Submission to ACCC

on State Water Regulated Charges 2014 - 2017

by Lachlan Valley Water Inc

September 2013

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EXECUTIVE SUMMARY

Business Risk of State Water

LVW disagrees with State Water's claim that the current tariff structure represents a serious risk to the commercial viability of State Water, and considers that State Water has not made an acceptable case for a change in the tariff structure.

LVW accepts that severe and widespread drought constitutes a risk to the financial viability of State Water, but submits that it is not efficient or equitable for State Water to shift all the risk to their customers through a charging structure that would guarantee State Water would receive their required revenue every year, including during a repeat of the most extreme drought for the last 100 years.

Non-Paying Customers

LVW recommends that ACCC require State Water to identify the costs of servicing non-paying customers, in particular basic landholder rights and the delivery of environmental contingency allowances, and that these costs are removed from the revenue requirement for water access licence holders.

Operating Expenditure

LVW supports the discretionary projects endorsed by the Lachlan Customer Service Committee.

LVW considers that State Water has not made a case for the inclusion of additional hydrometric services and gauging stations to allow the operation of CARM in the 2014 - 2017 period. LVW submits that the costs of implementing CARM, if there is customer support for the project, should be recouped from additional revenue achieved as a result of efficiency gains.

LVW recommends that State Water be required to identify and quantify the cost of any additional services required to deliver environmental water in excess of those required to deliver to other licences of the same category. These costs should be removed from the regulated operating expenditure and recovered from environmental water holders through a service level agreement.

The inclusion of a charge for collecting crop statistics on behalf of NSW Office of Water is not justified as this is not a water delivery requirement. LVW recommends that State Water recovers the cost of collecting crop statistics from NSW Office of Water.

The Federal Government made a commitment that the development and implementation of the Basin Plan was to be at no net cost to States, and LVW submits any associated costs for State Water should be recovered from the Government, not customers.

Overall LVW does not consider that State Water has provided a clear case as to why operating costs are increasing at a higher rate than inflation, with the exception of the discretionary projects, and recommends the cost increases be limited to the CPI rate.

Capital Expenditure

LVW submits that the offset fishways associated with the dam safety upgrade are not required for the delivery of regulated water and should not form part of the approved user share of capital expenditure.

LVW supports the inclusion of capital expenditure for remedial work at Lake Brewster but submits that State Water provide a detailed costing and justification for the proposed works, and make every attempt to source external funding for this project.

LVW supports the discretionary projects endorsed by the Lachlan Customer Service Committee, that is, $310,000 for Wallamundry Creek Structures and $30,000 for a gauging station.

LVW opposes the State-wide commitment of $5 million per year for CARM until a detailed business case is completed and endorsed by Customer Service Committees.

LVW submits that customers should not bear the cost of upgrading an information, communications and technology system that was not adequately planned and implemented initially.

LVW submits that it would be prudent and more likely to represent the actual capital expenditure profile to spread the capital expenditure evenly over the three years of the 2014 - 2017 regulatory period.

Return on Capital

LVW questions State Water's ability to meet its budgeted capital expenditure program, and proposes that the ACCC reviews State Water's actual capital expenditure for 2010 - 2014 at the end of the March 2014 quarter and use the capital expenditure to that date to set the actual opening Regulatory Asset Base (RAB) for the next regulatory period.

LVW supports the NSWIC submission on the Weighted Average Cost of Capital

LVW considers there is no justification for a WACC of 8.96% and that ACCC should determine the WACC adopting a beta of 0.6-0.7 and using the ACCC principles to set the Risk Free Rate.

Tariff Structure

LVW considers that State Water has not made a case to change to the proposed 80:20 fixed to variable tariff structure, and that State Water is grossly over-compensating for any revenue risk by also proposing price changes of up to 15% from one year to the next and allowing carryover from one pricing period to the next.

LVW believes the price adjustment and carryover provisions are not justified and that it is not acceptable that SWC, as a monopoly business, should have a pricing structure that enables it to earn a profit under all conditions, regardless of how little water is delivered.

LVW submits that the annual price adjustment mechanism is most likely to come into operation in drought conditions when usage has been low, and under those conditions it is likely to provide a price shock and exacerbate the financial pressure on irrigators

LVW supports the retention of the 40:60 fixed to variable ratio and a charging structure that enables sharing of risk between the business owners and customers.

LVW proposes that ACCC evaluate alternative measures for managing State Water's revenue risk.

Consumption Forecast

LVW proposes that the consumption forecast is based on the modelled long term average annual extraction limit for each river, as this provides an average that takes climatic fluctuation over the long term into account.

Irrigation Corporation Discounts

LVW recommends the phase down of discounts be reviewed and amended in light of the updated timing of the installation of the Metering Program in the Lachlan.

Metering Service Charge

LVW opposes any increase in the Metering Service Charge and recommends that the charge remain at current levels until there is actual data to substantiate a change.

LVW recommends ACCC reject the proposal to charge a metering information charge for sites that are not telemetered on the basis that this would be over-recovering the cost of providing the service.

Consultation

Overall, LVW considers that the consultation undertaken by State Water was inadequate, and generally comprised one-way provision of information from SWC to customers. There is no evidence that State Water has given serious consideration to the issues raised by customers during consultation.

LVW believes that, given the magnitude of the change proposed, SWC should have provided indicative figures for prices under a 40:60 tariff structure with an appropriate risk margin, with qualifications as to the assumptions SWC made in determining these prices.

SUBMISSION ON STATE WATER CHARGES - 2014 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 also reserve their right to make a separate submission. Our organisation is a member of NSW Irrigators Council (NSWIC). We support the NSWIC submission in general, and provide additional response as follows.

We are concerned at State Water's delay in lodging their submission in view of the major changes sought by State Water and ask that the ACCC take this into account by deferring the introduction of any change in tariffs to the end of the 13 month period allowed for ACCC's consideration of a pricing application.

Our response addresses the key changes proposed in State Water's application and the questions ACCC has asked in its information paper on State Water's application.

2. Business Risk of State Water

ACCC has asked whether State Water has made an acceptable case for its proposed change to the tariff structure.

