



Lachlan
Valley
Water Inc

Submission to IPART

Review of Prices

**for State Water Corporation
2010-2014**

by Lachlan Valley Water

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EXECUTIVE SUMMARY

1 Efficient Level of Operating Costs

LVW concurs that the 2009/10 opex should be considered the efficient cost base, but that there is further scope for efficiency gains in State Water's operations. We recommend the target should be to achieve an efficiency gain equivalent to inflation every year in the next determination period, ie, 2.5% per year.

LVW considers that the environmental and heritage and dam safety thematic expenditure does not constitute new expenditure for State Water but activities that State Water should already be undertaking as part of normal prudent management.

LVW considers the land management thematic expenditure is a business development for State Water rather than an activity associated with water delivery and should not be included in opex recoverable from users.

LVW supports the discretionary expenditure identified for the Lachlan valley.

2 Capital Expenditure

State Water has consistently underspent its capital expenditure budget in the past, and performance to date has not yet provided evidence that 2006 – 2010 capex will meet budgeted expenditure.

LVW recommends that IPART review State Water's actual capex to date for 2009/10 in the March 2010 quarter to get a more accurate indication of State Water's ability to achieve such spending, and that this be used to inform IPART's view on State Water's capacity to deliver the \$342 million capex program over 2010 -2014.

State Water has planned a 180% (\$220 million) increase in capex over the next determination period, with more than \$100 million in each of 2010/11 and 2011/12. This is a significantly higher level of annual spending than it has achieved in the past. A more prudent approach to capex planning would be to spread the capex planned for 2010/11 - 2011/12 over the period at least until 2013/14.

We also recommend that the review of State Water's actual vs budget capex to March 2010 be used to inform IPART's view on State Water's capacity to deliver the \$342 million capex program over 2010-2014.

3 Rate of Return

LVW submits that the rate of return for State Water should be the same as that applied to metropolitan water businesses.

LVW considers that State Water has over-stated the volumetric risk it faces and that the actual level of risk it faces does not justify an increase in WACC.

4 Valley Based Reports

LVW has found valley based financial reports provide useful information for CSC's and improve their ability to fulfil their role.

5 Allocating Efficient Costs

LVW submits that the cost-sharing approach used in the 2006 determination be maintained except for fish passage works or offsets required as a result of a dam safety upgrade for pre-1997 assets. LVW recommends the fish passage is treated in the same manner as the underlying work and is 100% Government cost share.

6 Consumption Forecasting

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

LVW recommends that State Water diversify its risk by investigating methods to widen its customer base by charging other users of its services.

7 Translating User Shares Into Prices

LVW supports a glide path modelling approach for translating users share of revenue into prices to reduce the price shock for customers.

8 Appropriate Price Structure

LVW supports continuation of the 40:60 variable:fixed price ratio.

9 High Security and General Security Charges

LVW supports the inclusion of an access premium in high security charges but not the introduction of a scarcity premium.

10 Capacity to Pay

LVW submits that licenceholders in the Lachlan do not have the capacity to pay increases of 40% in bulk water charges in 2010/11. We recommend that increases for individual irrigators be limited to 20% per year, as in the 2006 determination.

11 Rebates To Irrigation Corporations

LVW agrees that where the operation of an ICD results in economies of scale for State Water, then rebates are appropriate to the extent that there is a saving in State Water's costs.

LVW also agrees that as these cost savings reduce as a result of transformation, or any other reason, then the rebate should likewise reduce.

12 Metering Charge

If the metering scheme proceeds in this determination period LVW support the transitional arrangements proposed by State Water.

13 Length of Determination Period

LVW supports a 4 year determination period.

SUBMISSION ON STATE 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.

2. State Water's Role and Regulatory Framework

IPART has requested comment on

- *The appropriateness of State Water's proposed service levels over the 2010 determination period*

As a result of the restructure State Water's services have gone through significant change during the current determination period, much of which has only been finalised within the last 12 months. We do not yet have enough information to comment on the adequacy of the new service levels, particularly as key components of the user interface such as the Water Accounting System (iWAS) are only just being rolled out now.

