



# Lachlan Valley Water Inc

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Representing  
and Uniting All  
Lachlan Valley  
Water Users

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22 November, 2005

Mr J Cox  
Chief Executive Officer  
Independent Pricing and Regulatory Tribunal  
PO Box Q290  
QVB Post Office NSW 1230

Dear Mr Cox,

**Re: Bulk Water Prices – 2006/07 to 2008/09**

Please find attached our submission on bulk water prices. We would welcome the opportunity to provide additional comment after the independent consultant's report into operating and capital expenditure is released.

We also request the opportunity to be involved in the regional hearing in Dubbo to provide further input to this process.

Yours faithfully

Mary Ewing  
Executive Officer

# BULK WATER PRICES 2006/07 – 2008/09

## SUBMISSION TO IPART

### LACHLAN VALLEY WATER



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## BULK WATER PRICES 2006/07 – 2008/09

### EXECUTIVE SUMMARY

- Efficient Level of Costs.** IPART's 2005 determination found that the Lachlan was already at full efficient cost recovery for both SWC costs and DNR costs. SWC now proposes a 50% increase in operating costs from the average for 2001-2004 to 2006/07. We support the need for SWC to be viable and able to fund its efficient operating costs but do not accept that the proposed 2006/07 levels represent efficient operating costs. The budgeting and business management processes used by SWC reflect its monopoly position and lack of market discipline and provide no driver to control costs, increase productivity or consider more economic ways of delivering services. Our concerns are supported by the Marsden Jacob Cardno Report of May 2005 which found that there was no sound basis for the cost increases proposed by State Water and that SWC's forecast Opex levels for 2005/06 – 2008/09 did not represent efficient costs
- Cost of Corporatisation of State Water.** We are alarmed that the costs of corporatisation have increased from \$2.7 million in SWC's 2004 submission to \$8.2 million now, with cost savings not expected to eventuate until 2008/09, and question whether the process has been managed effectively.
- Level of Service.** As customers we want to be involved in assessing the trade-off between level of service to be provided and the cost of that service. We urge SWC to provide Customer Service Committees with accurate and timely information on the projected operating costs to enable customers to make informed decisions on the level of service required.
- Usage Base for Pricing Purposes.** Basing SWC usage prices on usage of 1 standard deviation below the WSP average diversions has a huge impact on price per ML. In the Lachlan the usage price is 55% higher than it would be if based on average usage. This results in over-recovery of \$1.5 million per year when the actual usage is the WSP average of 305,000 ML. LVW recommends that usage prices are based on modelled average WSP diversions, which already take into account climatic variability and usage limits.
- Ratio of High Security to General Security Entitlement Charges.** LVW considers there is a degree of double counting in the method SWC has used to calculate the increased security of high security water relative to general security. We suggest an alternative method is to consider the relative availability of water to high security and general security licence holders, which would yield a ratio of 2.38 for high security to general security.
- Wholesale Discounts.** In LVW's view there are cost savings for SWC, not because of the volume of water supplied, but in dealing with an Irrigation Corporation with one large licence rather than 100 shareholders. Where Irrigation Corporations provide services that assist SWC or DNR, then the Corporation should either receive a discount that reflects the cost saving or the service should be provided via a service level agreement between the Corporation and SWC or DNR.
- SWC Cost Shares.** SWC has a range of users of its services and efficient operation requires SWC to be transparent about where costs are incurred to meet the requirements of different types of users of its services. We urge that SWC be required to broaden its revenue base to recover costs from the full range of users.
- Community Service Obligation.** We recommend that the cost sharing principles be reviewed and delivery of basic rights be identified as a Community Service Obligation.

The cost of meeting this obligation rises steeply under severe drought conditions when the majority of the costs incurred by State Water relate to essential supplies and basic rights delivery, and it is inequitable that water access licence holders pay the full costs for this delivery of service.