Financial Position - Past and Current Regulatory Period Outcomes

State Water's submission describes the impact that the 2002-2009 drought had on its water sales and revenue, particularly during the 2007 - 2010 price determination period, and submits that the resulting volatility of revenue is a severe risk to the viability of the business.

Undoubtedly State Water's revenue is sensitive to volume of sales, but SWC obscures the real picture by presenting the data from 2007 – 2012 without acknowledging the effect that the change in the method of consumption forecasting and the volatility allowance have had from 2010 onwards. In the 2010 determination IPART approved a change to consumption forecasting based on the 20 year average consumption, to address one of the causes of the revenue shortfall during 2007 – 2010.

The change in the method of consumption forecasting, emergence from the drought and maintenance of the 40:60 tariff structure has resulted in a revenue recovery during the 2010 – 2014 pricing period. The lower consumption forecast, and the capacity under the 40:60 tariff structure to over-recover revenue when actual consumption is higher than forecast, allows this recovery to occur.

To show clearly the impact of the changes made in the 2010 determination we have split Table 4.2 in State Water's submission into the two regulatory periods. Table 1 below shows the revenue from the 2007 – 2010 regulatory period, and shows the impact of the drought

on State Water's sales and revenue. Actual sales averaged 30% of forecast and actual income averaged 77.5% of forecast over the period.

Table 2 shows the allowed revenue and actual or budgeted revenue for the 2010 – 2014 period based on State Water's data in the Supporting Information file. This indicates that most of the under-recovery in the first half of the 2010 - 2014 regulatory period is expected to be recovered in the second half of the period, with the overall revenue outcome estimated at a shortfall of $4.42 million, or 1% of total allowed revenue.

Table 1 Actual and Allowed Revenue – 2006/07 to 2009/10 ($ million, $2013/14)

	FY07	FY08	FY09	FY10	Total
Allowed revenue	$77.3	$75.0	$68.1	$75.2	$295.6
Actual revenue	$62.3	$56.5	$55.5	$56.3	$230.6
Difference	-$15.0	-$18.5	-$12.6	-$9.6	-$65.0

Table 2 Actual and Allowed Revenue – 2010/11 to 2013/14 ($ million, $2013/14)

	FY11	FY12	FY13*	FY14 Forecast**	Total
Allowed revenue	$92.0	$100.1	$107.8	$111.41	$411.31
Actual revenue	$82.4	$ 95.4	$114.0	$115.09	$406.89
Difference	-$9.6	-$4.7	$6.2	$3.68	-$4.42

(excludes MDBA & BRC pass through revenue)
Tables 1 and 2 based on Table 4.2 from State Water submission to ACCC.
* Forecast as at 31 March 2013.
**Table 9.1 and Table 9.5, State Water Supporting Information to ACCC

In LVW's view the above figures indicate that the current tariff structure is functioning effectively and does not represent the extreme risk to commercial viability claimed by State Water.

LVW disagrees with State Water's claim that the current tariff structure represents a serious risk to the commercial viability of State Water, and considers that State Water has not made an acceptable case for change in the tariff structure.

In understanding the effect of variable water sales on the business risk for State Water it is important to put the 2002 – 2009 drought in context. This was a severe, prolonged and state-wide drought, the worst in recorded history in some valleys, including the Lachlan. It was a very difficult time for State Water, as it was for most of their customers who had little or no water, but it should be recognised that this was less than 1 in 100 event, not one that could be expected to recur in every pricing period. It is unreasonable and an abuse of their monopoly position for State Water to use this extreme event to justify transferring all the risk onto their customers.

Despite the shortfall in revenue and the deterioration in earnings during the drought, when State Water's actual results during the period are examined in Table 3 below they show that only one year, 2008/09, recorded a loss and a negative return on assets, and the annual reports show a dividend payable to owners in all but one of the last 6 years. And despite the fact State Water's sales were only 31% of forecast during 2007 - 2010, we can see from Table 1 that State Water earned 77.5% of forecast revenue. This is a result that many of their customers would have been happy to achieve for their own businesses during the worst drought on record.

Table 3. Financial Indicators 2006/07 to 2011/12 ($ million $2013/14)

	FY07	FY08	FY09	FY10	FY11	FY12
EBIT	$12.8	$1.8	-$62.1	$71.1	$34.8	$43.1
Return on Assets	2.4%	0.3%	-12.3%	10.7%	4.7%	5.9%
Dividend Payable*	$11.884	$4.497	0	$3.07	$10.651	$4.002

* Dividend payable sourced from State Water Corporation Annual Reports

LVW agrees that severe and widespread drought constitutes a risk to the financial viability of State Water, as its function is to capture, store and deliver water. We submit that it is not efficient or equitable for State Water to shift all the risk to their customers through a charging regime that would guarantee State Water would receive their required revenue every year, including during a repeat of the most extreme drought for the last 100 years.

LVW submits that there are other measures to ensure State Water earns the required income and shares the risk between owners and customers, and will outline these in Section 6 of our submission dealing with tariff structure.

Management of Risk – Fixed Cost Structure

State Water argues that its costs are largely fixed with only a small proportion varying with the volume of water supplied, and that the mismatch between cost structure and tariff structure results in unacceptable risk to the business. We disagree with State Water's characterisation of 95% costs as being fixed. During the 2015-2017 period operating costs account for 42% of revenue on average and the return on capital accounts for more than half of State Water's revenue requirement. The '95% fixed cost' argument holds true only if one accepts that the business is entitled to earn a profit regardless of sales.

Other irrigation businesses such as Jemalong Irrigation Ltd in the Lachlan Valley review their costs annually and for 2013/14 have determined that 30% of costs are variable and will recover them through variable charges[1].

Long Term Supply Uncertainty

State Water also claims that long term supply uncertainty[2] constitutes a significant revenue risk. If there is a long term decline in water availability we suggest that providing State

[1] http://jemalongirrigation.com.au/members/uploaded/pricing/2013-2014.pdf
[2] p35, State Water application to ACCC, June 2013

Water with a revenue guarantee is exactly the wrong response as it will provide no signal to State Water of a fundamental change in the business conditions and no incentive for State Water to adjust its operations to meet this challenge.

