

# ACCC Draft Decision

## Additional Information

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## Introduction

In light of State Water's response to the ACCC Draft Decision, NSW Irrigators' Council (NSWIC) would like to provide further additional information in support of the ACCC's proposed cost recovery mechanism and tariff structure for State Water Corporation's (SWC) bulk water charges. The following sections are in direct response to State Water's consultant report prepared by Frontier Economics.

In particular, NSWIC would like respond to the Frontier Economics' claims on page 25 of the Final Report;

*"It would require accepting;*

- 1. that State Water's proposed tariff structure involves transferring an 'unreasonable' amount of volume-related risk from State Water to customers which is inappropriate.*
- 2. that State Water's proposed change to the tariff structure would have such a material impact on irrigator's cashflows particularly during dry years as to itself be a major cause of irrigators not being able to obtain finance.*
- 3. that any impacts of assigning more volume-related risks to water users are 'perverse' or 'unintended' and represent some sort of market failure to be addressed by State Water*
- 4. that no better instrument for farmers to manage such risks or to address any concerns about financial viability for some farmers exists."*

As we have outlined in our previous submission to the ACCC, we consider SWC's tariff proposal and associated cost recovery mechanism to be a direct attempt to shift business risk from SWC to customers. SWC's tariff proposal alone would eliminate the majority of SWC's volume-related risk and ensure that 88 per cent of SWC's allowed revenue is recovered independent of water availability. Such a revenue guarantee is under no circumstances available to SWC's customers. SWC's proposal is a clear attempt by SWC to exploit its monopoly power whilst irrigators continue to struggle with increasing input costs and highly variable output returns.

In addition, NSWIC stresses that water costs are a significant input cost for irrigators in NSW. While every irrigation operation is different, water charges can constitute 20 per cent of on-farm input costs and fixed water charges are a significant obstacle for irrigator's financial viability in years of low water availability. This point highlights the lack of understanding by Frontier Economics of farm business cashflow situations and irrigator's financial viability. Many irrigators continue to struggle with the aftermath of the millennium drought and hence often have minimal additional reserves to address significant price shocks. SWC's proposed tariff structure would constitute such a price shock - in particular when water availability is low. In these circumstances, fixed water charges are constitute an ongoing financial liability for irrigators despite the fact they are unable to utilise water to generate returns. To suggest that farmers have access to a range of other 'risk-mitigation' strategies is also flawed given the following argument;

- Funds held in farm management deposit schemes are often insufficient to cover the full impact of bulk water charges (and other input costs) during low water years. In addition, many irrigators utilise these funds to fund maintenance and innovation to increase yields and remain profitable.

- Funds from NSW and Commonwealth Government assistance are only available after a number of consecutive years of low water availability and only accessible under a strict set of criteria. In particular, the hardship provisions are only available in cases of three years of consecutive zero allocations. Hence it is unlikely that these funds will be readily available.
- Water trading cannot be considered an effective risk management tool as water market prices are highly volatile and not necessarily available in all areas of NSW. In addition, allocation trading to supplement cash flow has minimal effect on the proposed fixed entitlement charges as irrigators who hold the entitlement are liable to pay these costs. Furthermore, the assumption that allocation trade can be used to offset other on farm costs is based on the assumption that allocations are available. In case of dry years where cost pressures are greatest, allocations will not necessarily be available for trade. In the case of the Lachlan valley, only 4382 ML of temporary water was traded in 2009/10 (compared to 660,000 ML of entitlement in the valley) and only three general security water transfers took place. This indicates that in severe drought, water trading may not be an option. Furthermore, for a market to be an adequate risk mitigation mechanism, market depth must exist. This is unfortunately not the case in all valleys.

Finally, a change in the tariff structure, will have significant repercussions on the temporary and permanent entitlement market. It is possible that individual irrigators opt out of holding entitlements (i.e. a significant supply increase in the permanent market) and rely on temporary water to maintain their business (i.e. a significant increase in demand for temporary water). Such market implications must be considered by the ACCC when considering any changes in the tariff structure.

- Overall variable costs might slightly reduce during low water years but SWC's proposed tariff structure would mean that the proportion of input costs related to bulk water charges increases significantly during low water years, hence posing a direct threat to irrigator's financial viability.