Included in State Water's water delivery function are a number of services, eg, normal environmental and system flows, river frontage landowners consultation and drought contingency planning (refer Table 1.1), that are provided for the benefit of other users as well as customers. During drought these functions require an increased commitment of State Water resources and it is appropriate to review who should bear the costs of the services (refer p 10, 11 of this submission).

3. Efficient Costs

3.1 Operating Costs

IPART has requested comment on

- *The appropriateness of State Water's forecast operating costs over the 2010 determination period*
- *Whether there is scope for State Water to achieve further efficiency gains*

Regulatory Outcomes for Current Determination

State Water claims the current period regulatory outcomes have contributed to significant deterioration in its financial position and that it has not recovered the cost of providing services nor an appropriate return on assets.

However, Table 2.3 indicates that State Water has covered the efficient cost of providing services, and achieved a small, but positive, return on assets. This is a significant achievement considering that much of the state was in drought during the determination period. In fact, State Water's return on assets is not dissimilar from the return on capital that irrigation farmers achieved in 2006/07 as outlined in the RMCG Report¹.

¹ Pages 26, 27 RMCG Report 2009.

It is misleading for State Water to claim an \$83 million shortfall in user share revenues over the last 4 years when the basis for comparison, its 'notional' user share revenue, represents an inefficient level of opex. The relevant comparison is between the allowed revenue, representing an efficient level of opex as determined by IPART, and actual revenue. Any impairment of State Water's financial position due to the \$27.1 million shortfall between its desired (but inefficient) revenue level and the transitional (efficient) path determined by IPART, should be borne by shareholders not customers.

Forecast Operating Costs

We recognise that State Water has made good progress in reducing overall operating costs towards the efficient cost level determined by IPART and that it appears they will achieve the efficient opex level in 2009/10. As noted above, however, the lag in State Water reaching its efficient level of opex has resulted in a cumulative deficit of \$10 million², assuming the 2009/10 target is met.

For the 2010 determination period State Water's forecast operating expenditure is based on achieving the efficient level of costs in 2009/10, maintaining that level in 2010/11 and then achieving 2% per year efficiency gains from 2011/12 to 2013/14. State Water also proposes \$17.3 million additional thematic expenditure.

We agree it is appropriate that 2009/10 efficient opex be treated as a baseline but recommend that State Water sets a higher target for efficiency gains, and question the appropriateness of treating all the proposed thematic expenditure as additional opex.

Efficiency Gains

Notwithstanding State Water's comments about having reached a plateau in their ability to meet further cost reductions due to completing the restructure earlier than planned, we believe that there is further scope for efficiency gains in State Water's operations and that it should be able to achieve an efficiency gain equivalent to inflation every year in the next determination period, ie, 2.5% per year.

In saying that it has reached a plateau, State Water cites a theoretical deficiency in capability until systems and processes catch up, however, again State Water is comparing the speed of their restructure against their self-determined timetable, not against the timeframe established by IPART in the 2006 determination. It is not clear why implementation of efficient business systems didn't happen in step with the rest of the restructure, however, regardless of the cause, customers should not bear the burden of State Water's slowness in implementing the necessary business systems upgrades to achieve efficient operating costs.

We also consider additional efficiency gains can be achieved because the savings achieved by the restructure and reduction in staff numbers need to be put into perspective. Between 2002 -2004 State Water operated with 255 - 265 staff³. Numbers jumped to 304 in 2005 and had increased again to 350 by 2007⁴. This is a 35% increase over 3 years while delivering 45% less water.

The reduction to 300 staff brings the organisation back to where it was in 2005, just after corporatisation. We see this as the correction of an unsustainable rate of expansion in staffing and consider there is scope for further efficiencies.

² Table 3.1, p3-2 State Water submission

³ p 79 State Water submission 2005

⁴ p 3-2 State Water submission 2009

LVW considers it is appropriate to treat 2009/10 opex as the efficient cost base but that there is further scope for efficiency gains in State Water's operations. We recommend the target should be an efficiency gain equivalent to inflation every year in the next determination period, ie, 2.5% per year.

