Submission to IPART's Review of prices for State Water Corporation from July 2010

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Introduction

Macquarie River Food and Fibre (MRFF) welcomes the opportunity to respond to State Water Corporation's submission to IPART on the 2010 pricing determination for bulk water.

MRFF represents the interests of around 600 irrigators in the Macquarie Valley, including the interests of riparian irrigators, groundwater irrigators and the individual members of the Valley's seven irrigation schemes. MRFF is a member organisation of the state's peak representative group for the irrigation industry, NSW Irrigators Council (NSWIC).

MRFF contributed to and generally agrees with the submission that NSWIC makes to IPART. We provide our own submission to further highlight those points we believe to be of particular importance to MRFF members and, where we can, to provide further information and detail relevant to the Macquarie Valley.

Our submission is structured to provide specific feedback on a number of the issues raised by IPART in the paper released in July 2009. Throughout our response we make reference to statements, figures, tables and appendices provided in the State Water Corporation (SWC) submission.

General Comments

MRFF is generally disappointed to see that despite having reached full cost recovery many years ago in the Macquarie Valley and SWC having achieved efficiency gains in its business operations, SWC is again proposing significant price increases for water users in the Macquarie Valley. While we acknowledge that the entitlement charge for General Security is remaining relatively stable, SWC proposes increases of 185% and 79% for the High Security Entitlement Charge and Usage Charge respectively over the four year determination period.

SWC Proposed Prices based on 40/60 Fixed/Variable Ratio and 7.9% WACC

	2009/10 $/ML	2010/11 $/ML	2011/12 $/ML	2012/13 $/ML	2013/14 $/ML	Increase over period
High Security Entitlement Charge	5.78	14.62	15.12	15.67	16.50	185%
General Security Entitlement Charge	3.07	2.83	2.93	3.04	3.20	4.2%
Usage Charge	8.47	13.41	13.87	14.37	15.13	79%

We would like to acknowledge that MRFF supports the notion of a corporatised SWC and recognises the need for SWC to be a commercially viable business yet we dispute continued attempts by SWC to shift unnecessary amounts of its business risk onto its captive and narrow customer base.

As mentioned above, our submission provides specific feedback on issues raised by IPART in their paper released in July 2009, however, MRFF wishes to highlight the following key concerns upfront:

- We do not believe that SWC's financial position is as dire as they claim, given that SWC still managed to cover allowed operating expenses and provide some return on the Regulatory Asset Base. We note that this could be considered an enviable position given the drought conditions and economic turmoil that prevailed over much of the determination period.
- Given this outcome, we see little justification for the fundamental changes SWC proposes to both the consumption forecasting approach and WACC. Further, we out rightly dispute SWC's proposal to implement a rolling 15-year average as a suitable consumption forecasting model for the reasons advanced further in our submission.
- We wish to further highlight that not only has SWC overplayed their business risk, they are effectively 'double-dipping' by proposing changes to both the consumption forecasting approach and the WACC.
- MRFF has long argued that the "user" base to which SWC pricing is applicable is too narrow. We again raise this as a major issue of concern and in particular, highlight the flood mitigation role that Burrendong Dam plays in the Macquarie Valley. We ask that IPART seriously consider our arguments in this respect.

Comments on specific issues raised by IPART

The appropriateness of State Water's forecast operating costs for the 2010 determination period

Firstly, MRFF would like to recognise SWC's efforts in achieving a number of efficiency improvements during the current determination, resulting in reduced Operating Expenditure (OPEX). Yet despite these improvements, SWC has still failed to meet IPART targets for OPEX in 3 of the 4 years of the current determination (refer Table 3.1 of SWC submission). In fact, Table 3.1 in SWC's submissions shows that the variance in OPEX allowed and achieved over the period accumulated to $10.5 million, which will have had a significant impact on SWC's financial performance.

