# Submission to ACCC

# on Draft Decision on State Water 2014-2017 Pricing Application

# by Lachlan Valley Water Inc

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Prepared by:
Mary Ewing
Executive Officer
Lachlan Valley Water
PO Box 819
FORBES  2871

## EXECUTIVE SUMMARY

General Comments

Lachlan Valley Water welcomes the overall approach taken by ACCC, in particular the retention of the 40:60 fixed to variable pricing structure, the rejection of State Water's proposed 8.96% rate of return, and the reassessment of State Water's proposed increases in operating expenditure and capital expenditure.

LVW recommends that the merger of State Water and Sydney Catchment Authority should be taken recognised in the pricing decisions from July 2015 onwards. We understand that there is uncertainty at present regarding jurisdiction and that it will take time to finalise the merger, but expect that savings will be realised as the merger is implemented, and we urge the ACCC to take the merger into consideration in their decision on 2014 – 2017 prices.

Revenue Requirement

LVW supports the ACCC decision to reduce the revenue requirement in the Lachlan by $6.3 million over the determination period.

40:60 Fixed to Variable Pricing

Lachlan Valley Water strongly supports ACCC's decision to maintain the 40:60 fixed to variable pricing structure and to reject the revenue cap method proposed by State Water.

Unders and Overs Account

LVW supports an under and overs account as a means of managing State Water's revenue volatility. However, we are concerned that in a prolonged and severe drought, the negative balance in the account could build to a high level and possibly lead to price shock for customers. In order to avoid perverse pricing outcomes during prolonged drought we suggest a further mechanism may be required to limit the price increase in the following year to no more than 5%.

Metering Service Charge

LVW strongly supports the Metering Service Charges set out in the ACCC draft decision and recommends that there be no increase in charges until there is actual data to substantiate a change.

Consumption Forecast

Lachlan Valley Water is concerned that the 20 year moving average forecast of consumption includes the extractions during a very severe drought period and that this will have a significant influence on forecast extractions for many years.

If the 20 year moving average forecast of consumption is maintained LVW suggests a 'circuit breaker' mechanism, where if the actual extractions exceed the forecast extractions consistently through a 3 year pricing period, then ACCC should reassess the consumption forecast for that valley.

Operating Expenditure

LVW endorses ACCC's decision not to approve step increases above the base opex for staff vacancy rate costs, updating of flood manuals and water quality methodology.

LVW submits that the cost levels be reviewed prior to 1 July 2015 in order to take account of any efficiency savings as a result of the merger of Sydney Catchment Authority and State Water.

LVCW asks that ACCC review the issue of non-paying customers, and if State Water does not identify the costs for supplying non-paying customers, LVW recommends that ACCC should identify the costs and exclude them from the regulated supply costs.

Capital Expenditure

LVW supports the ACCC decision to reduce the proposed capital expenditure in the Lachlan by $8.11 million, including the decision to disallow State Water's 10% contingency allowance on fish passage projects, and the decision to reduce the capitalised labour and overhead costs included in capital projects.

LVW supports the NSWIC submission that a more thorough cost benefit analysis of environmental planning and protection projects be conducted to determine possible alternative methods that are more cost effective.

Regulatory Asset Base

In setting the opening RAB for 1 July 2014, LVW recommends that ACCC review State Water's progress in their capex program during the fourth quarter of 2013/14 to determine whether the estimated capex of $83.2 million will be achieved.

Return on Capital

Lachlan Valley Water welcomes the ACCC decision to set the rate of return at 7.44%, however, we believe that the merger of State Water and Sydney Catchment Authority will lower State Water's revenue volatility risk, and that this should be considered in the pricing. LVW supports the NSWIC submission that State Water's beta should be lower due to the merger between State Water and Sydney Catchment Authority.

## SUBMISSION ON DRAFT DECISION ON STATE WATER PRICING APPLICATION

### 1. Introduction

Lachlan Valley Water (LVW) is the peak valley-based organisation representing 660 surface water and groundwater irrigator members along the Lachlan and Belubula Rivers, 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.