9. **Customer Ability to Pay:** SWC acknowledges that unconstrained prices have significant impacts and cannot be implemented as they stand. It suggests mitigation options, either by spreading the cost increases progressively over 5 years or putting a limit on the maximum increase to a customer bill in a single year. LVW recommends that any increases in price for SWC and DNR combined be limited to 5% per year.
10. **RAB Approach.** LVW understands the pricing principles and accepts that SWC should be able to fund prudent capital expenditure in an efficient and flexible manner, and that a Regulatory Asset Base method may be an appropriate way of doing so. From a customer point of view there are significant problems with the way SWC has structured this RAB, specifically the opening value and the rate of return. The 1997 line in the sand is established pricing policy and the opening value of the RAB must be set at a level that does not seek a rate of return on pre-1997 assets. SWC's proposed 7% rate of return is excessive given SWC's risk profile and we recommend the WACC be set at the minimum acceptable level.
11. **Dam Safety Compliance.** LVW supports 100% of the costs of upgrading dams up to 1997 standards being borne by Government. We do not support SWC's proposed cost sharing after that. If the community higher standards of safety the flood mitigation benefits should be assessed through a process of identifying the assets at risk and quantifying the expected impact of dam failure on those assets in \$ terms. This would enable a costing of the total financial impact of dam failure and allow users' proportional share of benefit to be determined.
12. **DNR Water Resource Management Costs.** LVW views DNR's proposed redefinition of WRM costs as massive cost shifting to extractive users, and supports the retention of IPART's 2005 definition of WRM activities, and in particular, the criteria "*that the benefits to extractive users are insufficient on their own to justify the costs of the activities.*"
13. **Accountability for WRM Costs.** DNR's submission states that WRM costs are \$5-10 million lower than the cost base adopted by IPART in 2005. DNR must be accountable where funds have been collected from users and not spent on their proper purpose, and we ask that IPART undertake a reconciliation of DNR and SWC revenue collected and costs incurred. Licence holders should not be required to pay again for services that have been funded but not performed due to internal restructuring or management problems.
14. **DNR Cost Shares.** DNR proposes that licence holders have a primary duty-of-care obligation to meet the agreed environmental objectives as set out in the WSP's, thus protecting their access rights to water. LVW rejects this concept. Licence holders have a responsibility to meet their licence conditions and can only be expected to pay for services provided by Government where the services deliver on clearly defined outcomes. The WSP environmental objectives are guidelines for natural resource management outcomes that are part of Government's policy and regulatory responsibility to the community as a whole.
15. **Transaction Costs On Water Consents** We accept the principle that these costs should be subject to full efficient cost recovery. However, full cost recovery should be conditional on DNR improving the efficiency and timeliness of its service in order to provide a level of service commensurate with the costs. There should be no cost increases until current processing backlogs are cleared.

# **SUBMISSION ON BULK WATER PRICES 2006/07 – 2008/09**

## **1 INTRODUCTION**

Lachlan Valley Water (LVW) is the peak valley based organisation representing surface water and groundwater users in the Lachlan Valley. LVW is a member of New South Wales Irrigators Council and in addition to supporting the principles advocated in the NSWIC submission, our submission addresses the major areas of concern to Lachlan water users in both the State Water Corporation and Department of Natural Resources submissions.

We have approximately 550 members representing 650,000 ML surface water and 400,000 ML groundwater entitlement, including irrigators within Jemalong Irrigation Limited (JIL). This submission has been prepared on behalf of all members and represents a 'whole of valley' position, except where JIL members have reserved their right to make a separate representation on Wholesale Discounts.

## **2 WATER DELIVERY COSTS – STATE WATER CORPORATION**

We support the need for State Water Corporation (SWC) to be a viable water delivery business that is able to fund its efficient operating costs and capital expenditure in a manner that is equitable and transparent and does not exploit its monopoly pricing position. As such we are concerned that the SWC submission has not adequately addressed some fundamental pricing issues and has instead simply taken the position of passing costs on to their customers:

- achieving efficient costs
- the capital structure of State Water Corporation and its financial performance requirements
- cost sharing principles – SWC has a wide range of users of its water delivery services, but only some of these users are paying customers
- risk management

### **2.1 OPERATING EXPENDITURE**

#### **2.1.1 Efficient Level of Costs**

IPART's pricing determination for 2005/06 found that the Lachlan was already at full efficient cost recovery for 2004/05 for both SWC costs and DNR costs. We therefore find it difficult to understand why cost increases of approximately 50% between these levels and the 2006/07 levels are proposed by SWC.

State Water Corporation has used zero-based budgeting to forecast operating expenditure. The costs resulting from this approach, as highlighted in Table 1 below, suggest that zero based budgeting is not an effective approach to use for a monopoly business which is not subject to competitive market discipline.