> *MRFF urges IPART to consider the impact on SWC's current financial position from their failure to meet OPEX targets in the current determination, as shown in Table 3.1 of the SWC submission.*

In terms of forecast OPEX for the 2010 determination, MRFF understands that SWC has used the 2009/10 valley-based budget figures as the base to forecast OPEX over the next determination period. SWC notes (pg. 3-5 of their submission) that the 2009/10 budget reflects the efficient OPEX levels. The 2009/10 budget is then adjusted for further expected efficiency gains over the upcoming determination period, as well as some additional expenditure expected under the heading of "Thematic Expenditure".

While MRFF has no real issue with continuation of 2009/10 figures, assuming they are in fact efficient costs, we do question the accuracy of the budget figures shown in Appendix 3 of SWC's submission. MRFF notes that the Valley Operating Report for the Macquarie presented at the most recent Macquarie Cudgegong Customer Service Committee (9 September 2009) showed budgeted regulated operating expenses of $3.938M for 2009/10 compared to the $4.254M shown in Appendix 4 of the SWC submission. MRFF seeks clarification as to why there is an 8% variance in the two figures for Macquarie Valley OPEX.

> *MRFF submits that SWC should provide an explanation for the +8% variance in the budgeted OPEX figure for the Macquarie Valley for 2009/10 when compared to 2009/10 budget OPEX figures previously presented to the Macquarie-Cudgegong CSC.*

Further, MRFF is unconvinced that items SWC has flagged under "Thematic Expenditure" are in fact additional and efficient costs. It seems that in the main, the costs flagged under "Thematic Expenditure" are not new and should have been incorporated either under existing efficient OPEX levels or as legacy costs.

Based on previous consultation SWC has had with the Macquarie-Cudgegong CSC, MRFF understands that the so-called "Thematic Expenditure" is essentially immaterial for the Macquarie Valley. We are however dubious as to the inclusion of these cost components at all, and can see potential risks for our valley down the track. We would urge IPART to seek further justification for this expenditure from SWC before agreeing to its inclusion. We also note that while immaterial at this stage for the Macquarie, across the state Thematic Expenditure relates to increases in excess of 10% of SWC's total OPEX over the period. Given this, MRFF concurs with the points raised by NSWIC in their submission to IPART and in particular submits the following:

- *that most of the thematic expenditure items are discretionary in nature and ought be deferred until defined trigger points with respect to revenue are met.*
- *that those projects within the Environment and Heritage thematic expenditure budget that are as a result of state legislation ought be fully cost-attributed to the State Government. Further , or in the alternate, that those projects within the Environment and Heritage thematic expenditure budget that relate to heritage matters must be considered a legacy cost were the heritage asset was constructed prior to 1997.*
- *that the dam safety thematic plan expenditure is discretionary and that it be deferred until such time as revenues recover. We would also raise the question as to whether this expenditure should be considered a legacy cost.*
- *that the research thematic plan expenditure is discretionary and that it be deferred until such time as revenues recover.*
- *that the land management thematic plan expenditure is to develop non-regulated revenue streams and hence ought be funded by non regulated earnings and not be included in this Determination.*
- *that emergency and security thematic expenditure is a public responsibility and ought be funded solely by government.*
- *that the activities identified as "corporate" are, in fact, standard operating procedures that are already represented within regulated OPEX. As such, we oppose increased OPEX for these programs.*

We acknowledge that SWC has consulted individually with Customer Service Committees to determine "discretionary" service levels relating to specific projects and additional services that may be delivered in individual valleys based on customers identified needs. We endorse the continuation of this process.

MRFF notes that SWC attributes a proportion of the total NSW Government contribution to the Murray Darling Basin Authority to the Macquarie Valley. We understand that this is in line with the current determination, however, outwardly dispute the Macquarie's inclusion in this cost estimate. We note that the Macquarie system is a terminal system and therefore users in this Valley are neither responsible for, nor receive any benefit from, this cost component.

MRFF submits that the Macquarie Valley should be removed from any pass through costs to the MDBA and BRC.

