

**SUBMISSION TO THE IPART REVIEW OF
PRICES FOR STATE WATER CORPORATION (SWC), From July 2010**



By MURRUMBIDGEE IRRIGATION

INTRODUCTION

Murrumbidgee Irrigation Ltd (MI) is an unlisted public company providing water supply, drainage and environmental services to approximately 3200 landholdings or 1800 customer/shareholders in the MIA. The Company employs 170 staff and manages \$500 million of infrastructure assets servicing over \$2.5 billion in water entitlements.

The Murrumbidgee Irrigation Area (MIA) is one of the most diverse and productive regions in Australia contributing over \$5 billion annually to the national economy. The MIA was first established in 1912 following the commissioning of Burrinjuck Dam. Further expansion occurred in the 1970's with the completion of the Snowy Mountains Scheme and construction of Blowering Dam. The region has played a significant role in fostering cultural diversity with over 50 different nationalities now resident in the region. The region also played a significant role during and after WW1 and WW2 in terms of national security and repatriation.

In making this submission to IPART, Murrumbidgee Irrigation Ltd (MI) continues to recognise its regional and national responsibilities to assist in meeting water reform objectives for water supply services, while maintaining regional production and welfare of shareholders and other stakeholders.

MI is a member of the NSWIC and this submission complements that of the NSWIC.

OVERVIEW

The SWC submission to IPART is a marked improvement over past efforts in terms of its focus on the IPART framework, provision of supporting information, and its highlight of and discussion of key issues. It is also much less of an ambit claim in terms of forward operating cost estimates, and gives greater attention to the role of efficiency improvements. There is also less evidence of 'over-estimation' of capital expenditure relative to actual outcomes, and consequent risks for customers. These are all major steps forward.

Nonetheless, MI is very concerned about a range of issues, including:

- The lack of appropriate analysis supporting some fundamental assertions, including that SWC is in financial crisis due to the drought, climate change, and the need to borrow for future investment and that its recommended price increases are moderate. In particular:
 - ⇒ SWC's financial performance during the drought seems to have been affected more by inadequate expenditure control and delays in efficiency improvements than it has by revenue shortfalls due to the drought.
 - ⇒ Climatic risks for future financial performance seem to be overstated.
 - ⇒ SWC understates price increases when important cost elements (such as MDBA costs) have been excluded – but not eliminated – from future charges.
- The absence of a clear, comprehensive strategy to improve financial performance (and address the drought) and resort to 'easy' solutions such as lobbying for price increases via an increase in the WACC, reductions in forecast consumption, and/or moves to increases in fixed charges.
 - ⇒ The level of the WACC should provide SWC with an incentive to improve its performance rather than be an instrument to guarantee a good financial performance.
 - ⇒ Potential reductions in forecast consumption should be addressed by a drought related business strategy before relying on price changes to deal with volatility.
 - ⇒ SWC already has highly secure revenue (to cover opex and return of capital). A higher ratio of fixed charges will be a disincentive to improve performance.
- Activities that seem to ignore the need to improve SWC's performance and address potential drought such as the 9 per cent real increase in opex and a very high cost planned investment program that seems largely unrelated to commercial drivers (along with a request to review current cost shares in light of the increasing share of costs being borne by the Government).
 - ⇒ The proposal to increase required revenue by 58 per cent in real terms (with an expected deterioration of financial performance) over the next regulatory period is unsatisfactory.
 - ⇒ SWC's view that increases in the scarcity value of water buffers price increases for water delivery ignores cash flow problems and the role of scarcity price increases in driving restructuring of farm businesses (that is, the price of water increases but most farms experience net losses).
- A tendency to resort to arbitrary adjustments rather than quantitative analysis, and inadequate presentation of data and analytical methods that result in ambiguity/uncertainty about the impacts of certain activities for customers and stakeholders. For example:

- ⇒ The confusing role of debt levels and credit ratings in the estimation of revenue requirements (aside from calculation of an appropriate WACC).
- ⇒ An apparent double-counting for inflation via both the RAB and annual revenue through adjustment of charges.
- ⇒ SWC's understatement of price increases when important cost elements (such as MDBA costs) have been excluded – but not eliminated – from future charges.
- ⇒ Quite arbitrary treatment of the calculations supporting the proposed restructuring of HS and GS entitlement charges.
- ⇒ The calculation of and proposed claw back of ICD rebates.
- ⇒ The lack of comprehensive, detailed, and consistent data in total and by Valley.

