increases in FTE until NOW has made a satisfactory business case for the additional resources.

<u>2.1.3 Scope for efficiency gains</u>

In view of our comments in 2.1.1 and 2.1.2 we believe there are significant opportunities to improve efficiency and support the improvements recommended by PWC.

<u>2.1.4 Commonwealth Reform requirements</u>

LVW totally opposes the Scenario 2 put forward by NOW which suggests that an additional $10.5 million in costs associated with Commonwealth reforms should be recovered from licenceholders if not funded by the Commonwealth.

The Murray Darling Basin Intergovernmental agreement provided that these reforms were to be at "no net cost" to the States. If the Commonwealth is now not convinced of the business case for the reforms and is not prepared to comply with the agreement there is no justification whatsoever to transfer the costs to productive water users.

We support section 9 of the NSWIC submission and recommend that Scenario 2 be rejected.

2.2 Historical and forecast capital expenditure

IPART has requested comment on:

- *DWE's capital expenditure over the 2006 determination period, taking into account drivers of this expenditure and WM outcomes achieved*
- *DWE's forecast capital expenditure program, including its expenditure drivers, scope for efficiency gains and proposed WM outcomes.*

<u>2.2.1 Capital Expenditure 2006 - 2010</u>

We concur with PWC's finding on the effectiveness of the capital program and the recommendation to reduce the historical expenditure that is added to the Regulatory Asset base (RAB) by $1.78 million.

<u>2.2.2 Forecast Capital Expenditure Program</u>

We concur with PWC's finding on the forecast capital expenditure although we are concerned that NOW is once again proposing a significant expenditure without having prepared a sound business case.

2.3 Return of capital

IPART has requested comment on:

- *The appropriateness of DWE's proposed depreciation allowance, including the assumptions underpinning the calculation of this allowance.*

LVW accepts it is reasonable for NOW to receive a depreciation allowance but are unable to comment on the calculation of the allowance as NOW has requested a combined depreciation and rate of return on capital.

In the absence of other information we recommend that IPART roll forward the depreciation allowance from the 2006 determination.

2.4 Return on capital

IPART has requested comment on:

- *Whether DWE should earn a rate of return and, if so, the appropriate rate of return to apply on DWE's assets and the means of determining this rate.*

LVW strongly opposes a rate of return on capital in NOW's case. The justification advanced by NOW is that it provides a funding source to manage the financial risks of the business, however, we suggest that in NOW's case, with a very low RAB, a rate of return would not meet this function. Instead NOW's present risk management technique appears to be to delay capital spending when it does not have the funds.

NOW has provided a totally spurious comparison in Table 3 in 4.2.3 to justify a return on capital when the organisations it cites are water delivery businesses and own large infrastructure such as dams.

If NOW wants to earn a rate of return on capital then it cannot continue to enjoy a position as a monopoly service provider and should expose all parts of its business to normal commercial disciplines such as contestability for the services it provides.

LVW recommends that a return on capital is not justified.

2.5 Output measures and reporting requirements

IPART has requested comment on:

- *appropriate Water Management (WM) output measures, performance indicators and/or reporting obligations for DWE.*

With regard to performance indicators, we endorse the approach suggested by PWC.
An additional performance measure that should be considered for licensing administration and water consents transactions is to establish a target number of days required to complete each different type of transactions and report the number of transactions completed within that period.

With regard to reporting obligations, we recommend the reporting requirements in Appendix D of the IPART Issues Paper should be extended to providing that same information to stakeholders on an annual basis. In particular, valley based financial reports are critical – we do not believe there is any 'commercial-in-confidence' argument when NOW is providing a service on a monopoly basis. It is essential that NOW are accountable for the expenditure of charges paid by licence holders.

3. Allocating efficient costs between users and the community

IPART has requested comment on:

- *whether the cost sharing approach and ratios used in the 2006 determination remain appropriate. If not, the adjustments that are required.*

3.1 Cost Share ratios

We note that NOW proposes to increase the user share for C01-02 Surface water quantity data management and reporting, from 50% to 70%. While NOW forecasts an increase in operating expenditure for this activity as a result of taking responsibility for the operation of 128 additional gauging station, no explanation has been given for the proposed change in cost shares. We therefore recommend the cost shares remain unchanged.

4. Setting Prices

4.1 Forecast Water Sales

IPART has requested comment on:

- *The robustness of DWE's water usage (extraction) forecasts, as outlined in the submission*

Water Extraction Forecasts

While NOW's preference is for 100% fixed charges, if usage charges are retained it proposes adopting the CIE 15 year rolling average forecasts.

The statistical analysis by CIE concludes there is a structural break in patterns of water availability, however, this is not supported by the CSIRO Sustainable Yields Report for the Lachlan[7], which states "the average annual rainfall and runoff over the ten-year period 1997 to 2006 are 8% and 24% lower respectively than the long-term averages, but statistically, they are not significantly different due to high inter-annual variability".

We support the retention of the long run average consumption forecasts with the addition of recent years' data up to and including 2009/10 to more accurately reflect current conditions.