There is no incentive to control costs, increase productivity, or consider innovative and more economic ways of achieving the required outcomes. The following table compares past and projected Lachlan Operating Expenditure (Opex):

**Table 1. Comparison of Lachlan Opex, 2001/02 to 2006/07**

OPEX	Av. 2001/02- 2003/04	2004/05	2005/06	2006/07
<b>A Items (wages)</b>		1,428,879	1,761,200	
<b>B Items (other)</b>		1,190,831	1,726,800	
<b>Overheads</b>		995,000	1,154,100	
<b>Total (\$)</b>	<b>3,097,000</b>	<b>3,614,710</b>	<b>4,642,100</b>	<b>4,467,000</b>
<b>Increase from previous year</b>		16.7%	28.4%	-3%

Source of data: 2001/02 – 2003/04 Marsden Jacobs Cardno (MJA Cardno) report  
 2004/05, 2005/06 – State Water Corporation response to questions  
 2006/07 – State Water Corporation submission

Operating costs have jumped 50% from the average for 2001-2004 to 2005/06. While some of the increase is related to the additional costs of State Water becoming a separate corporate entity, we expect most of this should have been reflected in the 2004/05 cost increases. The increase between 2004/05 and 2005/06 is alarming with wages increasing by 23% and other items by 45%. We do not accept this represents efficient operating costs.

SWC argues that the funding provided to them statewide between 2001/02 and 2003/04 was some \$6 to 7 million per year below the funding level requested, however, it is clear from SWC's submission (Figure 7.4 on page 77) that the actual Opex in those years was in line with or slightly below IPART's determination of efficient operating costs. In other words, the revenue constraint from 2001/02 to 2003/04 forced State Water to operate at efficient cost levels and this has been achieved while maintaining acceptable levels of service to customers.

SWC claims the 2001/02 to 2003/04 level of costs is not sustainable in the long term, however, in our view the budgeting approach SWC has used is not conducive to operating a cost effective business. For an organisation where over 60% of costs are related to staff numbers, efficient operation should include the consideration of technology and other avenues to improve productivity, yet there is little evidence these areas have been considered in the budgeting process and SWC instead proposes to increase staff numbers by 22% (57 extra FTE) between 2004 and 2006/07 (p79, SWC 2005 submission).

Our concerns are supported by the MJA Cardno Report of May 2005, which concludes that there is no sound basis for the cost increases proposed by State Water and that SWC's forecast Opex levels for 2005/06 – 2008/09 do not represent efficient costs. Quoting from the MJA Cardno Executive Summary:

- 66. *No material change in function, obligation or service standards, post 2003/04 or the next regulatory period, was identified that justified an increase in total Opex costs in State Water's forecasts.*
- 68. *Forecasts for 2004/05 (used by State Water as the basis for forecasting Opex costs for the 2005/06 to 2008/09 period) have no obvious or logical connection with actual costs for the 2001/02 to 2003/04 period, or to any material change in function, obligation or service standards.*
- 69. *The 2004/05 forecasts adopted by State Water are not representative of an 'efficient' cost base. Accordingly, the Opex forecasts proposed by State Water for the 2005/06 to 2008/09 period do not represent 'efficient' costs.*

**Summary:** LVW does not consider SWC's projected costs represent efficient costs, nor does SWC's business approach lend itself to achieving cost control and more economic ways of delivering services.

### 2.1.2 SWC Corporatisation

In 2004 SWC identified the net costs of corporatisation at \$2.7 million (p52, SWC 2004 submission). The additional costs are now estimated at \$8.2 million (p100, SWC 2005 submission) and cost savings are not expected to eventuate until 2008/09. SWC's response to corporatisation seems to have been to increase staff numbers, with 20 additional head office positions created, rather than to look for efficient means of achieving the outcomes.

We question whether this represents efficient management of the corporatisation process and whether State Water was in a condition to meet Treasury expectations at corporatisation. SWC itself acknowledges that its financial information systems weren't adequate for the task, and capital expenditure has been underfunded for some years.

### 2.1.3 Level of Service

SWC states they have been guided by the level of service required by customers as established through the Customer Service Charter and valley Customer Service Committees (CSC's). In reality customers have had no opportunity for informed consideration of the trade-offs between cost and level of service because discussions between SWC managers and the CSC on levels of service have taken place in isolation from the budget process. SWC's IPART submission was prepared without informing the Lachlan CSC of the costs implicit in the preferred levels of service.

Customers want an informed consultation process where the level of service is linked with the expected cost and customers then have the opportunity to collaborate in determining the most economic way to deliver the required outcome. This may include increased adoption of new technology or customers accepting a different standard of service.

**Recommendation:** that SWC managers provide accurate and timely information to CSC's to allow the trade-offs between level of service and cost to be considered.