SUMMARY OF RECOMMENDATIONS

MI recommends:

1. The precise processes, methods, and impacts of SWC's investment grade credit rating need to be communicated more clearly to stakeholders than at present.
2. The permanent transfer of MDBA and BRC costs to the NSW Office of Water (NOW), and that these costs are subject to efficiency analysis when they are submitted to IPART.
3. Standardisation of the treatment of MDBA and BRC charges when comparing prices in the last regulatory period and SWC's recommended prices for the next regulatory period (to enable meaningful conclusions).
4. That while SWC does face revenue volatility because of drought, the associated financial risks have been overstated, as have the risks of structural climate change and business risks generally. In these circumstances, SWC should be given the opportunity to formulate a response consistent with its own analysis, namely a firm specific strategy to deal with the challenges of the drought, before any consideration of responses such as increases in real prices and the WACC, or a return to fixed revenue pricing.
5. That baseline opex less efficiencies as presented in Table 3.3 should be the starting point for the efficient level of opex in the forthcoming determination. This ought to be reviewed in order to identify potential cost reductions to reduce SWC's financial vulnerability if the drought continues. The thematic expenditure should generally be deferred or only undertaken with the specific agreement of the relevant paying customers (users or Government) that involves specific charges to meet the full costs (as seems likely for "discretionary service" related costs (section 8)).
6. That IPART review capex estimates for 2009/10 in light of actual expenditures as late as possible in the determination process in order to minimise potential for an overstatement of the opening RAB in the forthcoming determination.
7. That the proposed capex program be reviewed in light of financial risks associated with the drought and debt accumulation in order to identify opportunities for deferrals, disposals and decommissioning; and possible redirection of investments to generate alternative sources of revenue (including water saving activities).

8. That IPART ensure the WACC does not include a double counting of CPI adjustments.
9. That the SWC WACC be determined relative to market benchmarks without alterations to address firm specific risks identified by SWC, including no deviations to the equity beta, asset beta, debt gearing levels, or debt margin levels relative to other regulated utilities. On this basis alone, MI would expect continuation of a real pre-tax WAC of 6.5% given recent outcomes for other regulated businesses (table 5.3).
10. That SWC should not be able to return to a fixed charge business if the WACC is not increased.
11. That any alteration in the level of the real WACC, while requiring careful consideration of observed data and assumptions about risk premium, gamma, betas and gearing, needs to be accompanied by an explanation of why a shift in the cost of capital for the Australian market is expected to be sustained over the regulatory period.
12. That the risks of 'temporary influences' on WACC estimates be mitigated by making offsetting changes to the WACC in future determinations if the expected structural shift in the WACC is not realized. For example, Sydney Water should not be able to permanently pocket a 1 per cent premium if it washes out. (The idea being to make the establishment of the WACC much less interesting than the firm specific strategies required to deliver the target outcomes relative to the market.)
13. That, within the proviso that WACCs be stable unless there is a sustained increase in the cost of capital, the use of observable data wherever possible for the nominal risk free rate, inflation, and the tax rate – and a continuation of IPART's current estimates for the risk premium, gearing ratio, gamma, and tax rate.
14. If SWC's arguments that its benchmark level of debt gearing risks driving its investment grade down and its debt margin up are realistic/practical then MI would support a gearing level of 30% with an offsetting change to SWC's equity beta (to about 0.6 or less) to reflect this decoupling from assumed average market average conditions.
15. The current debt margin of 3.15 per cent seems high especially if it effectively increases the cost of debt (e.g., if accompanied by a high risk free rate) without offsetting changes to the cost of equity. The method of deriving debt margins should not of itself affect the structural estimate of the real WACC. For instance, solving the problem that data for BBB+ and BBB corporate bonds is not available over 10 years (the period used to derive the risk free rate) should not result in a structural increase in the real WACC.
16. That it does not support the arbitrary treatment of depreciation of SWC assets (being adoption of an 83 year average life for all assets).
17. That it does not support a review of cost shares. However, if there is such a review MI expects the opportunity to provide an input.
18. That the full cost of Tumut River works be met by Government.
19. That the current consumption forecasts be continued in the next determination.
20. That the proposed increase in the ratio of revenue from fixed charges for SWC and/or the increase in its WACC be rejected and replaced with a comprehensive review of the business and formulation a strategy that enables SWC to meet commercial returns within reasonable budget constraints in light of revenue risks arising from deviations in consumption forecasts.
21. That before changing the relative charges for HS and GS entitlement holders SWC should identify the efficient costs and the relative cost drivers (in line with IPART practice). If IPART

accepts the SWC proposal without a supporting cost analysis MI would like the opportunity to comment on the specifics of a 'scarcity premium' adjustment.

