23 October 2009

Mr James Cox
Acting Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office
NSW 1230

e-mail; *ipart@ipart.nsw.gov.au*

Dear Sir,

Re; State Water Corporation Price Review 2010

Thank you for the opportunity to provide written comment on the State Water Corporation Pricing Review 2010.

Auscott Limited is a vertically integrated agricultural business operating in regional NSW with operations in the communities of Warren/Trangie, Narrabri/Wee Waa and Moree. Our business is irrigated farming based on cotton and grains with associated downstream activity in cotton ginning, cotton and grain warehousing, cotton and grain marketing and cotton export. The regional communities that we live and operate in, and water entitlement and access, are foundation stones of our business.

We ask that you take the following submission into consideration in making a determination on this review.

Your's faithfully,
Bernard AF George
General Manager
Namoi Valley Operations
Auscott Limited

AUSCOTT LIMITED SUBMISSION TO IPART NSW

REVIEW OF PRICES FOR STATE WATER CORPORATION FROM JULY 2010

Overview

Auscott Limited operates farming, commodity processing and commodity marketing businesses in the Macquarie, Namoi and Gwydir valleys of NSW. In these locations the business depends on regulated river irrigation water supply as the primary input. In the past five seasons, the average allocation (Macquarie) or credit to accounts (Namoi and Gwydir) has been; Macquarie 10.5%, Namoi 20.5% and Gwydir 15.25%. (NSW Water Information) Such water availability represents part of a major drought sequence and an extremely stressed business environment for irrigators.

In order to survive in a business sense, irrigated agriculture operating in these valleys has implemented significant adjustments. These adjustments include major reductions in operating costs, postponement of capital improvements and a lowering of expectations of returns to capital invested. In short, farmers and the businesses associated with farming are in survival mode.

State Water is a monopoly service provider to irrigated agriculture. State Water's main function is the capture, storage and release of bulk water in rural NSW. During the period of the most recent IPART determination, 2007-2010, Auscott Limited has had deemed upon it, price increases for its general security water supply in the Namoi Valley of 38.8% for entitlement charges (an average 9.7% per annum) and 95.5% for usage charges (an average increase of 23.9% per annum) For the pending determination period, 2011-2014, State Water proposes price increases over the four year period of 18% on entitlement charges (4.5% per annum) and 66% on usage charges (16.5% per annum). The level of these increases is nothing short of price gouging by a monopoly supplier in a time when customers are struggling to survive.

Key Issues

Level of Customer Service

From an irrigator's perspective State Water's function is to store and deliver water to its irrigator customers. That is, the State Water product is water delivery. The reasonable basis of commerce is that customers should receive the specified product that they are paying for. This has not been Auscott's recent experience. Rather, the service level has been unsatisfactory with water on one recent general security regulated river order in the Namoi not delivered on time.

This episode was not typical of our experiences of State Water deliveries over many years and in three northern Valleys but nevertheless; it has shaken our faith in the level of customer service. The details are available if required by IPART.

Water prices set to suit expenditure

The building block approach ensures a cost plus pricing philosophy rather than one based on competitive business principles and efficiency gains. State Water customers are under duress from low water supply and a continuing drought. Many have implemented severe actions to cut their costs of operation and postpone non-essential capital expenditure. The appropriate action by State Water would be to implement meaningful efficiency gains and delivery lower water prices to irrigators until the drought subsides. Rather, we see a continued trend to higher cost and so higher water prices. Page 3-2 of the State Water submission points out that Operating Expenditure over the previous determination period failed to meet the IPART determination in every year. In 2007/08 the target was overspent by 12.5%. Under such circumstances the proposed 2% per year efficiency target for the coming determination period is under whelming.

State Water proposes usage cost increases in 2010/11 of 24.1% in the Gwydir, 40.4% in the Namoi and 58.3% in the Macquarie (p11-2) they say "driven mainly by the revised consumption forecasts" due to drought. Wouldn't it be wonderful if their irrigation farmer customers could simply wish up their commodity prices to suit lower production levels and so avoid the inconvenience of implementing meaningful efficiencies to survive the current business reality?

Consumption Forecasting

State Water proposes to abandon the Long Run average approach based on the IQQM model, which has been the basis of the NSW Water Sharing Plans under which irrigators currently operate.

Clearly we are in a period of record low water availability and irrigation businesses have to adjust to this reality. State Water should do the same.

The concept that State Water should now abandon the IQQM model for revenue forecasting and replace it with a 15-year moving average will only penalise irrigators with higher than necessary prices for a longer period when inflows return to trend.

If the IQQM is good enough to model irrigators access rules then its good enough to model irrigators consumption. The current dry period should be treated for what it is, a drought, which will pass.

Auscott Limited opposes this change in the pricing model.

Customer ability to pay

State Water cites a commissioned report by the consultants RMCG to conclude that " for most valleys the price changes will have a relatively small impact on income and profitability." Such a conclusion is erroneous and dismissive of the real impact.