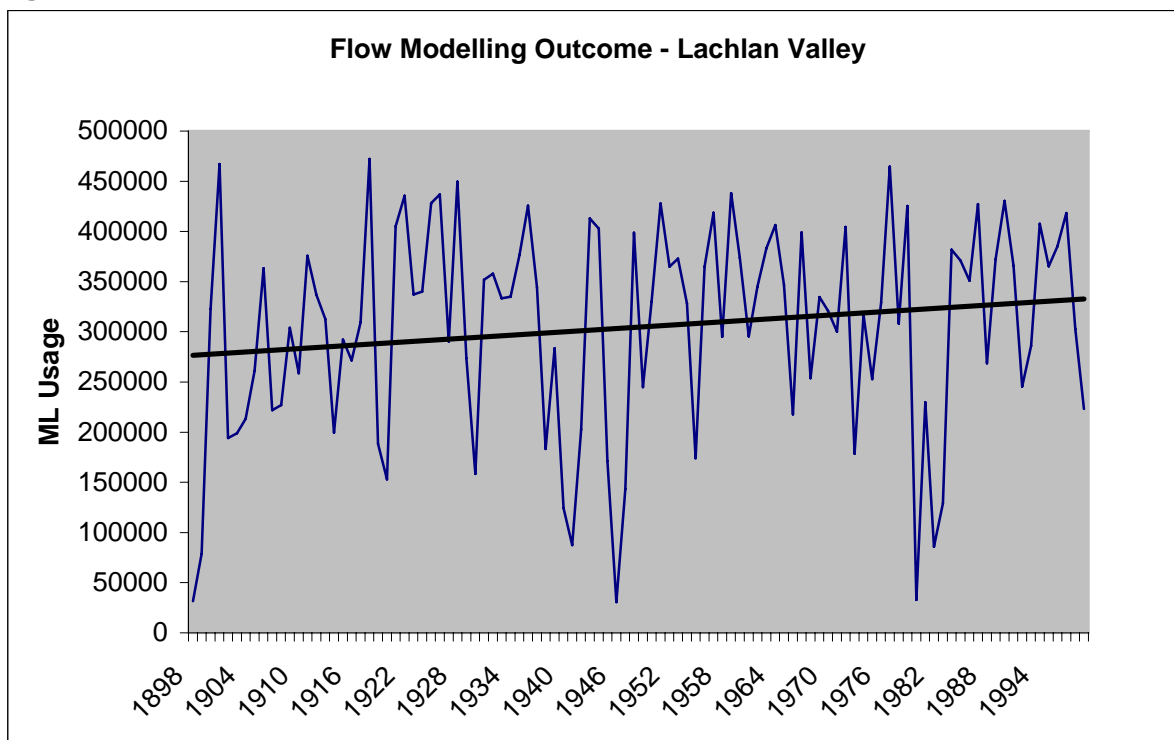
### 2.1.4 Usage Base for Prices

We strongly oppose SWC's proposal to base the usage estimate on one standard deviation below modelled average extraction. This is an extremely conservative measure and it vastly overstates the risk to SWC's revenue as only 17% of years will actually fall 1 standard deviation or more below the average diversion as modelled over 105 years for the Water Sharing Plan.

The following graph shows annual extraction as modelled for the Lachlan Water Sharing Plan (WSP) over the period 1898 to 1999, and the trend line. The modelled extraction data for the WSP already takes into account climatic variation and the use limit that is required to keep long term average extraction at the Plan Limit of 305,000 ML. Given that the average extraction already incorporates climatic variability, and the trend line has been rising, it is unrealistic to suggest the usage estimate should be based on anything like 198,952 ML.



**Figure 1. Modelled Extractions under the Lachlan WSP**



Source of data: DNR Lachlan WSP Diversions, IQQM E229

Actual extractive usage in the Lachlan over the past 8 years since the MDBC Cap was imposed has averaged 262,000 ML. This 8 year period includes the worst drought in history with 2 years of zero general security allocation and one year of only 3% general security allocation.

**Table 2. Lachlan River – Extractive Usage 1997/98 – 2004/05**

Year	Extractive Usage (ML)
1997/98	414,000
1998/99	278,000
1999/00	285,000
2000/01	407,000
2001/02	435,000
2002/03	224,000
2003/04	37,000
2004/05	18,000
<b>Average</b>	<b>262,250</b>

Source of data: State Water

Basing usage prices on 198,952 ML has a huge impact on price per ML. The usage price is \$5/ML (or 55%) higher than it would be if based on average usage. Charging SWC’s proposed unconstrained price of \$14.41/ML for usage when the actual usage is the average of 305,000 ML results in over-recovery of \$1.5 million per year. SWC makes brief mention of a revenue shortfall adjustment mechanism under section 10.3.8 in its submission, but makes no undertaking that such over-recovery would be reserved to smooth revenue fluctuations as a result of variability in water delivery rather than simply adding to profit.

We understand there is some risk to SWC’s revenue as a result of drought, however, given the usage history outlined above we recommend the usage estimate be set at the average usage for the next pricing determination and that SWC manage the risk by investing over-recovery in order to cover any future shortfalls.