22. That a WACC of 6.5% be used to calculate ICD savings from telemetry, and that the benefits of ICD cost savings are assigned only to ICD entitlement holders. This means that the starting estimate (2010/11) of the rebate for ICDs in the Murrumbidgee Valley would be almost \$1m for MI and about \$440,000 for Coleambally.
23. That implementation of the metering project by SWC should result in no change in effective charges per ML of entitlement for ICDs. This can be achieved by retaining current charges and the full rebate or making pro-rata adjustments to both as the need for the rebate declines.

DETAILED COMMENTS (BASED ON THE SWC SUBMISSION)

SECTION 1: BACKGROUND AND CONTEXT

MI acknowledges the solid performance of SWC over the last regulatory period in respect of levels of service, improved corporate systems, efficiency improvements, customer consultation, and delivery of performance indicators (section 1.4).

We are nonetheless confused with the proposed performance target of maintaining an investment grade credit rating of BBB (table 1.2). This seems to be a major issue in relation to SWC's future price recommendations. MI therefore recommends:

1. The precise processes, methods, and impacts of SWC's investment grade credit rating need to be communicated more clearly to stakeholders than at present.

MI is concerned about how MDBA (or MDDB) costs were treated in the last determination, where MI had to deal with the addition of \$1.5m per year (\$2006/07) to Murrumbidgee Valley costs arising from the MDDB very late in the process. SWC has suggested further change in the forthcoming determination to the treatment of MDBA charges (i.e., exclusion from SWC revenue requirements) and acknowledged an inability to assess the efficient level of these costs or the allocation in terms of cost drivers. On this basis MI recommends:

2. The permanent transfer of MDBA and BRC costs to the NSW Office of Water (NOW), and that these costs are subject to efficiency analysis when they are submitted to IPART.
3. Standardization of the treatment of MDBA and BRC charges when comparing prices in the last regulatory period and SWC's recommended prices for the next regulatory period (to enable meaningful conclusions) – see also section 11 below.

SECTION 2: STATE WATER'S FINANCIAL POSITION

SWC argues that under recovery of user share revenues due to drought and climate change, a high level of fixed costs, and high financial risks associated with an assumed gearing level of 60% result in unacceptable business risks.

MI acknowledges the significant reductions in consumption relative to the regulatory forecasts for the 2006/07 to 2009/10 regulatory period due to the extreme drought conditions (Table 2.1). However it

should also be acknowledged that the drought has had similar effects on all rural water delivery agencies throughout the basin and, more particularly and acutely, the farm businesses served by those delivery agencies. It should further be noted that most of those businesses do not have the option of increasing prices to meet the challenge of the drought and many of them have experienced significant financial losses and real declines in wealth. Those that have survived have usually undergone significant restructuring and alteration of business strategies to deal with the drought (especially through efficient improvements – including water use efficiency).

In this context it is reasonable to ask how severe were SWC's financial problems over the last regulatory period? Tables 2.2 to 2.4 present a dire picture. However, there are some problems with the data presented. First, the allowed revenue receivable from users in table 2.2 is overstated by \$27.1m (which was met through an operating subsidy). Second there is no data on actual costs. Third, the RAB seems to be adjusted annually for inflation which overstates the value of depreciation and undervalues the returns on the RAB. Finally, the interest expense is assumed not actual. In short the tables present a partial picture and do not enable a comprehensive analysis of actual financial performance.

Using data from SWC's financial statements presents a somewhat different picture, at least for those years for which data is available.¹

In 2006/07 SWC reported a net profit before superannuation/actuarial gains/(losses)² of \$9.6m or a 3.2 per cent return against the nominal RAB of \$304m at the start of 2006/07³. This is not a bad performance in a year when actual consumption (water deliveries) was 60 per cent below the regulatory forecast. SWC fully met tax obligations and made provisions for a dividend payment of \$5.7m. The year 2006/07 is shown to be the worst year for EBIT and pre-tax profit in Tables 2.3 and 2.4.

In 2007/08 SWC reported a net loss before superannuation/actuarial gains/(losses)⁴ of \$19,000 or a negative 0.006 per cent return against the nominal RAB of \$314.6m at the start of the year. The turnaround from 2006/07 was due to a \$3.2m reduction in revenue and a \$6.3m increase in opex. In other words, if SWC maintained expenditure at 2006/07 levels – which would still be above IPART approved growth in opex - net profit would have been about \$6m or about 2 per cent of the RAB.