We welcome the opportunity to comment on the ACCC's draft decision and would be pleased to provide further comment if additional information on key issues becomes available from State Water.

Our organisation is a member of NSW Irrigators Council (NSWIC). We support the NSWIC submission, and provide further response on key aspects of the draft decision.

**Merger of State Water and Sydney Catchment Authority**

The merger of Sydney Catchment Authority and State Water to form Bulk Water NSW was announced in March 2014, and is expected to provide a more efficient service to customers across NSW[1]. While the NSW Government has indicated it will take up 18 months to finalise the merger, we expect that changes will be made progressively during that period and these are likely to translate into cost savings and a reduction in overall risk for the merged entity. Already some changes are being made, notably an interim common board and CEO across the organisation.

We therefore expect that savings will be realised as the merger is implemented, and believe that this should be recognised in the pricing decisions from July 2015 onwards. We urge the ACCC to take the merger into consideration in their decision on 2014 – 2017 prices.

### 2. Total Revenue Requirement

Lachlan Valley Water endorses the overall approach taken by ACCC, in particular the retention of the 40:60 fixed to variable pricing structure, the rejection of State Water's proposed 8.96% rate of return, and the close examination of State Water's proposed increases in operating expenditure and capital expenditure.

LVW supports the ACCC decision to reduce the revenue requirement in the Lachlan by $6.3 million over the determination period.

**Operating Expenditure**

LVW endorses ACCC's decision not to approve step increases above the base opex for staff vacancy rate costs, updating of flood manuals and water quality methodology.

[1] Minister Hodgkinson media release, 4 March 2014.

Further comments on the operating expenditure are included in section 6.

**Capital Expenditure**
LVW supports the ACCC decision to reduce the proposed capital expenditure in the Lachlan by $8.11 million.

Further comments on specific areas of capital expenditure are included in section 7.

**Rate of Return**
LVW welcomes the ACCC decision not to approve the 8.96% rate of return requested by State Water, but suggests that the 7.44% rate of return set by ACCC is too high in view of the expected improvement in the systematic risk of State Water when the merger with Sydney Catchment Authority merger is completed.

Further comment on the rate of return is included in section 9.

## 3. Charges for Regulated Infrastructure

**Bulk Water Charges**

**40:60 fixed to variable pricing**
Lachlan Valley Water strongly supports ACCC's decision to maintain the 40:60 fixed to variable pricing structure and to reject the revenue cap method proposed by State Water.

As mentioned in our original submission, the revenue cap would have guaranteed State Water its desired revenue regardless of water sales, and in our view would not promote the economically efficient operation of a monopoly.

We endorse ACCC's view that the 40:60 tariff structure will provide sufficient revenue streams for State Water to deliver its services efficiently, and we consider this was demonstrated during the 2007-2010 pricing period when State Water earned 77.5% of forecast revenue despite delivering only 30% of forecast sales due to the severe drought conditions.

**Unders and overs account**
LVW supports an under and overs account as a means of managing State Water's revenue volatility.

However, we are concerned that in a prolonged and severe drought, as experienced from 2002/03 to 2009/10, the negative balance in the account could build up to a high level and have significant impacts on water prices in a valley, leading to price shock for customers. In a prolonged drought the higher prices would also be imposed at a time when customers had low water availability and low ability to pay.

In the case of the Lachlan, the extraction for the 10 years from 2003/04 to 2012/13 ranged between 11,787 ML to 394,082 ML, with an average of 99,728 ML, as compared with the 20 year moving average of 227,697 ML. Had the overs and unders account been operating then there would have been successive years of under-recovery, a steadily increasing negative balance in the overs and unders account, and a steadily increasing return on this balance that would be added to the revenue requirement in each subsequent year.