**Recommendation:** The usage estimate be set at the average usage as modelled for the WSP.

### 2.1.5 Wholesale Discounts

In LVW's view Jemalong Irrigation Ltd (JIL) provides services and information that assist SWC and DNR. We accept SWC's view that there are no economies of scale in terms of volume of water supplied, i.e, it costs them as much to service a 10ML water order as a 1,000 ML order. However, if the Irrigation Corporation did not exist SWC would incur additional cost to service 100 smaller licences rather than one large licence. We also understand that JIL provides information to DNR as part of its Environmental Report that assists DNR in meeting its regulatory functions.

We do not have information on these costs or whether the 27% discount for JIL is an accurate reflection of the cost savings. The key principle should be transparency. Where Irrigation Corporations provide services that assist SWC or DNR, then the Corporation should either receive a discount that reflects the cost saving or alternatively the service should be provided via a service level agreement between the Corporation and SWC or DNR.

**Recommendation:** That discounts be retained but the discount to be set at a level that transparently reflects the cost saving to SWC and DNR.

### 2.1.6 High Security and General Security Fixed Charges

SWC proposes a change in the ratio between high security and general security fixed charges in the Lachlan from the current 1.5 to 3.76 on the basis that the margin should be equal to the high security premium in the WSP multiplied by the numbers of years of high security storage that must be held before water can be allocated to general security.

LVW believes there is an element of double dipping in this calculation because the high security premium already factors in the requirement that the conversion of general security to high security licence should not impact on the reliability of any other categories of licence.

We suggest an alternative method is to consider the relative availability of water to high security and general security licence holders. In the Lachlan WSP the Plan Limit, ie the long term average usage, is set at 305,000 ML/year. High security is entitled to 100% allocation before any water is distributed to general security, therefore, if all high security water was used, this would leave 250,000 ML of the average annual usage for general security, and the relative availabilities of water are expressed in the following table:

**Table 3. Availability of High Security and General Security Water**

	Entitlement	Availability (ML)	Availability (%)
High security	55,000	55,000	100
General security	593,000	250,000	42

The ratio of high security to general security availability is  $100/42 = 2.38$ . We recommend this be adopted as the ratio for fixed charges.

**Recommendation:** That the ratio for high security to general security fixed charges be 2.38.

### **2.1.7 Hydrometric Services**

LVW supports SWC's proposal that water users should be responsible only for the costs of the 399 gauging stations required for the operation of regulated rivers.

### **2.1.8 Contestability**

LVW urges that where services are obtained by SWC by means of a service level agreement from DNR or any other organisation, as far as possible these services should be fully contestable.

### **2.1.9 Cost Shares**

Under the Water Sharing Plans (WSP) SWC has two types of users of its services – paying customers who hold water access licences, and clients who receive water as a result of SWC's operation of the river but who are not required to pay for that service, namely basic rights holders, recreational water users and the environment. The WSP places the environment and basic rights holders needs at a higher priority than extractive users, and limits extractive users on the Lachlan River to 25% of the average annual flow (p 6, Lachlan Regulated River WSP).

Even under average conditions the supply of water to basic rights holders and the environment has placed an increased workload on SWC, as noted on page 78 of their submission, which states *"river operations are now a year round activity as environmental flows and riparian releases are paramount"*.

It is therefore disappointing that in this submission, in contrast to their 2004 submission, SWC has identified that there are a whole range of users of its services but made no effort to recover costs from any of these other users. In failing to do so, SWC is failing to meet its objective *"to operate at least as efficiently as any other comparable business."* To operate efficiently SWC must broaden its revenue base to recover costs from the full range of users.

When SWC is required to meet operational requirements for users who don't pay for this service, there is no incentive to achieve efficiencies in the supply of this water. The financial benefit to other users was assessed in a report prepared for the Australian Conservation Foundation on the economic values derived by river dependent industries, which found that such industries on the Murray and Darling Rivers were worth \$1.6 billion per year.

Efficient operation requires SWC to be transparent about where costs are incurred to meet the requirements of different types of users of its services. Where environmental, social or other outcomes are sought and it is not possible to recover those costs directly from users they should be covered by a Community Service Obligation.

Under drought conditions the supply of water to non-paying clients assumes even greater importance and there are very real costs involved in managing the river to meet these priorities. Even under severe water shortage conditions the priorities of supply are:

1. Domestic
2. Environment
3. High security
4. General security

The experience in the Lachlan over the past 3 years is a graphic demonstration of this – by far the majority of flows managed by SWC have been to provide basic running of the river to

deliver essential supplies, basic rights and, in 2001/02, environmental flows, yet SWC has made no attempt to recover costs from any other users than licence holders.