Non-paying customers

There is a brief mention in Chapter 3 of State Water's submission regarding non-paying customers but State Water has chosen to make no attempt to recover the cost of supplying water to these customers.

"State Water also services non-paying customers, who receive raw bulk water without payment as they do not possess licensed entitlement. These customers can extract water as a high priority user. There is no further commentary about these customers within this submission." [3]

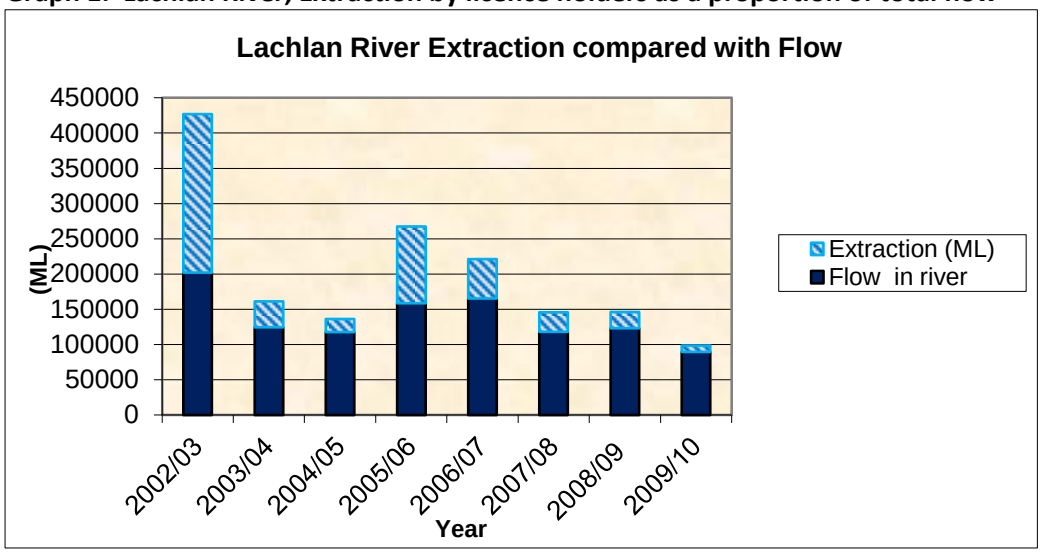
State Water has at least two types of non-paying customers

i. Environmental Contingency Allowances, which are volumes set aside in water storages for environmental requirements in accordance with the provisions of a Water Sharing Plan, and which require State Water to undertake resource and river flow assessments and operate structures in order to deliver the water, and
ii. Basic landholder rights, which is the right of landholders with a frontage to a body of water to take water without a licence for stock and domestic consumption[4] . There is currently no quantified limit by volume or pump size.

It is disappointing that SWC has chosen not to try and reduce its revenue risk by recovering the costs of servicing these non-paying customers, particularly when one of the groups, basic landholder rights, require significant resources from State Water during drought periods when SWC's revenue from paying customers is reduced. This was evident in the Lachlan during the drought, when usage by paying customers, particularly general security licence holders, accounted for very little of the total flow in the river, and the majority of the flow was required for operation of the river, to provide basic landholders rights and to deliver town water supplies and stock and domestic water.

[3] p17, State Water application to the ACCC, June 2013
[4] Section 52, *Water Management Act 2000*

Graph 1. Lachlan River, Extraction by licence holders as a proportion of total flow



Graph prepared by Lachlan Valley Water from State Water CAIRO data.

This was discussed by the previous CEO of State Water, Mr George Warne, during the 2010 price determination by IPART in his evidence to the Sydney hearing, when he spoke about the cost of servicing basic landholder rights. [5]

"I think that it is time for a revolution in that area and maybe within that are the seeds of a solution to this very issue of what it costs to run a river in an area that has population that is growing, subdivisions occurring at a rapid rate and people that really highly value a regulated river water source but are not paying one bean for it." and

"It's particularly disheartening for State Water in some of our very dry inland areas to be spending thousands of dollars and driving hundreds of thousands of kilometres to appease communities, many of which have got no commercial relationship with us whatsoever but they enjoy the full benefits of our efforts to run a regulated river system."

In our view State Water has taken the easy option in their submission and attempted to load the costs of servicing non-paying customers onto their paying customers, when clearly the costs are incurred for a different purpose. The water charging objectives of the Water Act include "to give effect to the principle of user-pays…"[6] and clearly these users of State Waters services are not paying for them. If State Water chooses not to take the opportunity to increase revenue by recovering costs from non-paying customers, then the existing paying customers should not bear the cost of this policy decision.

LVW recommends that ACCC require State Water to identify the costs of servicing non-paying customers, in particular basic landholder rights and the delivery of environmental contingency allowances, and that these costs are removed from the revenue requirement for water access licence holders.

[5] p62, IPART Review of Prices for State Water Corporation, Transcript of public hearing Sydney, December 2009.
[6] Schedule 2, Part 2, Water Act 2007

3. Operating Expenditure

ACCC has asked for comment on the operating expenditure in terms of:

- *prudency and efficiency*
- *the reasons for the expenditure put forward by SWC*
- *the level of expenditure proposed and the expenditure profile over 2014 – 2017.*

Lachlan operating expenditure

The proposed user share of operating expenditure in the Lachlan Valley over 2014 – 2017 averages $5.5 million/year, which is a 13.8% increase on the average annual costs for the 2010-2014 period, and significantly higher than the rate of inflation. State Water says it has already allowed for a 1% efficiency gain within these costs due to no real increase in salary costs over the period.

Four major activities account for 70% of the operating expenditure:

- Routine Maintenance = 29%
- Water Delivery and Other Operations = 20%
- Hydrometric Monitoring = 13%
- Environmental Planning and Protection = 8%

The major contributors to the increased operating expenditure costs in the Lachlan in the next 3 years are:

- Water Delivery and Other Operations (60% of the increase)
- Routine Maintenance (15% of the cost increase)
- Hydrometric Monitoring (15% of the cost increase).