Whether there is scope for SWC to achieve further efficiency gains over the 2010 determination period

We note that SWC has achieved efficiencies in a number of areas during the course of the current determination. We would expect that as the new business structure is bedded down along with new initiatives such as the Internet Water Accounting System, that there would be room for further efficiency gains within SWC's operations. We note that SWC have projected efficiency improvements of 2% per year from 2011/12 and we would suggest that these are relatively modest projections compared to gains sought by businesses operating in the private sector.

The information provided by State Water on its past and forecast capital expenditure, and the prudency and efficiency of this expenditure

MRFF notes large variances in the allowed CAPEX compared to actual CAPEX for the first three years of the current determination. It is then interesting, but not surprising, that SWC forecasts to "catch-up" on a significant proportion of it's underspend during 2009/2010. MRFF has obvious concerns about weighting expenditure toward the final year of the determination period given the clear implications that the opening Regulatory Asset Base (RAB) has on pricing. Further MRFF has concerns about the reporting of "forecast" capital expenditure for 2009/10 given SWC failure to meet allowed figures in the first three years.

MRFF submits that given the final determination will be made by IPART later in the 2009/10 financial year, CAPEX figures based on actuals rather than forecasts are used to set the RAB.

In terms of forecast CAPEX, MRFF feels that further information needs to be provided by SWC before we are able to comment on the prudency and efficiency of this expenditure for the Macquarie Valley. At a meeting held between SWC and a subcommittee of the Macquarie-Cudgegong CSC in August this year, SWC presented the following figures relating to capital works program over the period 2010/11 – 2013/14 (reported in $'000):

2010/11	2011/12	2012/13	2013/14
10,230	18,250	6,860	64

At this meeting, the basis for this expenditure was discussed and generally accepted as reasonable. However, the forecast CAPEX figures for the Macquarie Valley presented in Appendix 4 of the SWC submission do not reconcile with these figures. The table below shows the CAPEX figures from SWC's submission to IPART ($'000) and the variance from those presented to the CSC subcommittee.

2010/11	2011/12	2012/13	2013/14
14,712	19,342	2,566	1,829
Variance: + 44%	Variance: +6%	Variance: -63%	Variance: +2758%

Whilst we understand that there is likely to be some change from figures presented to CSC's in preliminary consultation as SWC prepares their final submission to IPART, MRFF would like the opportunity to question SWC further where significant variations (as seen above) exist.

MRFF submits that SWC provides an explanation for large variations in the proposed CAPEX program for the Macquarie Valley as submitted to IPART compared to CAPEX figures previously presented to the Macquarie-Cudgegong CSC.

An appropriate rate of return to apply on State Water's RAB and the means of estimating this rate

MRFF notes that IPART set a rate of return at 6.5% for the current determination and that this has not been achieved over the period. We further note that reduced revenue, due to below forecast sales, and failure to fully meet efficiency targets have contributed to financial performance that did not provide the set rate of return on assets.

MRFF has previously advanced arguments as to why we believe that the rate of return has been set unrealistically high. We are therefore very alarmed to see that SWC proposes a further increase in this rate to 7.9%. MRFF believes that our arguments for a reduced rate of return remain valid, and we resubmit them for IPARTs consideration:

- CoAG's 1994 agreement relating to full cost recovery did intend a return on investment, however, suggested that this rate might be up to 4%. MRFF submits that the proposed rate of return of 7.9% is substantially higher than CoAG's intention.
- A rate of 7.9% is more in line with higher risk, higher yielding stocks in the private sector that do not provide long term capital growth opportunities. MRFF submits that bulk water infrastructure is a longer term proposition that does not fit this category of investment.
- Further, MRFF fails to see the justification for paying commercial rates of return for a business that is yet to demonstrate efficient operations and in some cases relies on the use of substandard assets. In relation to this point, we remind IPART that Macquarie Valley customers can currently expect the likelihood of a shortfall in their water requirements being met at critical, peak demand period of the cropping season due to substandard infrastructure and valve capacity limitations on volumes able to be released from Burrendong Dam (noting that SWC has plans to upgrade valve capacity at full cost to customers).