SWC's failure to meet IPART efficiency targets on opex during the last regulatory period resulted in it profits foregone of \$4.4m and \$4.8m (in \$2009/10) in 2006/07 and 2007/08⁵ respectively.

This data suggests that although the drought reduced profitability for SWC the more important issues over 2006/07 and 2007/08 were cost control and efficiency rather than revenue volatility. Yet SWC focus solely on business risks associated with drought related revenue volatility, a high level of fixed costs, and high financial risks associated with an assumed gearing level of 60%.

¹ Annual reports for SWC are not available on its website after 2007/08.

² Superannuation/actuarial gains of \$5m are excluded.

³ This RAB is based on the opening value of \$294.2m plus actual capex less depreciation and without the CPI adjustment shown at Table 5.1 of SWC's submission to IPART.

⁴ Superannuation/actuarial losses of \$7.3m are excluded.

⁵ See tables 3.1 and 3.2 in SWC's submission to IPART.

MI believes the following needs to be borne in mind:

- Costs should not be fixed downwards but variable upwards. SWC submits that its cost control has improved over the last two years (Table 3.1), but suggests the need for a 9 per cent real increase in costs, including efficiency gains of 6 per cent, in the next four years despite its own clear expectation that the drought will continue. This seems inappropriate.
- SWC has overstated its exposure to revenue volatility
 - ⇒ About 70% of SWC's revenue is very secure, being about 38 per cent of total revenues sourced from the Government (after allowing for subsidy), about 25% of total revenue being a fixed component of user charges, and about 7% of total revenue being HS use and minimal GS use (e.g., through temporary transfers and carryover). If proposed changes to HS/GS pricing ratios are approved and temporary trade is deemed as use the security of SWC revenue will be further enhanced.
 - ⇒ Opex plus expected return of capital (depreciation) was also about 70% of total revenue (assuming capex meets targets). This means that SWC should not be at risk of net losses. The risks of revenue volatility for SWC impact the level of net profits.
- SWC has used benchmark financial indicators, in particular gearing, to support its risk assessment (e.g., table 2.4 applies an interest expense based on a benchmark gearing of 60%). However, these indicators are derived to determine an appropriate WACC rather than to assess balance sheet risks. Actual interest paid by SWC is low.
- SWC's balance sheet is not at material risk due the drought. All else being the same,⁶ the market place would likely have delivered a reduction in SWC's asset values to correct the reduction in the NPV of future revenues due to the drought. That reduction would have restored WACC returns without the increased revenue and prices being sought by SWC. Since SWC's balance sheet retains its values during downturns it is inappropriate to also guarantee revenue (as a 90/10 fixed charge regime would effectively do). Otherwise SWC would bear no commercial risk and have no incentive to improve performance.
- The revenue risks due to drought borne by SWC are much lower than those borne by farm businesses (SWC's customers). It is appropriate that both the firm and customers share in those risks. SWC overstates demand side factors in relation to forecasts of consumption/delivery. Demand will match increases in allocation when the drought ends, and will only become important when supply is very high. Likewise the global financial crisis is likely to have insignificant impacts on the demand for water unless supply is high.
- The risk of a 'structural change in climatic conditions' is over-emphasized. The CIE paper uses statistical methods to predict structural change without support of theory on structural climate change in terms of timing – which anticipates changes in the longer term – or the extent of the impacts on water allocations (as acknowledged by CIE in relation to CSIRO studies of expected allocation changes due to structural climate change).

⁶ For example, excluding probable efficiency and cost control responses that would be expected from a commercially operating private company.

- The finding that SWC's firm specific risks associated with drought relative to Sydney Water may be accurate however Sydney Water's customers do not have the same exposure to drought as SWC customers. Also, SWC fails to use that analysis to identify firm specific strategies to deal with the risks. Before blunt measures such as an increase in the fixed charge ratio and/or an increase in WACC are considered, SWC should be given the opportunity to emulate its customers in formulating and implementing a firm specific strategy to deal with the challenges of the drought.

In summary MI:

4. Believes that SWC does face revenue volatility because of drought, but that the associated financial risks have been overstated, as have the risks of structural climate change and business risks generally. In these circumstances, SWC should be given the opportunity to formulate a response consistent with its own analysis, namely a firm specific strategy to deal with the challenges of the drought, before any consideration of responses such as increases in real prices and the WACC, or a return to fixed revenue pricing.