New expenditure

We have the following questions regarding inclusion of the proposed thematic expenditures as new expenditure in addition to the efficient opex:

- (i) Whether the thematic expenditures are new expenditure or part of State Water's normal operating plan,
- (ii) whether the thematic expenditures are required in this determination period, given the constraint on revenue
- (iii) whether the thematic expenditure is incurred as part of State Water's water delivery business

Environmental and Heritage

While the Environmental Management Plan may have been developed after 2006, the legislative drivers have been in place for some years and we expect that State Water would already be substantially complying with these requirements as part of their existing project management process.

Dam Safety

The activities described in the dam safety thematic plan appear to fit within the category of ongoing monitoring rather than new work.

Land Management

The land management thematic plan appears to be a business development for State Water rather than an activity associated with water delivery where costs should be borne by users.

Discretionary Spending

LVW supports the discretionary spending identified for the Lachlan Valley.

LVW considers that the environmental and heritage and dam safety thematic expenditure does not constitute new expenditure for State Water but activities that State Water should already be undertaking as part of normal prudent management.

LVW considers the land management thematic expenditure is a business development for State Water rather than an activity associated with water delivery and should not be included in opex.

LVW supports the discretionary spending identified for the Lachlan Valley.

3.2 Capital Costs

IPART has requested comment on the prudence and efficiency of State Water's past and forecast capital expenditure.

Capex 2006 - 2010

State Water has consistently underspent its capital expenditure budget in the past, and even in the current determination period their submission shows that 60% of the projected capex for 2006 – 2010 will need to be spent in 2009/10 in order to meet the targeted 4 year capex⁵. In view of this we question State Water's ability to actually spend the 2006 – 2010 capex, and recommend that IPART review State Water's actual capex to date for 2009/10 in the

⁵ Table 4-2 State Water submission 2009

March 2010 quarter to get a more accurate indication of State Water's ability to achieve such spending.

Opening Value of Regulatory Asset Base (RAB)

The opening value of the RAB depends on whether the planned capex for 2009/10 is actually achieved, and there is clearly some doubt about this. The value of RAB has a significant impact on total revenue requirements and for that reason we believe it is important that IPART obtains as accurate as possible picture of State Water's actual 2009/10 capex before finalising the 2010 determination.

Capex 2010 - 2014

The projected capex for 2010/11 – 2013/14 is \$342 million, which represents a \$220 million (180%) increase over the current determination period. We question State Water's capacity to spend this amount, in particular, whether it is prudent for State Water to propose the very intensive capex program planned for 2009 - 2012, which now totals \$320 million including the catch up figure for 2009/10.

This is much higher than what State Water has previously achieved and we question whether the organisation has the systems in place to implement this program, particularly in view of their statement about the backlog of business system improvement projects within the organisation.

While most of the capex expenditures are associated with dam safety upgrades, and are therefore a Government cost share, nevertheless, the extremely high capital works budget adds to both the regulatory asset base (RAB) and the loan debt of State Water, and therefore increases the overall level of risk borne by the organisation and the rate of return required by shareholders.

Regarding the capex for the Lachlan valley, a brief review of proposed capex with State Water staff prior to the lodgement of State Water's submission indicated that some capex items in the 2010 determination period may have been duplicated, eg, fish passage offsets. This was unable to be resolved with State Water staff in the time available and we are unable to determine whether it has been clarified in this submission.

In summary, LVW considers a more prudent approach, taking into account past capacity to implement and current revenue constraints, would be to spread the capex planned for 2009/10 - 2011/12 over the full determination period until 2013/14. We also recommend that a review of State Water's actual vs budget capex to March 2010 will provide a guide to their capacity to deliver the much larger program over 2010 -2014.

State Water has consistently underspent its capital expenditure budget in the past, which raises a question about their ability to actually spend the 2006 – 2010 capex. LVW recommends that IPART review State Water's actual capex to date for 2009/10 in the March 2010 quarter to get a more accurate indication of State Water's ability to achieve such spending.

State Water has planned a 180% (\$220 million) increase in capex over the next determination period, with more than \$100 million in each of 2010/11 and 2011/12. This is a significantly higher level of annual spending than it has achieved in the past. A more prudent approach to capex planning would be to spread the capex planned for 2009/10 - 2011/12 over the period at least until 2013/14. We also recommend that the review of State Water's actual vs budget capex to March 2010 be used to inform IPART's view on State Water's capacity to deliver the \$342 million capex program over 2010 -2014.