MRFF discusses our concerns in relation to SWC's customer base elsewhere in this submission, however, do note here that we take issue with irrigation customers having to pay excessively high rates of return for delivery infrastructure to which we do not even have priority of access. Irrigation customers are classified as lower priority in terms of delivery service than all other customers and users, including flood mitigation, town water supply, stock, domestic and environment, as determined by the Water Management Act 2002 and implemented in the Macquarie Cudgegong Water Sharing Plan.

MRFF submits that the current rate of return of 6.5%, as set by IPART, is already above a level that MRFF considers realistic and appropriate and see little justification for an increase in this rate to 7.9% as proposed by SWC.

Whether it is appropriate to address State Water's revenue risk by adjusting the WACC

MRFF notes that SWC contends that IPART should compensate them for the risk of revenue volatility through an increased Weighted Average Cost of Capital (WACC). SWC bases this argument on economic and climatic risks being systematic in nature and therefore warranting a higher WACC (page 5-10).

MRFF accepts that economic and climate change may be systematic in nature, but disputes that there has been any demonstrable shift in these conditions that would warrant a change in SWC's risk premium. We discuss economic and climatic risk in turn below.

SWC discusses economic conditions in terms of demand-side volumetric risks (page 5-10). SWC argues that global financial conditions and commodity markets greatly impact on rural bulk water customers, presumably in terms of the use of water as an input to irrigated agricultural production. MRFF contends that demand-side volumetric risk is unlikely to be an issue for SWC as the level of development, variety of crop options and water management provisions (including trading and carry-over) will ensure that if water is available, there will be demand for it.

To warrant an increase in WACC, which would be a fundamental change in the price setting approach, MRFF believes that SWC must be able to argue that there has been a shift in economic conditions, rather than just a cyclical downturn. We would argue that there is no evidence to support this shift and that recent reports from leading agricultural economists, such as ABARE and the Australian Farm Institute, suggest that commodity markets are returning to more regular cycles and point to longer term opportunities for irrigated agriculture.

As acknowledged by SWC, the primary source of volumetric risk is actually on the supply side, which is determined by climatic conditions. We refer IPART to our discussion further on in this submission in response to SWC's proposed consumption forecasting approach. For the reasons outlined in that discussion, we reject the notion of a "structural break in patterns of water availability" as put forward by SWC's consultants, CIE. While MRFF acknowledge that there is evidence to suggest that climate change will impact on future water availability, there is no such evidence to suggest that the severe drought conditions of the past four years are the new norm, or that the full implications of climate change will be realised during the next four year period. In fact there is still considerable uncertainty around the impact that climate change will have on water availability at the valley level. To illustrate this uncertainty we point to the CSIRO findings from their Sustainable Yields report to the Australian Government, which for the Macquarie Valley shows climate projections to 2030 with variances in water availability from increases of 25% under a wet extreme to decreases of 25% under a dry extreme.

Nowhere in SWC's discussion of volumetric risk, or in their whole submission, have SWC acknowledged the substantial upside (in terms of profitability) associated with the current price setting approach. We note that when using any type of averaging to forecast consumption levels, there will be years of above average consumptions as well as years of below average consumption. We suggest that given the nature of SWC's business, they take a long term approach to risk management, and as part of this approach, consider how they might invest profits obtained in years of higher than forecast water availability.

In summary, MRFF sees no justification for an increased WACC based on shifts in economic and climatic risk for SWC for the upcoming determination period. Rather, there has been a cyclical downturn during the current determination period that has resulted in SWC, along with many other businesses, not being as profitable as they perhaps would have liked. We take this opportunity to highlight, that despite a run of bad years, SWC has still posted positive earnings before interest and taxation (refer Table 2.3 of SWC's submission). Not surprisingly, SWC has left aside any comparison to average market rates of return that have been achieved in the private sector across the same period.