**In order to avoid perverse pricing outcomes during prolonged drought we suggest a further mechanism may be required to limit the price increase in the following year to no more than 5%.** The ACCC draft decision states that their analysis of historical data shows that real variations in price due to the 'under and overs' mechanism would be 5% or less per annum.

**High Security Entitlements**

LVW supports the high security premium adopted by ACCC. In our view the calculation of the relative reliability of high and general security during recent years accurately reflects the value of high security water for customers during severe drought conditions, as were experienced in the Lachlan and Belubula valleys from 2002/03 to 2009/10.

## 4. Metering Charges

LVW strongly supports ACCC's decision that the costs proposed by State Water do not represent the prudent and efficient costs of servicing and maintaining meters.

Our original submission noted that there is no actual data to substantiate the significant increases in the metering service charge that were sought by State Water. The pilot program of the NSW Metering Program has only been rolled out within the last year and we expect that as the maintenance and servicing costs for the pilot program become available they will provide a guide to the efficient metering service charge.

This approach should result in no disadvantage for State Water because once the accurate maintenance costs are known, the Metering Service Charge can be adjusted, if necessary, to recover the costs in following pricing periods.

**LVW supports the Metering Service Charges set out in the ACCC draft determination and recommends that there be no increase in charges until there is actual data to substantiate a change.**

**Environmental gauging stations**

LVW supports the decision to implement a metering charge where the holders of water access licences nominate a gauging station as their nominated work, on the basis that this is consistent with the way productive water users will be charged a metering service charge for their extraction point.

## 5. Forecast water extraction and consumption volumes

Lachlan Valley Water is concerned that the 20 year moving average forecast of consumption includes the extractions during a very severe drought period, from 2003/04 to 2009/10, and that this will have a significant influence on forecast extractions for many years.

In the Lachlan's case the impact was extreme. The average for the 10 years from 1993/94 to 2002/03 was 355,666 ML[2]. The average for the next 10 years, from 2003/04 to 2012/13, was 99,728 ML. The impact of this second 10 year period will feed into consumption forecasts for the next 10 - 15 years.

From the Lachlan point of view the weakness of this approach is not the yearly fluctuations in forecast water extractions but the fact that there is a 'clump' of very low usage years which will maintain the 20 year moving average forecast at around 225,000ML – 230,000 ML, while the actual extractions may be well above that level. ACCC figures show actual usage in 2012/13 was 394,000 ML (73% higher than the 20 year average), and State Water is estimating usage in 2013/14 will be approximately 250,000 ML (10% higher than the average).

This may result in significant over-recovery and the usage charges consistently being set at a higher level than is required to recover the revenue target for that year, which is not an efficient pricing outcome.

LVW considers that a longer period than the 20 year moving average is required to reduce the effects of severe climatic fluctuation, and we have previously proposed that the IQQM long term average annual extraction limit for each river is used.

**However, if the 20 year moving average forecast of consumption is maintained then we suggest a 'circuit breaker' mechanism, where if the actual extractions exceed the forecast extractions by more than, say, 10%, consistently through a 3 year pricing period, then ACCC should reassess the consumption forecast for that valley.**

## 6. Operating Expenditure

As mentioned in the introduction, LVW believes that the merger of State Water and Sydney Catchment Authority should be taken into consideration in this pricing decision. We accept that there is a degree of uncertainty at present regarding jurisdiction and that it will take time to finalise the merger, but we understand that there are potential efficiency gains in corporate services and overheads, which should provide cost savings during this pricing period.

**LVW submits that the cost levels be reviewed prior to 1 July 2015 in order to incorporate any efficiency savings as a result of the merger into bulk water charges.**

[2] Data source - Table 7.7 ACCC Draft decision on State Water Pricing Application, 2014/15 – 2016/17

**Staff vacancy rate**
Regarding State Water's claimed 8% vacancy rate in 2012/13, we note that the Annual Reports for State Water do not support this claim and that the staff numbers for 2012/13 were 305.6 EFT, only 2.5% below average staff numbers since 2005/06.