SECTION 3: OPERATING EXPENDITURE

The control of and identification of potential for reductions in operating expenditures should be the first element of a comprehensive strategy to deal with the drought. Every opportunity to make savings in order to offset drought related declines in revenue should be identified.

Unfortunately, the drought, which purportedly represents the central business risk to SWC, hardly rates a mention in the analysis of past operating expenditures and forward estimates – probably on the grounds that costs are 100 per cent fixed (or extremely close to that). If that is correct then the focus should be on avoidance of cost increases.

SWC's delivery of significant gains to efficiency, despite being a significant improvement over past outcomes, suggests that meeting IPART targets was a more important driver than the drought. Even so, tables 3.1 and 3.2 show the accumulated profits foregone through failure to meet IPART efficiency targets on opex were \$10.5m in total and \$9.6m in respect of user opex costs (\$09/10).

On this basis MI recommends:

5. That baseline opex less efficiencies as presented in Table 3.3 should be the starting point for the efficient level of opex in the forthcoming determination. This ought to be reviewed in order to identify potential cost reductions to reduce SWC's financial vulnerability if the drought continues. The thematic expenditure should generally be deferred or only undertaken with the specific agreement of the relevant paying customers (users or Government) that involves specific charges to meet the full costs (as seems likely for "discretionary service" related costs (section 8)).

SECTION 4: CAPITAL EXPENDITURE

The review of proposed capital expenditures in light of mitigating business risks should be the second element of a comprehensive strategy to deal with the drought. As with opex, every opportunity to make savings in capex to offset drought related declines in revenue should be identified. Also, if SWC's assessment about dire risks associated with climate change is correct, it seems sensible to review investment in that light. In this context it is worth noting that, aside from the drought, water reforms have driven rural water delivery agencies to review current assets and networks with a view to identifying opportunities for decommissioning/disposal and cost savings.

Again, the most pressing factors in SWC's assessment of firm specific business risk – revenue volatility due to drought and debt accumulation - hardly rate a mention in terms of either analyzing past capex or formulating forward estimates.

MI acknowledges the improvement in actual delivery of capex relative to forecasts in the SWC submission. However, the risks to customers remain. Table 4.1 shows that there are still significant under-expenditures from 2006/07 to 2008/09 (and the data in Table 4.1 for 2007/08 does not match up well with actual data relative to budget in Table 4.4). 2009/10 shows a large increase in actual capex but 2009/10 is a forecast.

That said, the deferral and under-expenditure of capex – whether by design or by accident – will help to reduce SWC's exposure to downturns in revenue if the drought continues.

MI also acknowledges the improvements in planning and prioritization of future capex. The only missing variables seem to be the consideration of financial risks associated with the drought and debt accumulation.

MI therefore recommends:

6. That IPART review capex estimates for 2009/10 in light of actual expenditures as late as possible in the determination process in order to minimize potential for an overstatement of the opening RAB in the forthcoming determination.
7. That the proposed capex program be reviewed in light of financial risks associated with the drought and debt accumulation in order to identify opportunities for deferrals, disposals and decommissioning; and possible redirection of investments to generate alternative sources of revenue (including water saving activities).

SECTION 5: REVENUE REQUIRED FOR CAPITAL INVESTMENT

MI is concerned that the calculation of RAB values in tables 5.1 and 5.2 involves a double counting of CPI in costs. The current IPART framework allows for establishment of costs in constant dollars at the start of the determination period with a real return on the RAB of about 6.5 per cent. It then enables SWC to adjust annual charges/prices by changes in the actual CPI to ensure that the target real return of 6.5 per cent is maintained. If SWC make CPI adjustments to the RAB the nominal

WACC (say about 9.5 per cent) effectively becomes a real WACC because provision for CPI is made twice.

SWC's discussion of the proposed determination of an appropriate WACC is confusing for MI. SWC uses WACC variables (particularly gearing) to analyze its own business performance and risks. However it is MI's understanding that the WACC variables (gearing, equity betas etc) are used to build up a benchmark WACC reflecting a private company operating in the market rather than SWC's specific circumstances.

The purpose of the WACC is to ensure competitive neutrality and use of resources that is more consistent with market driven outcomes. That is, the WACC may not reflect the firm specific circumstances of SWC. A critical outcome of this approach is that if SWC – or any regulated entity – faces firm specific circumstances that result in deviations from market outcomes then it would have the opportunity to adjust its business operations/strategy accordingly.

If this is correct the nexus between the benchmark WACC and SWC's specific circumstances is the major incentive to drive SWC towards market based performance. If circumstances such as drought impacts on revenue, cost management, or efficiency issues drive SWC away from average market outcomes, the incentive is placed on SWC to identify and implement strategies to deal with those circumstances or issues.