3.3 Return on Capital

IPART has requested comment on:

- the appropriate rate of return for State Water's RAB
- whether it is appropriate to address State Water's revenue risk by adjusting the WACC

Rate of Return for Regulatory Asset Base (RAB)

State Water has argued that the present 6.5% pre-tax WACC does not adequately compensate for the level of risk it faces.

LVW agrees that State Water faces risk, particularly in times of low water availability, however, on reviewing the arguments advanced by State Water, and the actual results achieved by State Water as reflected in their Annual Reports, we consider State Water have overstated the impact of risk on the organisation. Their reported financial results indicate that State Water has made a profit, before superannuation actuarial gains or losses, in 2 of the last 3 years for which figures are available, and has covered operating costs, although not a return on assets, in all years.

We are aware that there are significant differences between how financial results are reported in Annual Reports and how they are reported for pricing purposes, however, it is the real level of risk faced by State Water that should be considered. That State Water has achieved these results during a low water supply scenario and while undertaking organisational restructuring indicates to us that State Water's underlying risk is lower than the organisation suggests.

State Water Financial Results

	2005/06 (\$'000)	2006/07 (\$'000)	2007/08 (\$'000)
Revenue	78,543	72,536	69,262
Other Income	145		
Expenses	(66,100)	60,443	(66,883)
Finance Costs	(4,349)	(2,533)	(2,448)
Profit/(Loss)	8,239	9,560	(19)

Source: State Water Annual Reports 2006/07, 2007/08

We disagree that the rate of return for State Water should be significantly higher than that faced by metropolitan water businesses. As outlined below, we believe that the level of demand fluctuation is very low, and while there is supply-side risk, State Water has mechanisms to manage the impact of that risk on its financial performance.

LVW submits that the rate of return for State Water should be the same as that applied to metropolitan water businesses.

Adjustment of WACC to Manage Risk

Volumetric Risk

State Water argues that it faces demand-side risk because irrigator demand for water is affected by economic conditions, and that this risk cannot be diversified or hedged. We contend that State Water vastly overstates the demand fluctuation and impact of commodity prices on demand, as demonstrated by Figure 2.1, where in 1999/00 when there was widespread flooding in NSW, demand fell by only 15% compared to the long term average. We do not agree that demand side risk is a major factor, and in fact, it is likely State Water has more upside demand opportunity than metropolitan businesses.

Supply risk is a factor, but having said that, State Water already has mechanisms in place to manage some of its supply-side risk, namely adjusting the consumption forecast and a proportion of guaranteed income through fixed water charges and from the Government share of costs. State Water acknowledges (p2-6) that over the current determination period it expects to recover 75% of approved (transitional) revenue requirements, despite actual water sales being only 30% of budgeted sales.

We believe that State Water has over-stated the volumetric risk it faces and that the actual level of risk it faces does not justify an increase in WACC.

LVW considers that State Water has over-stated the volumetric risk it faces and that the actual level of risk it faces does not justify an increase in WACC.

3.4 Output Measures

IPART has requested comment on:

- *appropriate output measures for the 2010 determination period*
- *the usefulness of valley based reports*

LVW has found the valley based financial reports have proved useful for Customer Service Committees (CSC) to improve their understanding of the State Water business and assist CSC's to fulfil their role. We recommend continuation of valley based reports.

4. Allocating Efficient Costs

IPART has requested comment on whether the cost sharing approach used in the 2006 determination is still appropriate

Cost Shares

We support the continuation of the cost sharing approach from the 2006 determination except in one respect, the cost shares for fish passage works or offsets resulting from dam safety upgrades on pre-1997 legacy assets.

We note that State Water sought guidance from IPART on this issue during the term of the determination and we recommend that the issue be reconsidered. Where the requirement to provide fish passage arises entirely as a result of a dam safety upgrade relating to pre-1997 assets, we submit the fish passage should be treated in the same manner as the underlying driver for the expenditure and that it be 100% government cost share.