The Lachlan CSC has also endorsed $215,000 discretionary projects over the next 3 years for a flood panel, gauging station and investigations**.**

LVW supports the discretionary projects endorsed by the Lachlan CSC and, while not within ACCC's role, recommends that discretionary projects be shown as a separate line item in State Water budgets so that there is clear accountability for the funds allocated for these specific purposes.

LVW does not believe State Water has provided a clear explanation as to why other operating costs are increasing at a higher rate than inflation and there appears to be no offsetting reduction in costs resulting from efficiency improvements.

Water Delivery Costs

SWC says that in order to increase water delivery efficiency and meet more demanding requirements for delivery of environmental water it is introducing Computer Aided River Management (CARM). The increases in Water Delivery and Hydrometrics are therefore due to the automation of infrastructure, the upgrading of systems to allow more efficient water delivery, and the need for more gauging stations and hydrometric services to allow CARM to be introduced.

To date State Water has provided only a broad outline of the benefits of CARM and has not provided any valley-specific information quantifying the possible efficiencies in the Lachlan

Valley. Consequently the introduction of CARM is not supported by the Lachlan Customer Service Committee until a detailed business case substantiating the claimed efficiencies and water savings is provided. We therefore question the inclusion of additional hydrometric services and gauging stations associated with CARM in this regulatory period when CARM has not been endorsed and is unlikely to be installed during the period, on the basis that the installation of telemetered meters, which provide real-time data required by CARM, is not due to commence in the Lachlan until mid-2014.

In addition, one of the objectives of CARM and more efficient water delivery is that there will be a reduction in operational requirements, ie, the volume needed to run the river and deliver ordered water. This should translate into more water retained in storages and more water available for State Water to sell, and therefore increased revenue. In that case we would expect that some or all of the costs of achieving increased efficiency would be recouped from the resulting increase in income, otherwise there is no financial benefit to customers from paying for the increased investment and operation of CARM.

LVW considers that State Water has not made a case for the inclusion of additional hydrometric services and gauging stations to allow the operation of CARM in the 2014 - 2017 period. LVW submits that the costs of implementing CARM, if there is customer support for the project, should be recouped from additional revenue achieved as a result of efficiency gains.

Delivery of Environmental Water

State Water claims that environmental water delivery needs are more complex than other extractive users and require greater analysis by the operators, more modelling and sourcing additional data from the past. However, their submission does not quantify any actual increased costs incurred in delivering environmental water. We recommend that if there is an identifiable and ongoing increase in the services required to deliver environmental water over and above that provided to other licences of the same category, then State Water should calculate this cost and recover it from environmental water holders by means of a service level agreement.

LVW recommends that State Water be required to identify and quantify the cost of any additional services required to deliver environmental water in excess of those required to deliver to other licences of the same category. These costs should be removed from the regulated operating expenditure and recovered from environmental water holders through a service level agreement.

Metering and Compliance

State Water's submission claims that it will be undertaking additional data analysis, customer education and compliance associated with the rollout of the new Metering program. It is unclear why these costs will be incurred when the capital costs of the program are to be funded by the Commonwealth, and State Water already has Customer Field Officers whose functions include compliance and customer education. If existing staff are simply undertaking different functions this should not result in an increase in costs.

Data Collection
SWC also propose to charge the Lachlan for collecting crop statistics on behalf of NOW[7].

This activity is clearly not a water delivery requirement but a water management activity required for water modelling and Water Sharing Plan impact assessment, and as such is a responsibility of NSW Office of Water (NOW). If NOW requires State Water to collect the data NOW should be paying State Water for that service. Water licence holders already pay charges to NOW to carry out water management activities and it would constitute double dipping if State Water were to recover charges for the same activity.

LVW submits that the inclusion of a charge for collecting crop statistics on behalf of NSW Office of Water is not justified as these are not a water delivery requirement. LVW recommends that State Water recovers the cost of collecting crop statistics from NSW Office of Water.

Basin Plan
SWC also say that implementation of the Basin Plan will cost $98,000 from 2015 to 2017 and includes that in their costs.

The Federal Government made a commitment that the development and implementation of the Basin Plan were to be at no net cost to States, and LVW submits that any associated costs for State Water should be recovered from the Government, not customers.

Overall LVW does not consider that State Water has provided a clear case as to why costs are increasing at a higher rate than inflation, with the exception of the discretionary projects, and recommends the cost increases be limited to the CPI rate.

[7] p46, State Water application to ACCC, June 2013

4. Capital Expenditure

ACCC has asked for comment on the changes in the Capital expenditure (capital expenditure) in terms of:

- *prudency and efficiency*
- *the reasons for the expenditure put forward by SWC*
- *the level of expenditure proposed and the expenditure profile over 2014 – 2017.*
- *SWC capacity to deliver major expenditure programs*

Prudency and Efficiency of Expenditure - Lachlan

State Water proposes $32 million of capital expenditure in the Lachlan over the regulatory period, of which $3 million is for Dam Safety Compliance at Wyangala Dam and a further $19.7 million is for fishway offsets required as a consequence of the Dam Safety project.

The $19.7 million is in addition to the $4 million for fishway offsets in the 2010-2014 regulatory period. We question the value for money of fishways in view of the rapidly escalating costs. In the Lachlan the cost of fishway offsets is two thirds of the actual Dam Safety Upgrade structural work carried out on Wyangala Dam, that is, $24 million for fishway offsets compared with $35 million construction work on the dam. In our view this level of cost is excessive and represents gold plating and should not be approved.

We are aware that ACCC is not reviewing the costs shares between Government and users but note that the fishway offsets represent a major cost shifting from Government to users. Dam Safety Compliance projects are 100% Government funded, reflecting the community requirement for increased safety standards on pre-1997 structures that, when constructed, met all current standards. Fishways, as an Environmental Planning and Protection measure, are 50% Government funded and 50% user funded. The fishway offsets are a direct requirement of the work being undertaken on Wyangala Dam as a result of the Dam Safety Upgrade and we believe should be considered as an integral part of the Dam Safety Compliance project as the project could not proceed without construction of either fish passage on the dam or offset fishways.