On this basis, if IPART allows SWC to alter the benchmark WACC then the major incentive to generate efficiency improvements (on both opex and capex sides) and business strategies to deal with SWC's business risks will be eliminated. The problem of SWC identifying business risks without identifying and implementing strategies to counter those risks would likely continue indefinitely with consequent welfare losses to the economy, shareholders and customers. MI therefore recommends:

8. That IPART ensure the WACC does not include a double counting of CPI adjustments.
9. That the SWC WACC be determined relative to market benchmarks without alterations to address firm specific risks identified by SWC, including no deviations to the equity beta, asset beta, debt gearing levels, or debt margin levels relative to other regulated utilities. On this basis alone, MI would expect continuation of a real pre-tax WAC of 6.5% given recent outcomes for other regulated businesses (table 5.3).
10. That SWC should not be able to return to a fixed charge business if the WACC is not increased.

It is somewhat difficult to assess the appropriate level of the variables in the WACC – especially those that are not drawn directly from market data (such as the asset beta, equity beta, gamma on imputation effectiveness, and the market risk premium). However MI would like to make the following observations/recommendations.

The long term weighted average return to debt and equity in the market has been remarkably constant. When returns to debt assets increase the returns to equity assets tend to decrease and vice-versa. Such inter-relationships are not readily reflected in the WACC formula used for regulated businesses as this relies on some fixed exogenous assumptions. For example, the 7.5% real pre-tax WACC for Sydney Water (set in 2008, see Table 5.3) seems to reflect high costs of debt without

adjustment in equity costs. But this has washed out within one year (as shown by 2009 data), leaving Sydney Water with a real premium of 1% over the rest of the market.

MI therefore recommends:

11. That any alteration in the level of the real WACC, while requiring careful consideration of observed data and assumptions about risk premium, gamma, betas and gearing, needs to be accompanied by an explanation of why a shift in the cost of capital for the Australian market is expected to be sustained over the regulatory period.
12. That the risks of 'temporary influences' on WACC estimates be mitigated by making offsetting changes to the WACC in future determinations if the expected structural shift in the WACC is not realized. For example, Sydney Water should not be able to permanently pocket a 1 per cent premium if it washes out. (The idea being to make the establishment of the WACC much less interesting than the firm specific strategies required to deliver the target outcomes relative to the market.)
13. That, within the proviso that WACCs be stable unless there is a sustained increase in the cost of capital, the use of observable data wherever possible for the nominal risk free rate, inflation, and the tax rate – and a continuation of IPART's current estimates for the risk premium, gearing ratio, gamma, and tax rate.
14. If SWC's arguments that its benchmark level of debt gearing risks driving its investment grade down and its debt margin up are realistic/practical then MI would support a gearing level of 30% with an offsetting change to SWC's equity beta (to about 0.6 or less) to reflect this decoupling from assumed average market average conditions.
15. The current debt margin of 3.15 per cent seems high especially if it effectively increases the cost of debt (e.g., if accompanied by a high risk free rate) without offsetting changes to the cost of equity. The method of deriving debt margins should not of itself affect the structural estimate of the real WACC. For instance, solving the problem that data for BBB+ and BBB corporate bonds is not available over 10 years (the period used to derive the risk free rate) should not result in a structural increase in the real WACC.

Depreciation is a very important component of the cost of capital and total asset management planning (section 5.3). SWC proposes to adopt an 83 year average life for all assets. However, an arbitrary average life approach for all assets pushes us away from sound asset and cost management. MI therefore recommends:

16. That it does not support the arbitrary treatment of depreciation of SWC assets (being adoption of an 83 year average life for all assets).

SECTION 6: BUILDING BLOCK REVENUE REQUIREMENTS

The analysis in this section reflects the impacts of the shortcomings referred to earlier, especially: the over-valuation of RABs and depreciation, the absence of a realistic strategy to meet commercial circumstances, and the seemingly unrestrained growth in capital expenditure leading SWC to conclude that a real increase in revenue of 58 per cent over four years will result in "ongoing

deterioration in State Water's financial position, driven by high debt gearing levels relative to State Water's underlying business risk".

A proposal for a 58 per cent real increase in revenue from customers to finance a failing business without a major review and reduction of proposed opex and capex (the major contributor to growth in charges) and the business itself is extraordinary. It suggests the relative importance of factors other than customers (both users and government) and shareholders, and perhaps the need for a fundamental restructuring of the business.