**Collection of crop statistics**

We also support ACCC's finding that a step increase above base opex is not required for the collection of crop statistics. We accept that the water supply work approval requires the collection of these statistics although we consider this is a responsibility transferred from NSW Office of Water which should trigger a reduction in costs when IPART carries out the next determination of the Office of Water's charges.

In our view State Water's claim of $173,000 per year to collect this data is exorbitant in view of the technology that is available to undertake surveys, and for this reason LVW agrees that the cost of collecting data does not justify an increase in the base opex.

**Non-paying customers**
LVW is concerned that State Water acknowledges that it delivers water to customers who do not pay for the services[3], but that it has made no attempt to implement 'user pays' principles and separate those costs from the prudent and efficient costs of providing infrastructure services for licenceholders.

We submit that the costs of providing services for other, non-paying users are high during periods of drought, when there is already significant price pressure on paying customers, and that the charging regime should not add to this pressure by requiring paying customers to meet the costs of providing services to others, in particular basic landholder rights and the delivery of environmental contingency allowances.

**LVW asks that ACCC review this issue and, in the absence of State Water identifying the costs for supplying non-paying customers, that ACCC should identify the costs and exclude them from the regulated supply costs.**

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[3] p17, State Water application to the ACCC, June 2013

## 7. Capital Expenditure

**CARM**
LVW strongly supports the exclusion of funding for the development of the CARM project when there is no customer support for it without a proper business case being developed and considered by Customer Service Committees.

**Capitalised labour and overheads**
LVW also supports the ACCC decision to reduce the capitalised labour and overhead costs included in capital projects.

We note that ACCC tried to obtain information from State Water on their allocation of labour and overheads but was unable to do so, and we request that if State Water is now able to provide this information as part of their response to the draft decision, that other stakeholders be provided with a further opportunity to comment on that information.

**Environmental planning and protection**
LVW supports the decision by ACCC to disallow State Water's 10% contingency allowance on fish passage projects.

Lachlan Valley Water remains concerned about the impact of the fishway offsets for the Wyangala dam safety upgrade on the user share of capex in the Lachlan. We therefore support the NSWIC position that while fishway offsets are more cost-effective than a fishway at the dam wall, the offset fishways are still an extremely expensive way of providing fish passage, and there may be more cost-effective means of achieving the environmental objectives.

**LVW supports the NSWIC submission that a more thorough cost benefit analysis of environmental planning and protection projects be conducted to determine possible alternative methods that are more cost effective.**

## 8. Regulatory Asset Base

**Timing of Capital Expenditure**
In view of State Water's history of failing to deliver its capital expenditure program on time[4], LVW is concerned that ACCC proposes to set the opening RAB at I July 2014 based on State Water's forecast net capex of $83.2 million in 2013/14.

We acknowledge that ACCC's normal practice is to roll forward the RAB based on estimated expenditure and then make a subsequent adjustment where required, as has been done in this determination for the opening value in 2010. However, we submit that State Water's

[4] P78, Bulk Water Prices for State Water Corporation and Water Administration Ministerial Corporation, IPART, September 2006.

persistent over-estimation of its ability to complete capital projects on time justifies a departure from ACCC's normal practice in this case.

**LVW recommends that ACCC review State Water's progress in their capex program during the fourth quarter of 2013/14 to determine whether the estimated capex of $83.2 million will be achieved. If it not certain the capex will be achieved then we recommend that ACCC review the opening RAB to reflect the actual capex for 2013/14.**

## 9. Rate of Return

Lachlan Valley Water welcomes the ACCC decision to set the rate of return at 7.44%. We also believe that the merger of State Water and Sydney Catchment Authority, by creating a larger business with greater geographic spread, will lower State Water's revenue volatility risk during the pricing period, and that this should be considered in the pricing.

**LVW supports the NSWIC submission that State Water's beta should be lower due to the merger between State Water and Sydney Catchment Authority.**