Providing offset fishways instead of fish passage on Wyangala has moved the responsibility for $12 million of capital expenditure from Government to customers, when customers have had no opportunity for input on the appropriateness of the expenditure or whether it is required for the delivery of regulated water.

LVW submits that the fishways are not required for the delivery of regulated water and should not form part of the approved user share of capital expenditure.

Other major items of capital expenditure in the Lachlan are the $3 million of urgent work on the Lake Brewster project. The work is an enhancement to a project funded through the Water Smart Australia program. The project was 60% funded by the Federal Government, provided both water quality and water efficiency outcomes, and returned water savings to the Federal Government. The Lachlan Customer Service Committee has endorsed the requirement for further work at Lake Brewster as a high priority but has not yet been

provided with a detailed project description or costing. LVW understands that State Water has not yet finalised the scope of works and costs of the project.

As the Lake Brewster project provides water quality as well as water efficiency outcomes and therefore a benefit for the whole community, LVW submits that State Water should accordingly source external funding for this project. LVW supports the inclusion of capital expenditure for remedial work at Lake Brewster but requires:

1. That detailed costing of the project be provided and justified
2. That State Water make every effort to source external funding for this project.

LVW supports the inclusion of capital expenditure for remedial work at Lake Brewster but submits that State Water provide a detailed costing and justification for the proposed works, and make every attempt to source external funding for this project.

Discretionary Capital Expenditure

LVW supports the discretionary projects endorsed by the Lachlan CSC.

LVW supports the discretionary projects endorsed by the Lachlan Customer Service Committee, that is, $310,000 for Wallamundry Creek Structures and $30,000 for a gauging station.

<u>Prudency and Efficiency of Expenditure – State-wide</u>

Computer Aided River Management

On a state-wide basis State Water have budgeted $5 million/year capital expenditure across NSW from 2014 – 2017 for Computer Aided River Management (CARM) but it is not clear what aspects of CARM this expenditure would cover. At this stage no Customer Service Committee is prepared to endorse CARM without a detailed business case, and State Water has not provided customer representatives with an evaluation of the pilot program or a business case applicable to each valley substantiating the claimed benefits. LVW believes that committing $5 million per year to this project is premature until such information is provided.

LVW opposes the State-wide commitment of $5 million per year for CARM until a detailed business case is completed and endorsed by Customer Service Committees.

Information and Communication Technology

While LVW supports the objective of improving State Water's information and communication technology (ICT) capability, we are concerned that the requirement for this program is as a result of previous ad hoc and unplanned development of ICT. LVW considers that the business owners rather than customers should bear the cost of upgrading a project that was not properly planned and implemented initially.

LVW submits that customers should not bear the cost of upgrading an ICT system that was not adequately planned and implemented initially.

Expenditure Profile

Capital expenditure 2010 - 2014

State Water has a long history of over-estimating its ability to carry out capital projects on time, and even in the current period the supporting information to their submission shows that expenditure has fallen behind budget and $67 million, or 30% of total NSW projected capital expenditure for 2010– 2014, will need to be spent in 2013/14 in order to meet the targeted 4 year capital expenditure[8].

In the case of the Lachlan $25 million, or 58%, of the projected capital expenditure for 2010– 2014 will need to be spent in 2013/14 in order to meet the targeted 4 year capital expenditure[9]. Based on this past performance we question State Water's ability to spend the projected 2010 – 2014 capital expenditure within this period, and recommend that ACCC review State Water's actual capital expenditure to date for 2011 - 2014 in the March 2014 quarter to determine State Water's progress and use the capital expenditure to that date to set the actual opening Regulatory Asset Base (RAB) for the next regulatory period.

The disadvantage to customers of budgeting the capital expenditure in the early years of the regulatory period but deferring the actual expenditure to end of the period is that the RAB is over-stated throughout the pricing period, and consequently there is an over-recovery of the return on capital during the early years of the regulatory period.

LVW questions State Water's ability to meet its budgeted capital expenditure program. LVW proposes that the ACCC review State Water's actual capital expenditure for 2010 - 2014 at the end of the March 2014 quarter and use the capital expenditure to that date to set the actual opening Regulatory Asset Base (RAB) for the next regulatory period.

Capital expenditure 2014 - 2017

We also question State Water's ability to complete the proposed capital expenditure program of a further $29.5 million in the Lachlan over the 2014 - 2017 regulatory period, and particularly the projected $17 million in the first year of the period. Combined with the projected expenditure of $25 million in 2013/14 that would mean State Water was forecasting expenditure of $42 million in the Lachlan alone over 2013/14 and 2014/15. In our view it would be more prudent to spread the projected capital expenditure for 2014 - 2017 evenly over the three years of the regulatory period.

LVW submits that it would be prudent and more likely to represent the actual expenditure profile to spread the capital expenditure evenly over the three years of the regulatory period.

[8] Table 7.1, p73, State Water application to ACCC, June 2013
[9] Table 7.1 Capital expenditure – Lachlan, State Water Supporting Information to ACCC, June 2013

5. Return on Capital

Regulated Asset Base (RAB)
As discussed in section 4 above, LVW considers that State Water has a long history of falling behind schedule on capital expenditure, and recommends that the ACCC adjust for this by reassessing the opening RAB for the 2014 – 2017 period on the basis of actual capital expenditure completed by the end of the March 2014 quarter.

LVW questions State Water's ability to meet its budgeted capital expenditure program. LVW proposes that ACCC review State Water's actual capital expenditure for 2010 - 2014 at the end of the March 2014 quarter and use the capital expenditure to that date to set the actual opening Regulatory Asset Base (RAB) for the next regulatory period.

Weighted Average Cost of Capital
ACCC pricing principles require that the Weighted Average Cost of Capital (WACC) should be set at a level commensurate with the commercial risk of the business and should allow the business to recover its efficient costs.

State Water proposes an increase in the WACC from 7.4% to 8.96% and argues in its submission that the business's underlying risk has not changed substantially since IPART's determination in 2010, therefore there should be little material difference in the WACC now compared with the WACC approved by IPART, although it wishes to adjust the WACC for the effect of moving from a real pre-tax WACC to a nominal post-tax WACC.