**Table 4. Extractive Share of Total Flows – Lachlan River**

Year	Total Flow	Extractive Use (High security & general security)	Extractive Use as % of Total Flow	General Security Allocation (%)
2001/02	789,000	432,000	55%	58
2002/03	435,000	200,800	46%	3
2003/04	171,000	36,900	22%	0
2004/05	136,000	18,000	13%	0

Source of data: State Water

There are clear grounds for a Community Service Obligation in a situation where water access licence holders are paying 100% of the costs of SWC's management effort but receiving only 20% of the output of that effort.

We recommend that the delivery of basic rights be defined as a Community Service Obligation. The cost of meeting this obligation is low when there is plenty of water in the system but rises exponentially under extreme drought conditions when the majority of the costs incurred by State Water relate to basic rights delivery.

**Recommendation:** That the cost sharing principles be reviewed and delivery of basic rights be identified as a Community Service Obligation.

#### 2.1.10 Customers' Ability To Pay

The proposed costs translate into the following prices at full cost recovery levels and unconstrained prices:

**Table 5. Regulated Lachlan River – Water Prices**

REGULATED	2005/06 PRICES (\$/ML)			PROPOSED 2006/07 (\$/ML)		
	Fixed HS	Fixed GS	Usage	Fixed HS	Fixed GS	Usage
State Water	5.80	3.86	4.42	15.56	3.15	14.41
DNR	1.46	0.97	1.12	2.40 *	2.40 *	
<b>TOTAL</b>	<b>7.26</b>	<b>4.83</b>	<b>5.54</b>	<b>17.96</b>	<b>5.55</b>	<b>14.41</b>

\* Note: DNR price per ML is estimated by LVW as DNR has only quoted total cost.

Unconstrained prices for SWC and DNR combined result in a 147% increase in the fixed charge for high security, 15% increase in the fixed charge for general security and 160% increase in the usage charge.

SWC's method of assessing 'average' users understates the impacts on irrigators. There are approximately 600 high security licences in the Lachlan, but 400 have 8 ML or less, and most of these are the 5 ML or 8ML high security stock and domestic licences held by many general security irrigators or riparian landholders. The impact on high security irrigators is therefore more likely to be represented by the high security licences above 8 ML. The average size of these licences is 270 ML, and usage data has shown that maximum valley high security usage has been 81%. On this data the impact of unconstrained prices on the average high security irrigator is \$4,800. The following table shows impacts on representative irrigators of SWC prices only:

**Table 6. Impact of Unconstrained SWC Prices on Representative Users**

<b>Licence Category</b>	<b>Entitlement (ML)</b>	<b>Usage (ML)</b>	<b>SWC Price 2005/06 (\$)</b>	<b>SWC Price 2006/07 (\$)</b>	<b>Absolute Increase (\$)</b>	<b>% Increase</b>
<b>High</b>	270	216	2521	7314	4793	190%
<b>General</b>	1000	500	6070	10355	4285	71%

Unlike SWC, irrigators have no ability to pass on increased costs and the unconstrained prices will cause a substantial reduction in farm profitability. We are aware ABARE is conducting a review of the impacts of these prices, and will comment further when that report is available. Unconstrained prices will also result in SWC being in conflict with the following objectives of the State Water Corporation Act 2004:

*“to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates” and*  
*“to exhibit a sense of responsibility towards regional development and decentralisation in the way it operates.”*

**Recommendation:** That any increases in price for SWC and DNR combined be limited to 5% per year.

### **3 SWC CAPITAL EXPENDITURE**

#### **3.1 Regulatory Asset Base**

SWC proposes that funding for capital costs should be based on the Regulatory Asset Base (RAB) method. We understand the pricing principles and accept that SWC should be able to fund prudent capital expenditure in an efficient and flexible manner, and that a Regulatory Asset Base method may be an appropriate way of doing so. However, we believe there are significant problems with the way SWC has structured its proposed RAB, in particular the opening value and the Weighted Average Cost of Capital (WACC).

##### **3.1.1 Opening Value of the RAB**

Financial viability is a key criteria for State Water. The Frontier Economics report, which SWC quotes extensively in its submission, notes that the performance of the RAB in terms of financial viability depends on the opening value of the RAB.

IPART has previously determined that pre-1997 assets are not included in the asset base for pricing purposes because the investment was made for social, regional development or other objectives rather than with the aim of earning a commercial rate of return. This principle was reviewed and re-affirmed in 2001. State Water’s post-1997 assets have a total value of \$75 million. However, SWC has proposed an opening value for RAB at 1/07/04 of \$300 million, and justifies this on the basis that a report commissioned by Government as part of the corporatisation process determined that the forecast cash flows justified an asset value of \$300 million.