Under the proposed price increase for general security water and based on the State Water estimates of water availability, Auscott Limited will face an increase in

2010/11 general security water charges from State Water in excess of $200000. This is not a generally insignificant input cost impost.

RMCG also point out on Page 42 of their report that proposed water price increases represent “a substantial annual change in comparison to average inflation rates (i.e. 3.2% inflation on average, over the past 20 years) On this basis, the average general security usage water price increase in the Namoi of 9.7% per annum over the past determination period and the proposed average increase of 16.5% per annum in the pending period are grossly out of line with inflation and any notion of “reasonable” price increases.

Capital expenditure

State Water’s performance in meeting capital expenditure programs in the current determination period are, by their own admission, “marked underspent” due to their own management. Given the performance in 2006/7, 2007/8 and 2008/9 the targets set for 2009/10 look ambitious. If water prices are being set on the basis of proposed capital investment that doesn’t take place according to plan then this is a grave concern for water users. This is particularly the case as the forecast capital expenditure over the next determination period, is forecast by State Water to shift in emphasis from dam safety upgrades to “renewal and replacement of assets and upgrading” and “modernising water delivery and other operational aspects.”

Such expenditure is long overdue. While irrigators have been submitted to an upper bound price recovery regime we have not seen the corresponding investment in infrastructure that would reasonably justify such a pricing policy. If water prices are increasing significantly based on capital expenditure plans, then State Water must be held accountable to a level of capital refurbishment on water delivery infrastructure performance, which sees these funds efficiently invested on time and on target.

Government should rightly pay for any capital program driven by safety upgrades and environmental obligations. A case in point is where government initiated safety upgrades trigger new investment in fish passage. In such cases, government should pay all of the fish ladder costs.

We reject any notion that government/irrigators shares should somehow be adjusted to provide less impact to government. Government should rightly pay for the benefit of water infrastructure that accrues to the environment and non-irrigator water users unless they are willing to charge those users directly.

Such users include but are not limited to; “the environment”, other downstream States, recreational users, communities benefiting from stored water and flood mitigation and, graziers on floodplains.

<u>Government "Buy back' of water entitlements.</u>

We agree with State Water's treatment of charges for Adaptive Environmental Water.

Government has become a major entitlement holder in some of the valleys in which Auscott operates. According to website data the government now owns considerable entitlements in the Gwydir and the Macquarie and some in the Namoi. Such shares of the resource will have a considerable effect on the economies of catchment communities. It is unclear to us from the State Water submission, how the entitlement and usage charges for water held by the Environmental Water Holder will be met. We propose that such charges be fully met by government.

<u>Ratio of fixed to variable costs</u>

If the "users pay" philosophy is good enough for water pricing then it's also good enough for water delivery. Irrigators are already paying fixed charges for water that is not delivered in drought times.

The current ratio of 40% fixed and 60% variable gives irrigators some minor degree of risk management against these low water supply years. The alternative 90:10 ratio nominated by State Water does not and is rejected by Auscott.

<u>Rates of return and the Weighted Average Cost of Capital</u>

The WACC is stated to represent " a return to debt and equity holders for committing capital to State Water and bearing the risks associated with business" (p5-2). The submission goes on to contend that the 6.5% real pre-tax WACC specified in the 2006 determination is inadequate.

State Water customers have to live with the commercial reality of market interest rates and returns to capital. In the current climatic and financial conditions, many irrigators are suffering negative returns and may well continue to do so. Why should a government monopoly that has the support of the taxpayer be quarantined from commercial market rates of return? Large business loan interest rates are currently around 6.0%. State Water's current 6.5% WACC is out of line with the market let alone any proposed increase to 7.9%. (p5-4)

<u>Full recovery and upper bound cost structures</u>

Investment in working infrastructure. If water prices to irrigators are to be structured to full cost recovery and upper bound pricing, then irrigators could rightly expect capital investment in working infrastructure to ensure the water storage and delivery systems that they are paying for are updated. Of the capital expenditure analysed and reported in the submission (p4-3) for the 2006 determination period, only a small component of the $122 million total expenditure went to Water Delivery and other operations, Structural and Other enhancement or Renewal and Replacement. This allocation is repeated in the plans for the 2010 determination period until 2013/14 when decent reinvestment in irrigator infrastructure emerges. If we are to pay upper bound pricing then we expect significant ongoing investment in irrigator related infrastructure, not just in one year out of eight.

Metering service charge

In recent years irrigators in the Northern Basin have been required to invest in a standard of metering which rightly brings measurement of our usage to a high level of accountability. State Water now proposes another change to metering that may well require further investment in private off-takes and pumping structures. Auscott would argue that our metering installations are currently at high comparative standards.

Given many Northern Basin users have spend considerable funds in getting pumping installations and off-takes up to the current standards, State Water should now fund any further modifications.

END