The Australian Competition and Consumer Commission (ACCC) assured NSWIC and its members at two council meetings (November 2013 and March 2014) that the current tariff structure of 40 per cent fixed and 60 per cent variable charges will be maintained. This assurance was supported by the ACCC Draft Decision which was released in March 2014. The ACCC stated explicitly that;

*'The ACCC's draft decision is to maintain State Water's current tariff structure so that 40 per cent of its revenue is recovered through entitlement charges (fixed charges) and 60 per cent is recovered through usage charges (variable charges) over the 2014-17 regulatory period. The ACCC considers this tariff structure best contributes to the BWCOP.'*<sup>1</sup>

In addition, the ACCC stated that the continuation of the current tariff structure is appropriate;

*'The ACCC considers that a 40:60 tariff structure with an appropriate form of price control will also allow State Water the opportunity to recover its efficient costs. An*

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<sup>1</sup> ACCC Draft Decision on State Water Pricing Application 2014-15 - 2016-17,

*appropriate form of price control will allow State Water to adjust its prices to account for a proportion of the difference between its actual and target revenue. This structure avoids the detriments associated with transferring volume related risk to customers, while allowing State Water to earn sufficient revenue to efficiently deliver its services'.<sup>2</sup>*

In addition, the ACCC shared NSWIC's view that a change in tariff structure to 80 per cent fixed and 20 per cent variable charges would constitute an unreasonable shift of risk to customers;

*'The ACCC considers that the 80:20 fixed to variable structure does not promote the three BWCOP factors which we have identified as particularly relevant to water infrastructure charges. The ACCC considers that State Water's proposed 80:20 tariff structure would transfer an unreasonable amount of volume-related risk from State Water to customers and that this has potential perverse and/or unintended pricing outcomes for the financial viability of farm businesses and on farm investment.'<sup>3</sup>*

Furthermore, the ACCC indicated in its Draft Decision that not all of the Basin Water Charging Objectives and Principles (BWCOP) should be equally considered for the determination of State Water's bulk water charges;

*"In having regard to the BWCOP, the ACCC considered the following aspects of the BWCOP to be particularly significant:*

- o avoid perverse or unintended pricing outcomes*
- o to ensure sufficient revenue streams to allow efficient delivery of the required services*
- o to promote the economically efficient and sustainable use of water resources.*

*The ACCC placed more weight on these aspects of the BWCOP as it considered them to be the most relevant to determining water charges for MDB valleys<sup>4</sup> (emphasis added).*

While State Water has argued in its response to the ACCC that the proposed tariff structure would impose an inappropriate amount of risk for State Water, we highlight the ACCC's Draft Decision that;

*'The ACCC considers that a 40:60 tariff structure in conjunction with the ACCC's proposed form of price control will adequately address any risk to State Water of revenue under recovery as a result of volatility in water availability.'<sup>5</sup>*

NSWIC supports this analysis and adds that State Water's initial and subsequent submission to the ACCC clearly indicates an intention to shift all of State Water's business risk to customers without acknowledging that customers are exposed to a significantly greater degree of risk as part of their business operation. The following section will provide further detail on this point.