> *MRFF submits that volumetric risk has been overplayed by SWC and that there is a significant revenue upside that SWC has failed to acknowledge in their submission. Further, MRFF submits that the conditions of the current determination period have been cyclical in nature and that there is no evidence to suggest a shift that would warrant an increased WACC for the upcoming period.*

The implications of transferring pricing responsibility from IPART to the ACCC for the Murray Darling Basin and any transitional arrangements that IPART might put in place to ensure a smooth transition

MRFF would like to take the opportunity to note that we have ongoing confidence in the IPART pricing determination process. We believes that IPART is best placed to continue in its current role given it has the demonstrated corporate knowledge, human resources and stakeholder trust that is necessary to complete this task in an efficient and effective manner. We see no reason to abandon this system.

> *MRFF submits that we are not in favour of transferring pricing responsibilities from IPART to the ACCC.*

The appropriateness of State Water's proposed approach to depreciation, asset classes and lives

MRFF notes that SWC proposes a change in the asset lives that it applies to an average of 83 years, compared to the 2006 Determination of 160 years for existing assets and 75 years for new assets. MRFF has reservations about this proposal as, on the surface, a reduction in asset lives will lead to an increase in depreciation expense and effectively another area of fee increase for customers. However, in their submission, SWC claims (page 5-13) that "any net increase to depreciation (return of assets) revenue requirements will be offset by future reductions in return on assets revenue requirements, as regulatory assets will depreciate at a faster rate".

MRFF would have expected that following the “detailed review” SWC undertook of its water infrastructure and land and building assets in 2008/09, a more robust approach to depreciation, asset classes and lives would have been proposed. Surely this would entail depreciation schedules based on the management plan of each individual asset, as is standard practice in private sector entities.

MRFF submits that as part of its review IPART confirm SWC’s assertion that there will be no net increase in depreciation, and hence pricing, as a result of averaging asset lives at 83 years.

The usefulness of valley-based reports

MRFF appreciates the provision of valley-based reports through the Customer Service Committee process and notes that SWC have made significant improvements in the delivery of these reports over the years. We further appreciate the good working relationship that our organisation maintains with SWC and the efforts that SWC have made to consult with stakeholders in the lead up to this pricing determination. We are, however, concerned and disappointed that figures presented in the SWC submission to IPART are not easily reconciled with figures previously provided via valley-based reports and the CSC. We trust that there will be opportunity to reconcile these differences during the course of the determination.

Whether the cost sharing approach used in the 2006 Determination remains appropriate

MRFF recognises that in the current determination IPART endorsed an ‘impactor pays’ approach to sharing costs between users and government. MRFF recognises and concurs with the notion of users paying full cost recovery for access, however, there is an extended list of users that must also be included as paying customers. MRFF made sound arguments during the course of the previous determinations for widening IPART’s definition of ‘users’ and we believe that IPART must revisit these arguments when considering cost sharing principles.

Flood Mitigation Role of Burrendong Dam

We remind IPART that the officially acknowledged purpose of Burrendong Dam when it was expanded in the 1950s, was for flood mitigation, in addition to irrigation and provision of stock and domestic supplies. In fact, almost one-third (489,000 ML) of the dam’s total storage capacity (1,678,000) is designated and operated solely for flood mitigation, with the remaining 1,189,000 ML designated for irrigation, stock, domestic and environmental purposes. To then allocate all operating costs associated with the dam to irrigation customers is not only inequitable but plainly incorrect.

MRFF submits that recognition of Burrendong Dam’s flood mitigation role is particularly important given such a large part of the Macquarie’s infrastructure, storage and delivery costs are related to Burrendong Dam. We further submit that this is a valley specific issue with Burrendong being one of only two dam’s in the state that was constructed for the purpose of *flood mitigation. Bearing in mind this officially recognised role of the dam, flood mitigation must surely be recognised under the 'impactor pays' approach.*

MRFF has previously demonstrated figures that might provide a proxy for estimating the relative distribution of costs pertaining to Burrendong Dams flood mitigation role. These figures are based on work undertaken by the then DLWC investigating the consequences of Burrendong Dam failure under an extreme flood event. MRFF resubmits this table for IPARTs consideration.