This is inconsistent with State Water's argument elsewhere in the submission it is necessary to reduce the revenue volatility risk by adopting a package of measures designed to ensure it receives a guaranteed revenue. Where the revenue risk has been reduced, then the WACC should also be reduced. In addition, the financial environment in which State Water is operating is now more benign as interest rates are at lower levels now than they were in 2010.

LVW considers that State Water is over-compensating for its commercial risk by asking for a WACC of 8.96% when it also aims to remove all revenue risk by moving to 80:20 fixed to variable ratio and adopting the annual price adjustment and carryover provisions. We specifically question:

Beta – SWC proposes a beta of 0.9, suggesting it is only slightly less risky than the market. LVW submits that State Water, as a monopoly business experiences lower risk than, for example, an energy company that operates in a wider market. Where less than 20% of the organisation's revenue is at risk in any 1 year, then it is significantly less risky than the market and we recommend should be assigned a beta in the range of 0.6 – 0.7 as recommended under the Water Charge Infrastructure Rules (WCIR)

Risk Free Rate - ACCC principles are that the risk-free rate should be based on 10 year Commonwealth Government Securities, averaged over a 10-40 day period immediately prior to the pricing period. SWC proposes to base the risk-free rate on the CGS yield over a 10 year period, which would give a 5.26% rate. LVW supports the ACCC principles.

LVW supports the NSWIC submission on the WACC.

LVW considers there is no justification for a WACC of 8.96% and that ACCC should determine the WACC adopting a beta of 0.6 - 0.7 and using the ACCC principles to set the Risk Free Rate.

6. Tariff Structure

ACCC has asked whether State Water, in its application and through previous consultation, made an acceptable case for the proposed change to its tariff structure.

ACCC has also asked whether State Water has made an acceptable case for a shift to a revenue cap regulation where prices could go up and down by up to 15% per year.

State Water Proposed Prices

State Water has proposed a 'revenue cap' approach, which could more appropriately be described as a revenue guarantee approach, by moving to an 80:20 fixed to variable ratio to reduce its revenue risk, and then to remove all further revenue risk by introducing two additional measures:

a) Allow adjustment of prices from one year to the next to make up an over or under-recovery in the previous year, subject to no more than 15% increase in the bill for a typical customer.
b) If the 80:20 tariff structure and price adjustments still don't earn State Water the approved revenue, then State Water wants to carryover any excess or shortfall from one pricing period to the next.

Table 4. Proposed Prices – Lachlan Valley

	2013/14 Actual ($/ML)	2014/15 proposed ($/ML)	2015/16 proposed ($/ML)	2016/17 proposed ($/ML)	% change 2013/14 to 2016/17
HS entitlement	12.36	12.57	17.52	23.14	87%
GS entitlement	4.42	5.13	7.16	9.44	114%
Usage (HS & GS)	18.04	18.20	13.67	8.39	-53%

As stated in Section 2 of this submission, LVW does not believe that State Water has made a case for a change to the tariff structure, and considers that State Water has understated the reduction in risk that has already occurred as a consequence of the change in consumption forecasting.

LVW considers that State Water has not made a case for the proposed 80:20 fixed to variable tariff structure, and that State Water is grossly over-compensating for any revenue risk by also proposing price changes of up to 15% from one year to the next and allowing carryover from one pricing period to the next.

Implications of Tariff Structure for Customers

LVW has consistently supported a higher weighting towards usage based pricing because farm incomes are highly variable and usage based charging is better aligned with ability to pay. In addition, we consider that the 40:60 fixed to variable ratio provides an incentive to State Water for efficiency improvements.

Water users are particularly concerned about the impact of an 80:20 tariff structure and the annual price adjustment provision during average or drier conditions. Tables 1.2 and 1.3 provided by State Water in their submission are extremely misleading in presenting the

illustrative general security customer bills based on usage of 60% and 100%. State Water is well aware that both these values are significantly higher than the long term average annual usage allowed under the Lachlan Water Sharing Plan and also significantly higher than the 20 year average consumption forecast that State Water uses for the Lachlan.

State Water quotes a Lachlan general security licence holder with 100% usage as receiving a 21% reduction in water charges over the pricing period and a general security licence with 60% usage receiving a 5% reduction in charges over the period.

This is totally unrepresentative of the expected outcome for customers on average as the long term average availability for general security water users under the Lachlan Regulated Water Sharing Plan in the Lachlan is 42%, and at this usage they will experience a 10% increase in charges, matching the 10% increase in revenue sought by State Water. If usage was at the level reflected in State Water's 20 year rolling average consumption of 220,300 ML, ie, 30% of entitlement, then the price increase from 2013/14 to 2016/17 would be 22%.

Table 5 below shows the expected impact of the 80:20 tariff structure on a general security irrigator.

Table 5. Bill Impacts for 500 ML General Security Licence in the Lachlan

Usage	2013-14	2014-15	2015-16	2016-17	% change from 2013-14 to 2016-16
0	$ 2,210	$ 2,565	$ 3,580	$ 4,720	114%
20%	$ 4,014	$ 4,385	$ 4,947	$ 5,559	38%
40%	$ 5,818	$ 6,205	$ 6,314	$ 6,398	10%
60%	$ 7,622	$ 8,025	$ 7,681	$ 7,237	-5%
80%	$ 9,426	$ 9,845	$ 9,048	$ 8,076	-14%
100%	$11,230	$11,665	$10,415	$ 8,915	-21%

Table 5 illustrates the potential outcome of the 80:20 fixed to variable ratio for irrigators during a drought where they could be facing between a 38% to 114% increase in charges compared with the current 40:60 fixed to variable ratio. To then load a further 15% annual price adjustment on top of that when there is no water to generate income and no ability to pay the charges in our view constitutes an unacceptable price shock.

The water availability in the Lachlan during the 2002 -2009 drought, as shown in Table 6, provides an indication of the impact of drought on irrigators' ability to pay. Clearly general security irrigators were severely affected due to extremely low water availability, but high security irrigators are also affected because their businesses are geared to a high level of utilisation and a highly reliable water source.