This RAB is an outcome of the assumptions made about cash flows, depreciation and rates of return, rather than an intrinsic value. The forecast cash flows were derived from State Water’s proposed Opex and Capex program, and if the Opex and Capex were to change, presumably the asset value that could be justified would also change.

In effect, the only way that the RAB is able to generate SWC’s desired income is to overturn previous pricing principles. This is a perverse outcome that penalises current customers of

SWC for changes in Government policy. This casts doubt on the basis on which SWC was established as a corporation, its capital structure and indicates the requirements for full cost recovery are not achievable within the timeframes allowed and in the context of established pricing principles.

The Frontier Economics report, while it concluded that the RAB approach was preferred to the forward looking annuity, nevertheless found a number of areas that needed to be improved before the RAB should be adopted and recommended that the forward looking annuity be retained for 3 years to allow Goulburn Murray Water to:

- improve the accuracy of the asset management process
- analyse the ability of customers to pay, and
- establish an opening RAB to deal with the transitional issues.

MJA Cardno identified the accuracy of the asset management forecasts as an issue for SWC. They found that the basis for planning Capex was reasonable in TAMP 2004 and had improved since 1997, but also indicated that there was some way to go because the cost of the TAMP had increased from \$398 million in 2000 to \$627 million in 2004 despite the expenditure of \$49 million Capex in the interim, and that the basis for the increase had not been adequately explained (section 56, Executive Summary, MJA Cardno).

We believe the issues identified by Frontier Economics are also areas of concern in SWC's approach and must be addressed before any move away from an annuity is considered.

One of the reasons SWC advances for adopting an RAB (p61, SWC 2005 submission) is that SWC will otherwise be forced to reduce its Opex program, thus reducing maintenance and levels of service to customers. We fail to understand why this should be so, given that the RAB is a method of funding Capex not Opex. Using the RAB to generate funding for Opex is likely over time to reduce the drivers for efficient operating expenditure.

**Recommendation:** that the opening value of the RAB be set at a level that recognises no return should be payable on pre-1997 assets.

### 3.1.2 Rate of Return

SWC now proposes a 7% WACC to reflect what it calls the greater risk associated with a move towards more usage based pricing.

In its 2004 submission SWC proposes a 6% rate of return with 40% of revenue from usage charges. It now proposes a 7% rate of return because 50% of revenue, rising to 60% in 2008/09, will be from usage charges. Based on the user share of revenue for 2006/07 (p107, SWC 2005 submission) the additional revenue 'at risk' due to usage based charges is \$6.8 million. The 7% rate of return (based on the user share of RAB at \$276 million, p89 SWC submission) generates \$2.76 million extra revenue, a risk premium of 41%.

This is clearly exorbitant and is symptomatic of SWC's approach to the issue of increasing revenue, by advancing any argument to support a rate of return that cannot be justified on any basis other than exploitation of monopoly pricing power. Few companies in the private sector return a 7% dividend to their shareholders, SWC is not a high risk entity where loss of capital is a risk and SWC is still dealing with the transition to a state owned corporation and the challenge of operating efficiently.

In our view SWC overstates the risk to financial viability of usage based pricing. SWC's submission refers to the Lachlan in noting that usage can drop to zero (in fact it was 18,000 ML, not zero). However, even at this level SWC's 2004/05 revenue from the Lachlan will be \$3.44 million, sufficient to fund efficient operating costs.

**Recommendation:** That the WACC be set at the minimum level of the acceptable range.

### **3.2 Dam Safety Compliance**

LVW's position on this is the same as in our 2004 submission. We agree that Government is responsible for 100% of costs of the dam safety compliance program to bring dams up to 1997 standards. We do not accept State Water's proposal that users bear 50% of the cost of upgrades for flood mitigation dams and 100% for non-mitigation dams thereafter. This is not an equitable sharing of the costs relative to the flood mitigation benefits of the upgrades, which are driven by community demand for a higher standard of safety.

We recommend that flood mitigation benefits are quantified through a process of identifying the assets at risk and quantifying the expected impact of dam failure on those assets in \$ terms. This would enable a costing of the total financial impact of dam failure and allow users' proportional share of benefit to be determined.

