Lachlan
Valley
Water Inc

Submission to IPART

Draft Determination of Bulk Water Prices

for State Water Corporation
2010-2014

by Lachlan Valley Water

April 2010

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SUBMISSION ON DRAFT DETERMINATION FOR STATE WATER, 2010

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 separate submissions.

LVW is a member of NSW Irrigators Council (NSWIC). We support the NSWIC submission and provide the following comment on specific issues.

2. Addressing the risk associated with revenue volatility

The draft determination includes a volatility allowance in State Water's operating expenditure to address the risk associated with revenue volatility due to variable sales.

While acknowledging that the effect of variable sales needs to be managed, LVW believes IPART has over-compensated for the revenue risk to State Water by including a volatility allowance plus the reduction in forecast usage plus an increase in the weighted average cost of capital (WACC).

As noted in our initial submission to IPART, State Water has chosen not to implement an obvious strategy to address revenue volatility, namely to widen their customer base to include other users of their services such as recreational users and those exercising basic landholder rights. State Water states it has not pursued recovery of costs from other users and beneficiaries because of the difficulty in doing so. While we acknowledge this is a genuine issue, we also point out that it detracts from efficient operation when users are able to demand State Water provide service levels without incurring the cost of such service provision.

We therefore consider it is unreasonable that the chosen risk management method loads the cost onto a sub-section of users and does not contain checks and balances. A major concern for State Water customers, who are already under severe cost pressures of their own, is the over-recovery of revenue as a result of the volatility allowance.

In the Lachlan's case the volatility allowance of $480,000/yr equates to the usage charge for 36,500 ML per annum, so State Water will be over-recovering at any delivery of greater than 222,000 ML, in effect giving State Water the same outcome as using the 15 year rolling average usage it had proposed.

We submit that the volatility allowance will lead to over-recovery of revenue and is unnecessary when two other means of managing risk have also been proposed.

However, if the volatility allowance does remain it should operate in such a way that it manages the impact of variable water sales for both State Water and water users. The proposed model protects only State Water. IPART has said State Water **may** hold this allowance in a designated account but does not require State Water to do so. This leaves the way open for the volatility allowance to be folded into general operating income, boosting profit and potentially being paid to the NSW Government as a dividend, rather than fulfilling the risk management function, particularly in a situation where sales are close to or exceed the forecast level.

We recommend that State Water be required to hold the volatility allowance in a separate account that is available only when extraction is below the forecast level. This would ensure it fulfilled the risk mitigation function and would protect licence holders from over-recovery of revenue.

LVW recommends that the volatility allowance is unnecessary, given that the risk of lower water sales has been addressed by the 20 year rolling average usage estimate and that an increase in WACC has been recommended.

However, should IPART retain the volatility allowance in its current form, it must require State Water to hold the allowance in a designated account so that the allowance can properly fulfil a risk management function.

3. <u>Price Path</u>

LVW considers that the smoothed NPV neutral price path adopted by IPART produces a significant price shock for Lachlan water users in 2010/11. A general security licence holder using 50% of their entitlement will suffer a 23% bill increase and a high security customer using 80% of their entitlement will suffer a 17% bill increase.

This leads to an anomaly where customers in valleys that are below full cost recovery have their bill increases capped at 10% per annum while customers in valleys at full cost recovery are subject to significantly higher per annum increases.

We have analysed the State Water charges as a proportion of farm cash costs in both cases and concluded that State Water bills do not represent a significantly different proportion of farm cash costs in the valleys that are at full cost recovery compared with those below full cost recovery.

This can be seen in Tables 12.7, 12.8 and 12.9, which show that State Water charges are expected to constitute 8.5% of farm cash costs for HS users in the Peel Valley by 2013/14, and 3.5% for GS users. In the Lachlan Valley by 2013/14 State Water charges are expected to constitute 1.56% of farm cash costs for HS users with 150 ML and 4.11% for GS users with 1000 ML.

Therefore it cannot be claimed that the relative impact of large increases in charges in valleys below full cost recovery would be more severe than in valleys at full cost recovery.

We understand and support the capping of bill increases in the valleys not at full cost recovery but believe it is inequitable that State Water customers are treated differently in different valleys.

LVW recommends that either the glide path approach be adopted or that the same bill capping procedure be applied to all valleys in order to reduce price shocks for customers.