Table 6. Water Availability by Licence Class 2002/03 – 2009/10

Year	High Security Allocation (%)			General Security Allocation or Cumulative AWD (%)
	Towns	S&D	Irrig.	
2002/03	100	100	100	3
2003/04	70	70	70	0
2004/05	50	30	30	0
2005/06	100	100	100	19
2006/07	80	80	80	0
2007/08	70	50	30	0
2008/09	70	50	30	0
2009/10	50	15	10	0

LVW strongly opposes the proposed 80:20 tariff structure and considers that State Water has not justified a case that this change is necessary to manage revenue risk.

LVW submits that the annual price adjustment mechanism is most likely to come into operation in drought conditions when usage has been low, and under those conditions it is likely to provide a price shock and exacerbate the financial pressure on irrigators.

Annual price adjustment and carryover provisions

Were they approved, the price adjustment and carryover provisions would provide State Water with 100% guaranteed income over time and would have successfully moved all revenue risk from the owners to the customers. The only impact of a drought on State Water's owners would be in the timing of receiving dividends. Adopting all three revenue guarantee mechanisms is over-compensating for the risk faced by State Water.

LVW believes it is not acceptable that SWC, as a monopoly business whose customers have no option but to use its services, should have a charging structure than enables it to earn a profit regardless of how little water is delivered.

ACCC Pricing Principles – Efficient Costs

We agree that it is in the interest of all parties that State Water remains a viable business, however, a charging structure that guarantees State Water will receive 100% of its desired income over time regardless of business and climatic conditions is not consistent with the ACCC pricing principles. The principles require that the revenue is reasonably likely to meet the prudent and efficient costs of providing infrastructure services in the regulatory period. We suggest that for State Water to have a guaranteed income when delivering only 30% of the average supply of water will provide no incentive for the organisation to achieve efficiencies in their normal operation or when faced with changes in the operating environment. Sharing between owners and customers of the risks arising from external factors will provide an incentive for both parties to aim for an appropriate response to adverse conditions.

LVW believes the price adjustment and carryover provisions are not justified and that it is not acceptable that SWC, as a monopoly business, should have a pricing structure that enables it to earn a profit under all conditions, regardless of how little water is delivered.

LVW supports the retention of the 40:60 fixed to variable ratio and a charging structure that enables sharing of risk between the business owners and customers.

Alternative Approaches to Managing Revenue Risk

As mentioned in section 2 of our submission, LVW considers that there are alternative measures available to State Waters to manage their revenue risk while at the same time minimising impacts and price shock for customers, and maintaining a sharing of risk. In addition, we believe State Water has greater capacity to manage the risk of a drought than an individual water user because it has a geographic spread across NSW, it currently has only 30% debt level and we believe it has some capacity to shift the timing of expenditure, defer filling staff vacancies etc. Following are our comments on the arguments that State Water advanced for rejecting these alternative methods of managing the risk:

- **Revenue volatility allowance.** SWC argued that customers are best placed to manage their own risk, however, as outlined above, LVW considers that State Water has greater capacity to manage risk than an individual irrigator. State Water also says that there is no precedent within ACCC principles for such an allowance, but when this question was put to ACCC representatives at stakeholder meetings ACCC made it clear that a volatility allowance has not been ruled out.

- **Unders and overs account.** SWC claims that this is too administratively complex to administer and that it would need to over-recover high amounts in some years to offset lack of income in drought years. If State Water can manage a business with 6000 customers and a $400 million turnover we question why managing an 'unders and overs' account would be too complex to handle. Many businesses build up reserves in favourable conditions in order to manage adverse conditions. State Water also puts forward the argument that customers are best placed to manage their own risk, and again we dispute this.

- **Price choice approach –** State Water's submission maintains that it is too difficult to correctly price two options, say 80:20 and 40:60, without knowing how many customers would choose each option, and that it could be subject to people gaming the system by trading allocation between licences with different charging models. We acknowledge the complexity and risks inherent in this approach and suggest it would have been constructive for State Water to work with customer representatives on identifying the risks and developing a workable model, but to us it appears that State Water weren't interested in exploring this option.

- **Maintain 40:60 tariff structure but use annual adjustment to ensure revenue recovery.** State Water rejected this approach due to too much fluctuation from year to year in prices and we concur.

- **Different Tariff Approaches in Different Valleys.** One other alternative that LVW recommends is worthy of consideration would be to have different tariff structures in different valleys. The 80:20 tariff structure may be suitable for valleys where there are predictable inflows and a high reliability, while valleys with more variable inflows, such as

the Lachlan, may be more suited to a higher weighting towards usage-based charging. This was not considered by State Water but the ACCC, during stakeholder consultation, indicated this approach could be considered.

LVW proposes that ACCC evaluate alternative measures for managing State Water's revenue risk.

ACCC has also asked what would be the implications of a move to higher fixed charges and lower usage charge, and whether the proposed change would impact on:

- *The volume of water entitlements held by irrigators and other customers of State Water*
- *Decisions to use water*
- *The type of water access entitlements held*

LVW considers that a higher fixed price is likely to reduce willingness to hold permanent water entitlement, which may then follow through into water markets, potentially making water a less attractive asset due to a higher holding cost.

At the same time we expect the 80:20 fixed to variable ratio to drive an increase in water usage, with potential negative environmental outcomes.

ACCC has asked whether State Water's proposed valley conversion factors used to escalate high security charges are reasonable.

The drought highlighted the considerable difference in reliability between high and general security under drought conditions, and it is our understanding that one of the reasons that conversion of general to high security is no longer available is that the severity of the drought made it difficult to accurately calculate an appropriate conversion factor that would not reduce the reliability of other licence classes.

LVW considers the high security premium adopted by IPART more accurately reflects the relative reliability of high security water.

7. Consumption Forecasts

ACCC has asked whether we consider State Water's future demand forecast based on the average extractions over the past 20 years, to be reasonable.

LVW considers that State Water's own submission[10] indicates that past usage is not a predictor of future usage, and that usage is largely driven by climatic conditions, which influences both water supply and crop water requirements. Figure 4.3 in State Water's submission shows that there are large fluctuations in usage both above and below the average and that it not unusual for State Water to experience periods of above average sales that extend beyond one regulatory period.