## **4 WATER RESOURCE MANAGEMENT COSTS – DNR**

### **4.1 Definition of WRM Costs**

DNR's proposal to redefine WRM activities amounts to nothing more than the wholesale shifting of DNR costs on to extractive users. There are few DNR activities that have not found their way on to the list of 60 activities now described by DNR as WRM activities. DNR cites the development of the National Water Initiative (NWI) as driving this change but has selectively interpreted sections of the NWI and COAG agreements.

The NWI allocates a clear community benefit to water planning through Section 37, which requires water planning to provide for "*secure ecological outcomes by describing the environmental and other public benefit outcomes for water systems*".

Section 64 on best practice pricing requires "*water pricing and institutional arrangements which*

- i. *promote economically efficient and sustainable use of:*
  - a. *water resources*
  - b. *water infrastructure assets*
  - c. *government resources devoted to the management of water and*
- ii *give effect to the principle of user pays...*

LVW does not accept that DNR's proposed definition of WRM costs will result in pricing that meets NWI requirements to promote economically efficient and sustainable use of water resources.

LVW opposes DNR's attempt to move away from IPART's 2005 definition of WRM activities as being those:

- activities that would not be necessary were it not for the past, current and future patterns of extractive water use, including the construction and operation of dams, weirs and pumps
- activities that are directly concerned with the hydrology of the NSW surface water and groundwater systems
- where the benefits to extractive users are insufficient on their own to justify the costs of the activities.

## 4.2 Actual WRM Costs

DNR states that WRM costs fell by \$4 million in 2004/05 and are \$5 – 10 million lower than the cost base used by IPART in its 2005/06 determination (p13, DNR 2005 submission). SWC's submission also referred to lack of funds in 2001/02 and 2002/03 when DLWC provided SWC with \$7 million per year less than had been requested.

What accountability is in place where DNR has been collecting funds from licence holders for services it has not been performing, or has been collecting funds to cover bulk water distribution costs but not passing them on? Where funds have been collected and not spent on their proper purpose these funds should be offset against claims for future cost increases.

**Recommendation:** That IPART undertake a reconciliation of DNR and SWC revenue collected and costs incurred. Licence holders should not be required to pay again for services that have been funded but not performed due to internal restructuring or management problems.

## 4.3 User Share of Costs

DNR's central proposition is that under the new system of water entitlements, licence holders have a primary duty-of-care obligation to meet the agreed environmental objectives as set out in the WSP's, thus protecting their access rights to water (p24, DNR submission). This is like saying taxpayers have a duty to achieve government budgetary outcomes, rather than a duty to pay tax as provided under the legislation.

The concept is flawed because the environmental objectives, in the Lachlan Regulated WSP at least, are poorly defined, not timebound and not quantified. For example, the objectives of the Lachlan WSP (p 3, Lachlan WSP) include a river flow regime that makes provision for the following outcomes

- i. *a diversity of natural in-stream and riparian habitat and biota*
- ii. *the restoration, by naturally triggered flooding, of the riverine floodplain to its previous rich mosaic of ecosystems*
- iii. *an abundance and diversity of native aquatic species, and so on.*

There is no way of identifying when these outcomes are met. An added difficulty with DNR's approach is that water sharing plans are about sharing volumes of water, they are not river management plans, and the above outcomes cannot be met without also addressing non-flow related issues such as land management.

How can licence holders have a duty of care to meet undefined outcomes, most of which are not completely within the control of the WSP's?

If water users are to pay for services provided by Government the services should be capable of being clearly defined and should be services in excess of what would be provided by Government as part of its regulatory responsibility to the community as a whole. For this reason we consider that a key criteria for defining user shares is the requirements that WRM activities are those where "*the benefits to extractive users are insufficient on their own to justify the costs of the activities*".

DNR proposes substantial cost increases for unregulated rivers (40%) and groundwater (40% for highly managed areas and 495% for other groundwater areas) but only minimal information substantiating the proposed increases. Again we question whether DNR's proposed costs for managing the resource are warranted given the utilisation of the



resource and the risk to it, particularly in the case of other groundwater areas. We would like to make further comment on this issue when the independent consultants have completed their report.

## **5 TRANSACTION COSTS ON WATER CONSENTS – DNR**

We accept the principle that these costs should be subject to full cost recovery. However, DNR has a major problem with the efficiency and timeliness of its transaction processing. Customers have been receiving a sub-standard service for at least the last 3 years, with delays of 2 years in processing applications not uncommon.

For DNR to achieve full cost recovery it must provide a standard of service commensurate with the level of costs. Performance could be benchmarked against the performance of the Land Titles Office in processing land transfers.

The inefficiency exhibited over the past 3 years has imposed added costs on licence holders as they wait for transactions to be processed. We propose that during the period while the processing backlogs are eliminated, there should be no increase in licence transaction costs.