LVW submits that the cost-share ratios used in the 2006 determination be retained except for fish passage works or offsets required as a result of a dam safety upgrade for pre-1997 assets. LVW recommends the fish passage is treated in the same manner as the underlying work and is 100% Government cost share.

State Water suggests on p 7-5 that IPART 'revisit' the rationale for the allocation of cost shares, but makes no specific recommendation on changes. We reject this suggestion, the rationale for the cost shares has been comprehensively reviewed in past determinations and there is no compelling argument to change them, except in the respect outlined above.

State Water comments that that it believes it is an unintended outcome that the Government share of costs will increase by 149% while the user share of costs will increase by 22% in the 2010 determination. We do not understand why this would be described as unintended when it is a predictable outcome of undertaking the dam safety upgrade program. Changing

community standards have driven higher dam safety standards, and the wider community are the main beneficiaries of higher safety standards. Therefore it is consistent with the impactor pays principle that the Government cost share is increasing, and there is no reason to revisit the shares.

5. Setting Prices

5.1 Forecast Water Sales

IPART has requested comment on:

- *State Water's consumption forecasts*
- *The implications for prices and State Water's financial viability of continued reduced water availability*

Consumption Forecasts

The statistical analysis by CIE concludes there is a structural break in patterns of water availability, however, this conflicts with the CSIRO Sustainable Yields Report for the Lachlan⁶, 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**” (my emphasis).

The 15 year rolling average methodology proposed by State Water, which includes the worst drought in recorded history, is not an accurate indicator of future availability or usage during the next four year period. Adopting this method would result in significant time lags where periods of high or low usage that may be significantly different from the current supply conditions would be reflected in current pricing, leading to significant under or over-recovery of efficient costs. It is acknowledged that water availability fluctuates widely, and this is incorporated in IQQM. We recommend the retention of the long run average (LRA) with the addition of recent years' data up to and including 2008/09 to more accurately reflect current conditions.

LVW recommends the retention of the long run average (LRA) with the addition of recent years' data to more accurately reflect current conditions.

Viability under Continued Reduced Water Availability

LVW acknowledges that it is in the interests of irrigators for State Water to be viable, and likewise customers also need to be viable.

There is some irony in State Water's recognition that revenue shortfalls associated with lower consumption impact directly on their own regulated earnings, but unwillingness to acknowledge that fixed water charges paid by irrigators impact directly on irrigators' profitability when availability of water is low.

Many rural businesses have suffered reductions in profitability due to the combination of drought and the global financial crisis and it is unrealistic for State Water to expect to be able to achieve a return of 6.5% every year under such conditions.

State Water has proposed only two options for addressing its revenue risk – increasing the WACC and reducing the consumption forecast. An obvious strategy that State Water should consider is widening their customer base. State Water acknowledges that there are other beneficiaries of its river operation services but dismisses the option of recovering a proportion of costs from other users and beneficiaries as difficult.

⁶ page ii, Executive Summary, CSIRO 2008

While drought has reduced the supply of water available for delivery to paying customers, at the same time drought conditions require a higher proportion of State Water resources to be devoted to ensuring river operations meet the needs of higher priority users such as riparian landowners, environmental requirements for baseflow and recreational users. In the Lachlan valley, for example, general security irrigators have received less than 10% of the flow in recent years but have been asked to pay 80% of the costs of operating the river, a situation that is not tenable in the long term.

If water supply for extractive use decreases, either due to climatic variability or future regulatory changes, the demands on State Water services from water users who are not currently paying customers are likely to increase and we recommend this is an issue that should be addressed by State Water.

LVW recommends that State Water diversify its risk by investigating options to widen its customer base by charging other users of its services.

5.2 Translating User Shares Into Prices

IPART has requested comment on:

- *The appropriate approach to translate users share of revenue requirement into prices*

Given that the price increases sought by State Water represent an 85% increase in usage charges in the first year, and a 41% gross overall increase⁷, LVW supports a glide path modelling approach to reduce the price shock for customers.

LVW supports a glide path modelling approach for translating users share of revenue into prices to reduce the price shock for customers.