SECTION 7: RATIOS FOR SHARING COSTS BETWEEN USERS AND GOVERNMENT

MI is disappointed with the proposal to review cost shares in light of the large increases in costs driven by the Government over the next determination (using current arrangements for allocating costs to customers).

This adds to uncertainty and instability and effectively sets customer against customer (as well as other stakeholders and non-paying customers) rather than the primary requirement of customers subjecting SWC's spending programs to a needs assessment – especially in light of the drought. In short, the best way to review the cost shares is for the NSW Government to put on its 'customer hat' and request a review of SWC's proposed opex and capex programs in light of services that it will receive. MI therefore recommends

17. That it does not support a review of cost shares. However, if there is such a review MI expects the opportunity to provide an input.

Although not mentioned in SWC's submission to IPART, there is the possibility that SWC has included \$2m per year for the next 10 years for Tumut River works for the Murrumbidgee Valley in either or both its forward estimates of operating and capital expenditure. The project involves expenditures normally associated with catchment management to address erosion and degradation of habitat and diversity. In addition it is our understanding that a proportion of these costs are linked to bank stabilisation and other remediation works linked to high summer flows in the Tumut River for the purpose of delivering water for irrigation downstream. It is inconsistent for SWC to argue for a structural change in irrigator consumption and to impose costs associated with high flows at the same time. MI is uncertain as to whether SWC have considered the marked reduction in peak summer flows that will take place due to government buy-back programs and climate change and the resultant effect on planned remediation works. It is not known how these costs have been allocated (to users generally, specific users, or to Government), but MI is of the view that irrigators have not driven the costs (as currently understood). On this basis MI recommends:

18. That the full cost of Tumut River works be met by Government.

SECTION 8: PROPOSED PRICE SETTING APPROACH

Although MI is at full cost recovery it supports the continuation of the Government subsidy to users where it is recommended by IPART and is met by Government. The measure of the price path to the appropriate level of cost-recovery determined by IPART should not have implications for SWC

revenue if the subsidy is being met by Government (i.e., the full revenue requirement is met by user prices plus the Government subsidy).

SECTION 9: CONSUMPTION FORECASTS AND ENTITLEMENT VOLUMES

Changes to methods for establishing consumption forecasts have not been justified either through SWC's analysis of its past financial performance during the worst drought on record, or by CIE's statistical analysis that the drought is indicative of a structural change to climate.

As noted earlier much of SWC revenue is very secure through charges to Government, HS users, and minimum levels for GS (with carryover supporting GS minimums), so the impacts on SWC's financial position are not as great as might be implied by the raw consumption numbers. In fact, the evidence suggests that the major problems contributing to SWC's financial position in 2006/07 and 2007/08 were failures in cost control and in meeting IPART efficiency targets, rather than revenue shortfalls due to reductions in consumption.

The use of a 15 year moving average of actual deliveries in each valley rather than long term IQOM outcomes results in a 19.9% increase in usage prices throughout the SWC service area and a 9.4% increase for the Murrumbidgee Valley. The impact is similar to a move to a higher ratio of fixed charges. Such changes are not likely to do much for SWC's underlying financial position without addressing problems with cost control, efficiencies, and unrestrained capital expenditure. However, it will have significant impacts for individuals because some valleys will experience price increases of up to 30 per cent even if the drought continues.

In any case, the use of long term averages and higher use revenues was expected to minimize costs for those who do not have water during drought in the previous determination. This approach shouldn't be discarded within one regulatory period because the length and depth of the drought has surprised everyone.

On this basis MI recommends:

19. That the current consumption forecasts be continued in the next determination.

SECTION 10: STRUCTURE OF BULK WATER PRICES

As noted earlier MI believes that the impact of declines in usage revenue on SWC's financial performance has been overstated both in absolute terms and relative to other issues (such as cost control, efficiency, and restraint of capital expenditure). On this basis MI recommends:

20. That the proposed increase in the ratio of revenue from fixed charges for SWC and/or the increase in its WACC be rejected and replaced with a comprehensive review of the business and formulation a strategy that enables SWC to meet commercial returns within reasonable budget constraints in light of revenue risks arising from deviations in consumption forecasts.

The treatment of the balance between GS and HS entitlement charges is somewhat arbitrary relative to other cost apportionment under IPART. In effect SWC is proposing an adjustment of the estimated

long term conversion factor with an additional conversion factor based on a moving average of allocations for GS relative to HS over the last 15 years. The proposed approach implies that the relative driver (by type of entitlement) of fixed costs is variable according to climatic conditions or that there should be a differential in usage charges as well as entitlement charges.