4.2 Water entitlement and usage charges

IPART has requested comment on:

- *The appropriate balance between DWE's fixed and usage charges*
- *The merits of having regulated river, unregulated river and groundwater charges that are valley specific as opposed to being uniform throughout the State or regions.*

4.2.1 Balance between Fixed and Usage Charges

We strongly oppose NOW's proposal to move to 100% fixed charges.

We consider that would move all the risk of variable usage onto licence holders and reduce even further any incentive for NOW to achieve efficiencies.

Furthermore, we disagree that NOW's costs are 100% fixed regardless of the volume of water delivered.

LVW considers there is a strong relationship between volume of usage and the amount of work required by NOW in groundwater sources. That is, an area where usage is low should need little monitoring or additional management, while in an area with high usage there is greater potential for local impacts to occur and we would expect that additional monitoring and more intensive management would be required.

LVW supports retention of the current split between fixed charges and variable charges.

4.2.2 Valley specific charges as opposed to uniform charges

LVW opposes the proposal to amalgamate groundwater charges into only 2 regions – inland and coastal. To move to a standard charge across all inland valleys will result in a complete lack of transparency and probable cross subsidisation.

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[7] page ii, Executive Summary, CSIRO 2008

NOW's 2006 submission stated that the main factor influencing unit cost differentials among groundwater users in different valleys was the volumes of groundwater entitlement[8], implying that to a large extent a fixed level of service is required to manage a groundwater area regardless of the volume of entitlement held. NOW also stated that highly managed groundwater areas require higher levels of input than less highly managed areas.

NOW has now advanced an argument that is completely the reverse but has provided no substantiation.

At the same time NOW has prepared 6 separate water sharing plans for groundwater sources in inland NSW, indicating that different management is required across these 6 major areas, and very probably that different levels of costs will be incurred.

LVW strongly supports transparent, valley specific pricing for regulated, unregulated and groundwater sources.

4.3 Adjusting prices to deal with risk

IPART has requested comment on:

- *Mechanisms to address risk associated with variations between forecasts used in setting prices and actual levels in water availability and extractions*

LVW recognises the low availability of water in recent years has reduced NOW's revenue, as it has their customers' income. As noted elsewhere, we consider NOW has some capacity to manage the impact of reduced revenue by deferring WM activities, but we acknowledge there may be value in allowing price adjustments in a subsequent determination period to account for variation outside a preset range ('deadband). The mechanism should operate for variation both over and under the 'deadband' and be managed on a cumulative basis over the full determination period.

4.4 Linking prices to DWE's water management performance

IPART has requested comment on:

- *Potential regulatory mechanisms to link DWE's performance to its prices over the upcoming regulatory period*

NOW's performance in meeting the reporting obligation imposed on it in the 2006 determination, and in providing information to IPART for this determination, has been very poor, with late and incomplete provision of information.

LVW therefore recommends that NOW's water management charges should remain at the 2009/10 levels for the 2010/11 year

An example of where there has been wide variation between NOW's WM performance and its prices is the variation between forecast and actual expenditure on different groundwater sources in 2006 - 2010, with the Lachlan and Macquarie significantly underspent compared with forecast[9]. In the case of the Lachlan we calculate the underspend at $2.3 million, or the equivalent of almost 2 years' WM charges.

In a situation like this where there is a large variation we recommend there should be a mechanism within the determination period to suspend WM charges until NOW undertakes the planned water management activities.

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[8] p31, DNR 2006
[9] p99 PWC 2010

4.5 Length of determination period

IPART has requested comment on:

- *The appropriate length of DWE's upcoming determination period*

LVW supports a 4 year determination period. The determination process imposes a high workload and cost on all parties involved and in our view it is preferable that these costs be spread over a longer period of time.

We note that NOW has requested a 3 year determination period to allow the Office to reassess the resources required to deliver its responsibilities once the Basin Plan is established, and that NSW will be responsible for currently unknown operation, compliance and maintenance costs associated with State Priority Projects once the projects are implemented.

As the critical date for current water sharing plans to comply with the Basin Plan is 2014, when the plans would have been reviewed in any case, we suggest that NOW has already factored the Basin Plan responsibilities into its estimates by identifying 47.5 FTE's to undertake new core activities and 57 FTE's to undertake Commonwealth reform activities.

We also consider the State Priority Projects are unlikely to generate operation or compliance costs within the determination period because most of them are still at the business case stage and have not yet commenced on-ground works.

LVW supports a 4 year determination period.

4.6 Assessing the impacts of pricing decisions

IPART has requested comment on:

- *The impact of DWE's proposed prices on water users*

NOW suggests that although they are seeking price rises of around 100% in the first year, overall the impact of increased charges is relatively small because bulk water costs are a small proportion of total farm costs.

We disagree that the impact will be minor when most regulated and unregulated river water users in the Lachlan have received virtually no water allocation over the last 4 years.

LVW suggests a glide path approach be adopted to smooth the impact of price increases.