5.3 Appropriate Price Structure

IPART has requested comment on:

- *The appropriate balance between fixed and variable charges*
- *The impact of proposed prices on customers*
- *The appropriateness of a measure such as scarcity pricing to address revenue volatility; and a different sharing of revenue risks between irrigators and State Water*
- *Any practical limitations if a form of scarcity pricing was introduced*

Balance Between Fixed and Variable Charges

LVW members support continuation of the 40:60 fixed:variable ratio.

High Security and General Security

State Water proposes to include both an access premium, to reflect greater security of supply of high security, and a scarcity premium, to reflect the increased value of the supply.

Recent conditions have clearly demonstrated that high security is a more valuable product and we agree that the access premium should be adjusted according to the relative security of supply for HS compared with GS. Our preference is for the conversion factors to be updated to take into account recent data, but we note that the NSW Office of Water (NOW) has indicated to State Water they prefer to leave conversion factors unchanged for the

⁷ p 32, RMCG Report 2009

foreseeable future, and recommend that IPART seek further information on that NOW before the 2010 determination is finalised. In the absence of that we recommend that IPART seek information on the long term modelled availability of HS and GS over the last 110 years (or other term as available from IQQM for each valley).

We submit that the scarcity premium is not a matter for water pricing, which is intended to reflect the efficient cost of supply.

State Water's arguments for the scarcity premium are confused – it contends that the value of HS entitlements change according to seasonal conditions, and that the charges should change accordingly, but surely a change in the underlying value of the licence should be reflected in the market price of the entitlement, not in the charge for the entitlement.

In summary, LVW supports the inclusion of an access premium (as occurs now) in high security charges but not the inclusion of a scarcity premium.

LVW supports the inclusion of an access premium reflective of security of HS supply in high security charges but not the inclusion of a scarcity premium.

Impact of Prices on Customers

State Water has commissioned a report from RMCG Consultants on the ability of customers to absorb high water charges. The report suggests that overall the gross impact of increased charges is relatively small considering that the gross value of irrigated agricultural production in NSW is generally more than \$2500/year.

The expected additional cost of State Water's proposed prices across NSW in 2010/11 is \$13,600,000. We dispute that the impact will be negligible when the state is experiencing severe drought and most irrigators have received very low water allocations over the last 4 years. The impact is even higher when it is understood that the increases in the Murray and Murrumbidgee are very low (a decrease in the Murrumbidgee) and that \$13,000,000 of the increased cost falls on the remaining valleys, who collectively use only 35% of the water deliveries.

It should also be recognised that the additional cost does not translate to an improved water product delivered by State Water – it's simply the same product but State Water will recover 24% extra revenue if the proposed prices are approved by IPART.

With regard to the Lachlan Valley, the RMCG report states that the impact on Lachlan irrigators of State Water's requested prices is an additional \$3500 – 6,000 per business. This is an increase of 41%, or \$3,000,000 for the whole valley, in 2010/11.

The RMCG report also indicates that irrigation farms in the Lachlan recorded an average loss of \$94,000 in 2006/07 (refer p 26 and 27 RMCG). In the midst of a severe drought, when irrigators have received only 8.5% of total valley entitlement on average over the last 4 years, there is no capacity to pay an increase of this size.

LVW contends that licenceholders in the Lachlan do not have the capacity to pay increases of 40% in bulk water charges under current conditions. We recommend that increases for individual irrigators be limited to 20% per year, as in the 2006 determination.

5.4 Other Charges, Levies and Rebates

Rebates to Irrigation Corporations

IPART has requested comment on:

- *Whether it is appropriate to maintain rebates to ICD's*
- *The level of these rebates and justification for this position*

We agree that where the operation of an ICD results in economies of scale for State Water in relation to metering and billing, or there are system-wide benefits resulting from real-time monitoring of diversions, then rebates are appropriate to the extent that there is a saving in State Water's costs.

We also agree that as these cost savings reduce as a result of transformation, then the rebate should likewise reduce.

Metering Charge

IPART has requested comment on:

- *The appropriateness of State Water's metering service charge proposal*

LVW has concerns about the implementation of the NSW Metering Scheme, but if the scheme proceeds we support the transitional arrangements proposed by State Water.

Length of Determination Period

IPART has requested comment on:

- *The appropriate length for the 2010 determination period*

LVW supports a 4 year determination period.