Estimated Impacts of Burrendong Dam Failure

Impacted Category	Impact in $ Millions	Impact as % of Total
Residential	933	11%
Commercial	2,011	34%
Industrial	1,827	22%
Public Assets	2,212	26%
Replace Dam	308	3%
Total Indirect Impacts	53	1%
Agricultural	257	3%
Total	**8,501**	**100%**

SWC has also recognised the importance of the Dam's flood mitigation role and has recently re-established the Macquarie Flood Mitigation Zone Reference Group to provide stakeholder input into how to best manage flood events. To further highlight that this stakeholder group is much wider than SWC's irrigation customer base, we note the representatives who have been included on this reference group:

- Local council groups: Wellington Shire, Dubbo City, Narromine Shire and Warren Shire
- Floodplain landholders representing various segments of the river
- Macquarie Marshes
- Macquarie Cudgegong Customer Service Committee
- Environmental Flows Reference Group
- Department of Environment and Climate Change

Incorporating the Full List of "Users"

MRFF notes that there are numerous higher priority water users than irrigators in the Macquarie, who are not currently included as paying customers.

MRFF submits that there are a number of user groups who should be included as paying customers. We stand by our submission in previous determinations that we would welcome the opportunity to work with IPART and SWC to develop a robust and dynamic cost sharing calculator that better reflects the expenses SWC incurs in servicing its different customers.

As a particular example, we refer to the 160,000 ML environmental water allowance in the Macquarie[1]. This allowance is classified as general security with the same access rules as irrigation general security water. A portion of the environmental water is also able to be traded, and the full allocation is able to be stored, carried over and is accessible on demand, therefore incurring the same costs to SWC as irrigators' general security water. Given the management conditions associated with the delivery of the environmental water allowance we cannot understand why it is not subject to the same charges as other bulk water.

Another example is the unregulated and regulated water that is used as replenishment flows in the effluent creeks of the Macquarie system. Management of these flows is a considerable cost component yet is totally free of delivery charges to those users who require the service.

The costs to service these 'non-paying' users have become particularly evident in these recent years of very low allocation, when paying irrigation customers have seen little to no irrigation water delivered yet have witnessed the continued service provided to subgroups of non-paying customers.

To further exacerbate our point that all users need to be identified as customers, we refer IPART to the make-up of SWC's Customer Service Committees and Community Consultative Committees, which includes irrigators, stock and domestic users, local government, industry, environmental flow management agencies and Catchment Management Authorities. We note that these committees allow all users, whether paying customers or not, rights to be consulted and have input to SWC's business planning, asset planning and management, and other fundamental operating decisions.

Specific comment on user shares in relation to fish passage works

As a final comment on the cost sharing approach, MRFF would like to highlight our concerns in relation to SWC's fish passage program. We note the request made by SWC that the user share for fish passage maintenance is 100%. This is an important issue as the work is likely to be a significant cost base for SWC, however, we disagree that the nature of the expenditure is "operational rather than compliance", as fish passageways were installed and are required to be operational as a result of compliance.

> *MRFF submits that fish passage maintenance cost shares should reflect the cost shares as per their installation, which is only 50% attributable to users.*

We further note that fish passage upgrade, as opposed to maintenance, has been, and will continue to be, triggered by dam safety compliance works. In this instance, the fish passage works cost recovery should be treated in the same fashion as the dam safety compliance works.

> *MRFF submits that the cost of fish passage upgrade works that are triggered by dam safety upgrades should be 100% be funded by government.*

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[1] Note that the environmental water allowance is an allowance within the Water Sharing Plan and does not refer to environmental water purchases made through State and Commonwealth Government programs, which are subject to the same conditions and charges as the licence class from which they were purchased.

State Water's consumption forecasts, as outlined in its submission

MRFF is strongly opposed to SWC proposal to disregard the current Long Run Average (LRA) approach to consumption forecasting, based on IQQM, in favour of a rolling 15 year average, based on actual extractions.