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<sup>2</sup> Ibid, p.16

<sup>3</sup> ACCC Draft Decision, attachment A, p.213

<sup>4</sup> ACCC Draft Decision, Appendix A, p. 210

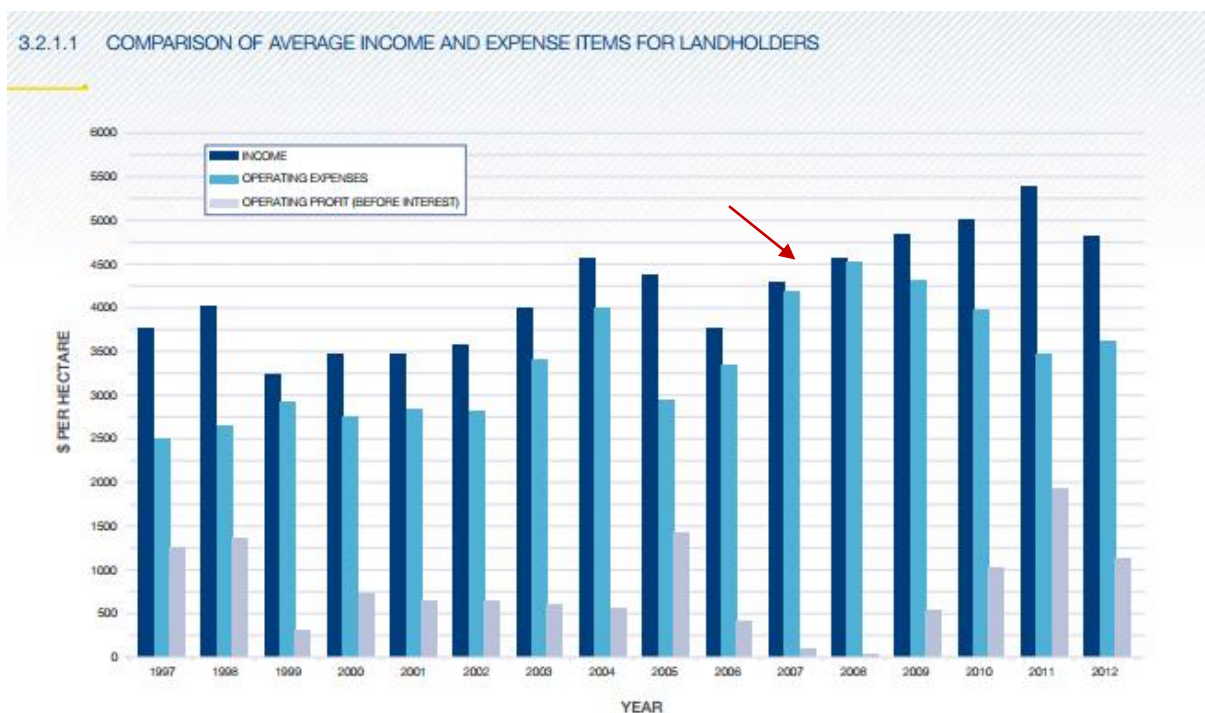
<sup>5</sup> Ibid, 216

## Operating Expenditure and Revenue

The current 40:60 (fixed/variable) tariff structure is based on the assumption of 100 per cent allocation, despite the fact that long term yield on entitlements (General Security (GS) in particular) are well below that in most values in NSW. As such, the example of a 50 per cent allocation as suggested by Frontier Economics is a significant overstatement of the long term average yield in some valleys.

Irrigators who hold GS entitlements have paid fixed entitlement charges to SWC despite the fact that during the millennium drought allocations were often minimal (if not zero). This ongoing fixed liability is of importance, as irrigators often have few opportunities to pass any additional cost increases on. In addition returns are often minimal in these years. NSWIC has continuously raised this issue since the bulk water charge determination in 2006<sup>6</sup>.

The importance of fixed charges is further supported by the *Australian Cotton Comparative Analysis (2012)* prepared by Boyce Chartered Accountants<sup>7</sup>. The study shows that farm financial viability is threatened in case of low water availability. As the graph below outlines, operating expenditure in cotton production (when cotton was actually grown) is highly variable and in years of very low water availability (2007 and 2008), operating expenditures and income were nearly identical.



If the tariff structure during these years was based on a 80:20 fixed/variable model, then operating expenditures would most likely have exceeded income and hence led to a negative net financial position for irrigators in those years.

The graph above also shows that both operating expenditure are highly variable in food and fibre production. Operating expenditures include a large list of inputs which varies

<sup>6</sup> file:///C:/Users/Stefanie/Downloads/Submission\_-\_Bulk\_Water\_2006\_-\_NSw\_Irrigators\_Council\_-\_website\_document.pdf