LVW proposes that the modelled long term average annual extraction limit for each river is used, as this provides an average that takes climatic fluctuation over the long term into account.

8. Irrigation Corporation Discounts

Irrigation Corporations receive rebates on the basis that State Water does not incur costs for billing, metering and compliance for the Irrigation Corporation members, and because the real time data provided by Corporations provides a system wide benefit to State Water. For 2014-2017 SWC says that the real time data from the Metering Program will remove much of the benefit it currently gets from Irrigation Corporations in terms of real-time data and consequently proposes to phase down the rebates. The proposed rebates for JIL are:

Table 6. Jemalong Irrigation Ltd Rebate

	2013/14	2014/15	2015/16	2016/17
Rebate	$92,000	$69,659	$62,148	$60,714

LVW supports the Irrigation Corporation discounts on the basis of the costs that State Water avoids incurring as a result of the Corporation's activities. We question whether State Water's proposed phase down of the discount in 2014/15 accurately reflects the likely reduction in avoided costs that year. The rollout of the Metering Program in the Lachlan is currently expected to commence only in mid-2014 and we therefore doubt whether it will provide sufficient real time data to State Water in 2014/15 to justify such a reduction.

LVW recommends the phase down of discounts be reviewed and amended in light of the updated timing of the installation of the Metering Program in the Lachlan.

[10] Figure 4.3, p 36, State Water application to ACCC, June 2013

9. Metering Service Charges

State Water proposes to substantially increase the Metering Service Charge, despite the fact that the NSW Metering Program is still in its infancy[11] and complete and accurate costs are not available. We strongly oppose this increase when there is no information to justify the increase. LVW strongly recommends that the Metering Service Charge remain at current levels until there is actual data to substantiate a change. We believe there will be no negative consequences for State Water in this as the Metering Program is well behind the projected timeframe for rollout, the meters will initially be under warranty and are expected to have a 20 year life and therefore it is unlikely there will be high maintenance costs incurred during this regulatory period. Once the accurate maintenance costs are known State Water can then adjust the Metering Service Charge to recover the costs in following pricing periods.

There appear to be some inconsistencies between costs for different meters that have not been explained, for example, the cost to validate a 450mm meter is $396 while the cost to validate a 400mm meter is $133, but there is also an inspection cost of $133. We suggest that this lack of clarity about the level of costs and reasons for costs to be incurred is sufficient to take the approach to maintain the Metering Service Charge at the 2010 level and adjust only once accurate maintenance costs are known.

We also note that State Water includes a range of inspection and maintenance tasks in the charge and we question why there are not offsetting cost savings in that State Water staff currently inspect meters at least annually and read meters up to 4 times per year.

LVW opposes any increase in the Metering Service Charge and recommends that the Charge remain at current levels until there is actual data to substantiate a change.

Unregulated and Groundwater Meters

NOW and State Water are currently negotiating the transfer of all metering activities from NOW to State Water. As a consequence State Water will now collect the metering charge directly from customers and proposes to include a 'metering information system charge' equivalent to the telemetered metering solution charge of $115/meter because although the sites are not usually telemetered, SWC believes the customers derive a benefit from telemetered data generally.

We reject the proposal to charge a metering information charge for sites that are not telemetered because we believe that this would be over-recovering the cost of providing the service. We believe that any benefit gained by unregulated and groundwater users from real time extraction data in an unregulated or groundwater system is difficult to quantify, and would be hard to identify because State Water is not actively managing the system.

LVW believes that either State Water has set prices so that the telemetered metering cost is already fully recovered from those who have telemetered meters and there is no justification for charging non-users an additional charge, or if State Water maintains there is a system-wide benefit and non-users should be charged, then the unit cost of the

[11] Section 15.2, p166, State Water application to ACCC, June 2013.

telemetered metering solution for customers who have telemetry should be reduced so that there is no over-recovery.

LVW recommends ACCC reject the proposal to charge a metering information charge for sites that are not telemetered on the basis that this would be over-recovering the cost of providing the service.

10. Consultation

ACCC has asked whether the consultation undertaken by State Water was adequate and whether any other information should have been made available by State Water.

ACCC's pricing principles require that State Water seek input from customers on matters including

- Price and service trade-offs
- Investment decisions
- Proposed tariffs

Proposed Tariffs
While State Water did provide information on their pricing proposals through a number of forums, from our point of view as a customer there has been little genuine engagement on the key issues.

State Water acknowledges that two of the three top priorities for customers were to maintain the existing tariff structure and to consider price choice based on the customer's risk profile, but there appears to have been little effort to actively consider either of these issues. The price choice option was suggested by customers in February 2012 and State Water did not lodge their submission until July 2013, however, as far as I am aware State Water did not work with customers to develop the option during that period. State Water appears to have made their own internal assessment and dismissed the idea without discussion with customers.

Given the magnitude of the change proposed by State Water with an 80:20 fixed to variable ratio plus the price adjustment and carryover provisions, and the strong preference of customers to retain the 40:60 fixed to variable ratio, we believe that reasonable consultation would have required State Water to provide at least indicative figures on prices under a 40:60 structure, with appropriate qualifications about the assumptions made during the calculations. Its refusal to do so emphasises State Water's reluctance to consider the impacts on customers seriously.

Investment Decisions
Similarly with investment decisions, State Water's submission notes that no Customer Service Committee was prepared to endorse its proposal to introduce Computer Aided River Management (CARM) in the absence of a detailed business case, notwithstanding this, State Water has gone ahead and included $5 million per year for CARM in its proposed capital expenditure.

The only issue on which there was consultation was the price and service trade–offs, where State Water asked Customer Service Committees to nominate discretionary projects for inclusion in the proposal.

Overall, LVW considers that the consultation undertaken by State Water was inadequate, and generally comprised one-way provision of information from SWC to customers. There is no evidence that State Water has taken any notice of the issues raised by customers during consultation.

We believe that SWC should have provided indicative figures for prices under a 40:60 tariff structure with an appropriate risk margin, with qualifications as to the assumptions SWC made in determining this price.