4. Cost Sharing between Users and Government

LVW considers that IPART's decision to retain a 50% user cost share for fish passage works triggered by dam safety upgrades represents an incorrect application of the "impactor pays" principle.

The dam safety upgrades are being undertaken in order to meet changing community and safety standards, not in order to improve the dam's functional ability to deliver water. The requirement to provide fish passage is therefore a direct consequence of undertaking the safety upgrade on a dam and should be treated as an integral component of the dam safety upgrade.

Under these circumstances the "impactor" is the change in community expectations and standards. The beneficiary of the upgrade is also the community at large rather than irrigators. We submit that the fish passage should therefore be funded in the same way as the safety upgrade on pre-1997 assets, namely as a legacy cost.

LVW recommends that the provision of fish passage as a result of dam safety upgrades to pre-1997 assets be considered an integral component of the dam safety upgrade and therefore 100% funded by Government.

5. Capital Expenditure

LVW supports the Atkins/Cardno recommendation that State Water's expected capital expenditure for 2009/10 be reduced by $13 million to allow for the likelihood that State Water will not meet its increased expenditure forecast this year.

We also support the Atkins/Cardno recommendation that State Water should take a more prudent approach to cold water pollution mitigation and that proposed solutions should initially be tested at one site to determine whether they are technically and economically feasible rather than automatically being included in the costs for the upgrades to Keepit, Copeton, Wyangala and Burrendong.

6. Rebates to Irrigation Corporations

LVW supports the provision of rebates to ICDs to the extent that the services provided by ICDs reduce State Water's operating costs, and agrees with IPART's recommendation on rebates.

We support the draft decision that if an individual within an ICD transforms to create a new licence on the river that should result in a reduction in the rebate, however, if water entitlement is transferred out of an ICD without transformation and is simply added to an existing licence on the river we expect there would be no additional cost incurred by State Water and therefore no reduction in the rebate.

7. Return on Capital

As noted earlier, LVW considers that the increase in pre-tax WACC from 6.5% to 7.4%, combined with the other measures designed to address the risk associated with revenue volatility, over-compensates for the risks faced by State Water and is not warranted.

While LVW agrees that State Water needs to be a successful business, the ability to charge a mandated return on capital insulates State Water from the commercial discipline and business conditions that its customers face.

We note that State Water's customers have earned very low returns on capital in recent years, in the order of 1% or less, and that for State Water to expect to continue to earn 7.4% return during the most severe disruption to supply the irrigation industry has faced in 100 years is not commercially realistic.

LVW considers that the risks faced by State Water are heightened by the requirement for State Water to pay 70% of profit as a dividend to NSW Government. This reduces State Water's ability to retain earnings to both manage the risks associated with revenue volatility and to fund its capital expenditure program from earnings rather than borrowings.

One of the reasons State Water advanced for increasing the rate of return was in order to retain its investment grade credit rating. IPART has considered 3 alternate methods of maintaining an investment grade credit rating and requested comment on them:

- Increase equity funding through larger equity injections from shareholders
- Defer portions of the capital expenditure
- Increase the WACC premium

LVW considers that the threats to State Water's credit rating are largely driven by Government as a result of the size and timing of the capital expenditure program being proposed and the decision that this expenditure should be debt funded. We consider the stepped deferral option for capital expenditure outlined by IPART is worthy of consideration and discussion with the NSW Dam Safety Committee to determine the risk associated with such deferral. We understand that indefinite deferral is not acceptable, however, a partial, stepped deferral should be considered as an option if the over-riding objective is to maintain State Water's credit rating.

If deferral is determined by the NSW Dam Safety Committee to carry an unacceptable risk, and the shareholders require State Water to undertake a capital expenditure program that substantially increases the risk to the entity, it is reasonable to expect that the shareholders should bear that risk. LVW considers that increasing the WACC premium is the least desirable method of maintaining the credit rating because Government is the impactor for the expenditure decision but costs would fall on customers as well.

We concur with IPART's observation that firms making large capital investments often seek additional equity funding through reinvestment of dividends. We also note that many public companies in Australia raised large amounts of equity in 2009 to recapitalise their balance sheets.

LVW therefore considers that prudent management and alignment with good commercial practice would require increased equity funding of State Water in order to maintain an investment grade credit rating.

LVW supports larger equity injections from shareholders as the means of maintaining State Water's credit rating.