MRFF recognises that SWC's approach to consumption forecasting is the key driver behind the significant increase in the proposed usage charge for the Macquarie Valley given the proposed 30.1% reduction in current consumption figures (refer Table 9.3 of SWC's submission). MRFF, and the irrigation businesses that comprise our membership, can well appreciate the impact that periods of reduced water availability has on business profitability, but we refuse to accept SWC's absurd argument of a supposed "structural break" in patterns of water availability as a sound basis for SWC shifting their business risk onto their customer base.

In choosing to argue that the LRA approach is no longer valid, SWC have relied on commissioned work from the Centre for International Economics (CIE) that used a statistical analysis to draw the conclusion that "current low extractions reflect a structural break in patterns of water availability rather than normal climatic variability". MRFF questions the credibility of basing this argument on statistical analysis as opposed to any of the actual science that is available around the climate change issue. We suggest that the current science shows no evidence that demonstrable change, attributable to climate change, will occur in water availability in the next four years of the determination period. SWC basically admit this when they note that "climate change models are based on much longer timeframes than the next four years" (page 9-3).

We have previously noted the considerable uncertainty around the impact that climate change will have on water availability at the valley level. This uncertainty is highlighted by the CSIRO findings from their Sustainable Yields report to the Australian Government, which for the Macquarie Valley shows climate projections to 2030 with variances in water availability from increases of 25% under a wet extreme to decreases of 25% under a dry extreme. It should be noted that even these extremes projected to 2030 are within the 30.1% reduction in water availability in the Macquarie Valley as proposed by SWC for the next four years. In fact the CSIRO's best estimate for 2030 is well within this range with an 8% reduction in water availability and 4% in overall diversions.

Even if we were to humour SWC and the CIE and their notion of a "structural break", MRFF disputes that the alternate proposal, being the 15 year average, is an effective means of addressing the issue. On page 49 of their report, the CIE state that "it is likely that structural change in extractions has occurred in the southern river valleys over the past five years" and that "in the northern and central valleys, there is less evidence of structural changes in extraction". Yet the outcome of the 15 year average approach has the greatest impact, in terms of reduced average extractions, on the Macquarie (central), Border (northern) and Namoi (northern) valleys.

MRFF submits that the CIE statistical analysis is not a credible approach for forecasting future climatic conditions and scenarios for water availability. Further, MRFF suggests that even if a case did exist for a "structural break in water availability" the proposed 15-year average is far too *severe an approach to consumption forecasting and fails to provide an effective solution to the problems relating to climate change that they have identified.*

On this basis, MRFF submits that IPART reject SWC's proposal to move to a rolling 15 year average methodology for consumption forecasting and instead, retains the Long Run Average approach, based on IQQM, as used in previous determinations.

MRFF takes further issue with the 15 year average proposal, as presented by SWC and the CIE, in that the consumption figures presented are not based on 15-years of actual data at all, but rather 14 years of data (refer page 58 of the CIE report). In the case of the Macquarie Valley, this means that the very high (80%) allocation year of 1994/95 is excluded from the dataset (data obtained from SWC Valley Business Plan for the Macquarie-Cudgegong).

MRFF submits that it is misleading to present the consumption forecasts as based on a 15 year average, when in fact only 14 years of data have been used. MRFF suggests that IPART ask SWC why the 15th year has not been included when this data is commonly available.

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

We believe that SWC's rather loose argument to change the consumption forecasting approach, as they have attempted to do in previous determinations, is nothing more than an excuse to shift part of its natural business risk onto customers. In response to this, MRFF highlights that even though SWC incurred significant reductions in sales due to severe drought conditions during the current determination period, SWC has still managed to record a profit on regulated revenue. This can be clearly seen in Table 2.3 of SWC's submission, which shows positive earnings before interest and taxation (EBIT) as well as positive return on assets in each of the four years of the current determination.

MRFF does recognise the difficulty in forecasting consumption figures for the purpose of determining prices, and in the absence of a crystal ball, there are likely to be years when figures are too high and other years when figures are too low. Not surprisingly, SWC provides no discussion as to how they would deal with surplus revenue should consumption figures prove to be too low.