MI has differences in both fixed and usage charges for HS and GS entitlement based on the long term relative costs of shares in and use of relevant infrastructure and operating services. However, it is very difficult to judge whether the adjustment recommended by SWC is reasonable without an analysis showing relative costs driven by HS and GS entitlement holders.

MI therefore recommends:

21. That before changing the relative charges for HS and GS entitlement holders SWC should identify the efficient costs and the relative cost drivers (in line with IPART practice). If IPART accepts the SWC proposal without a supporting cost analysis MI would like the opportunity to comment on the specifics of a 'scarcity premium' adjustment.

The large customer (ICD) rebate for MI in 2009/10 is \$994,704. SWC proposes to reduce that to \$800,165 next year with further reductions to \$772,573 in 2013/14 (in \$2009/10).

Table 10.6 shows that the average expected value of the cost savings due to ICDs in the Murrumbidgee Valley from 2011 to 2015 is \$1,540,000 (although MI believes this should be about \$1,433,000 with a WACC of 6.5%). This should result in an equivalent cost saving to the ICDs but the total rebate proposed in 2010/11 to MI and Coleambally is just \$1,154,439 (table 10.7). The problem is that table 10.6 assigns the savings to all users by averaging the savings across all entitlement rather than just the entitlement in ICDs. On this basis MI recommends:

22. That a WACC of 6.5% be used to calculate ICD savings from telemetry, and that the benefits of ICD cost savings are assigned only to ICD entitlement holders. This means that the starting estimate (2010/11) of the rebate for ICDs in the Murrumbidgee Valley would be almost \$1m for MI and about \$440,000 for Coleambally.

MI concurs with the proposal to reduce ICD rebates pro-rata for reductions due to entitlements held by the ICDs (through transformation or permanent sale outside the ICD area), and the use of the rebate by SWC to meet the costs of additional SWC customers.⁷ However, there is nothing to be gained by attempting to forecast future entitlement holdings. The annual actual value of the rebate can be calculated using the starting level of rebate per ML of entitlement (about \$0.71 on MI estimates using SWC costs) adjusted for actual inflation and actual annual entitlements held (as is currently done for entitlement charges other than the rebate).

We further acknowledge that the rebate will reduce pro-rata with implementation of the metering project as long as there is no impact on effective MI charges because the socialized costs of metering and telemetry should fall correspondingly. That is, both the rebate and the charges that drive the need for the rebate will disappear. The same impact would be delivered if both the charges and the rebate remain. MI is unconcerned as to what method is actually applied. On this basis MI recommends:

⁷ The possibility of this transfer of costs from ICDs to SWC (and DWE/NOW) has always motivated MIs support for appropriately estimated rebates or discounts.

23. That implementation of the metering project by SWC should result in no change in effective charges per ML of entitlement for ICDs. This can be achieved by retaining current charges and the full rebate or making pro-rata adjustments to both as the need for the rebate declines.

SECTION 11: PRICES FOR INDIVIDUALSERVICES

Tables 11.1 and 11.2 do not provide a good basis for comparing the current prices for entitlements and usage with the prices proposed by SWC for the next regulatory period because the proposed prices exclude MDBA (formerly MDBC) and BRC costs. This means that observations of decreases in prices by State Water are not correct.

The real price changes proposed for the Murrumbidgee Valley are underestimated by about 50 cents per ML of entitlement if the estimates of expected MDBA pass through costs contained in appendix 4 of SWC's submission to IPART – about \$1.3m per year (\$2009/10) - prove to be correct. However, these estimates may be conservative given that MDBC pass through costs to the Murrumbidgee were \$1.5m per year (\$2006/07) for each year of the last determination, and will likely have increased substantially due to inflation over the last three years.

SECTION 12: IPACT ON CUSTOMERS OF PROPOSED CHANGES

The same comments about the need to ensure the comparison of like for like apply when drawing conclusions about affordability and billing estimates. For example, figure 12.2 purports to compare old 2009/10 prices with new 2010/11 prices in terms of average total cost to GS users. In fact, when MDBA/MDBC costs are included a slight decrease in total costs is most unlikely for GS entitlement holders.

The data present in figure 12.3 supports the view that a continuation in Government subsidy is required in some valleys that are not currently recovering full costs. For example the costs involved for the North Coast would render water use unviable without some form of subsidy.

That said, the data also suggests the need for an urgent re-examination of the business strategy including levels of service and future expenditures in those catchments that require high subsidies.

[ENDS]