In previous determinations MRFF has suggested that SWC might manage variability in use by debt funding shortfalls and investing surpluses. Customers could then be charged those costs that might arise from a net shortfall i.e. the difference in interest rates. We would urge that IPART reconsider this option as a more appropriate and cost effective approach to risk management.

Options for meeting the cost of providing water in valleys in which cost reflective prices may not be practical

MRFF notes the intent of the National Water Initiative, that where full cost recovery is not practical, the cost of providing water must be met via a transparent subsidy from government.

The appropriate balance between fixed and usage charges

Whilst we are aware that increasing the proportion of fixed charges would reduce the volatility of SWC revenues and would have led to an improved financial situation for SWC over the current determination, MRFF maintains its preference for the current 40/60 fixed/usage charge ratio. In considering this issue, MRFF urges IPART to also consider the impact of variable water supply on SWC's customers. It is not reasonable or affordable for customers to have to pay significant entitlement charges during repeated periods of very low allocation.

> *MRFF submits that the balance between fixed and usage charges remains at the current ratio of 40/60 fixed/usage.*

MRFF would further like to note on this issue, that although we highlighted our preference for lower fixed charges in earlier consultation with SWC, we dispute the claim made by SWC (page 2-7 of their submission) that customers "indicated a preference for a higher WACC, rather than higher fixed charges". For the reasons advanced in earlier parts of our submission, MRFF does not believe that even under the current fixed/usage ratios that the higher WACC proposed by SWC is warranted.

The impact of State Water's proposed prices on its customers

Much has been made in the SWC submission to IPART of the financial position SWC finds themselves in given a determination period that has seen unprecedented drought conditions resulting in consumption figures being well below those forecasted. Yet despite these difficult conditions, which have been coupled with a global financial crisis, SWC has still covered its allowed operating costs and made, albeit a modest, return on assets.

Very little, if any, recognition is given by SWC to the impacts that the extended drought has had on its irrigation customers. In the entire 'Ability to Pay' report commissioned by SWC about two paragraphs are given to the impact of drought on customers.

MRFF, and the irrigation businesses that comprise our membership, can well appreciate the impact that periods of reduced water availability has had on business profitability and while we have an interest in the ongoing viability of SWC we would urge IPART to consider the impacts that the drought conditions have also had on SWC's irrigation customers.

The appropriateness of State Water's proposal to recover the cost of meter service provision

MRFF wishes to reserve opinion on the issue of meter upgrades until further information on the program roll-out is available. Suffice it to say that we are currently unhappy with some of the arrangements under the CAG agreed State Priority Project. We would also like to ensure that there is no 'double-dipping' in terms of costs charged by SWC to its customers in relation to metering services.

The appropriate balance between high security and general security entitlement prices

MRFF has submitted in previous determinations that we supported the removal of cross subsidies between different water users within the same valley and that it was equitable to take the Water Sharing Plan conversion rate from general security to high security as an appropriate ratio to reflect the increased costs associated with delivering increased security.

In their submission, SWC notes that current access premiums, based on Water Sharing Plan conversion factors, do not adequately reflect the reliability of supply and propose that they be be adjusted by a scarcity premium. MRFF rejects the notion of a scarcity premium on the basis that scarcity is priced in the water market and to further price it via delivery pricing would be both inappropriate and unnecessary.

In the absence of appropriate conversion rates, MRFF concurs with NSW Irrigators Council submission that IPART adopt a cost based approach to access premiums. That is, SWC should determine a premium based on additional fixed operating costs that are incurred solely for high security use. MRFF further submits that this rationale should be applied across all of SWC's customer base, for example, town water supplies have a higher priority than high security bulk water and incur higher storage costs, it therefore seems reasonable that they should also attract proportionately higher entitlement charges.

The appropriate length for the 2010 determination period

MRFF agrees that a four year regulatory period, as per the current determination, is appropriate.