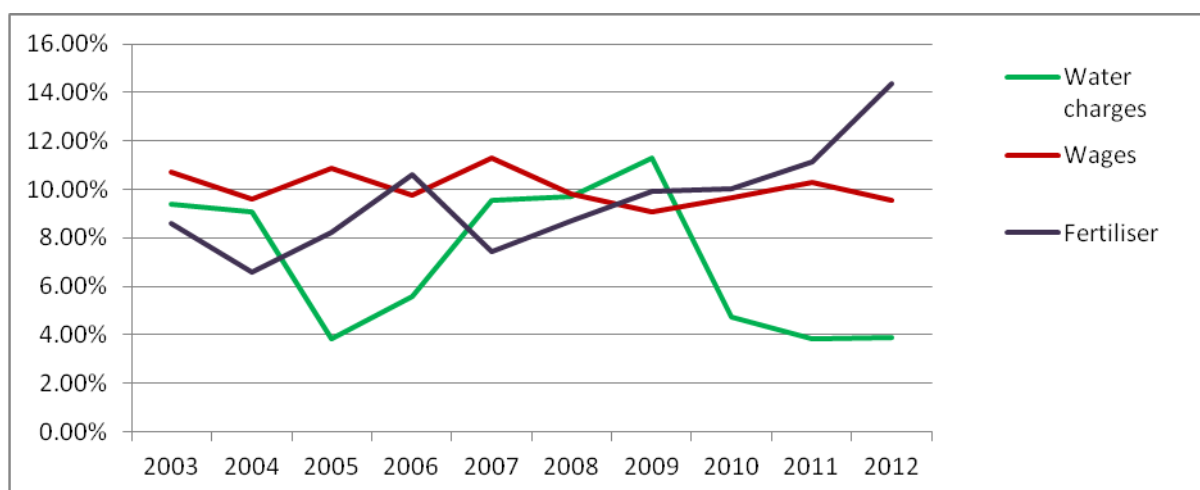
<sup>7</sup> <http://www.boyceca.com/assets/uploads/1/files/Corporate%20Ag/Australian%20Cotton%20Comparative%20Analysis%202012.pdf>

between dry and wet seasonal conditions. An example provided in the Boyce study is given in the table below (yellow indicates that in case of zero water availability, these costs would be reduced or not incurred);

EXPENSES	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Cartage	69	70	96	105	128	101	100	112	136	117
Chemical application	105	172	137	158	115	110	87	136	138	131
Chemicals - defoliant	67	95	55	57	54	71	79	63	55	53
Chemicals - herbicide	133	178	153	109	159	183	174	108	108	85
Chemicals - insecticides	232	451	198	292	132	116	144	151	142	84
Chemicals - others	10	11	5	3	3	4	48	38	11	7
Chipping	50	44	44	66	91	39	24	15	2	3
Consultants	54	69	58	59	75	63	76	72	64	57
Contract picking	195	178	173	180	257	250	255	261	282	241
Contract farming	108	135	57	89	77	85	42	24	122	164
Cotton picking wrap	12	9	19	11	10	6	14	9	55	84
Depreciation	322	376	206	199	338	508	372	426	164	178
Electricity	40	33	25	21	40	46	59	79	76	29
Fertiliser	292	263	242	356	312	394	428	399	387	517
Fuel and oil	216	239	229	323	418	429	327	305	258	271
Hire of plant	11	10	3	3	9	12	2	7	22	43
Insurance	131	152	116	144	227	216	217	179	161	123
Licence fee - bollgard	52	49	127	150	173	232	218	252	286	292
Licence fee - roundup	12	14	16	25	26	50	50	62	60	56
Motor vehicle	26	30	22	22	30	31	34	35	21	19
R&M - farming plan	147	143	174	135	133	139	137	154	121	109
R&M pumps & earthwork	121	151	114	101	128	133	116	183	61	84
Seed	84	103	80	77	112	98	105	126	115	146
Water charges	319	364	113	188	399	439	486	189	134	141
Wages - employees	365	384	321	327	473	445	391	384	357	344
Wages - proprietors	82	91	46	38	96	105	106	69	20	21
Administration	66	75	45	41	68	58	58	35	49	47
Other farm overheads	81	111	75	73	103	162	154	103	65	155
	3402	4000	2949	3352	4186	4525	4303	3976	3472	3601

Table 1

The Boyce study furthermore highlighted that water charges (highlighted in red) are one of the three most important inputs into food and fibre production. In addition to chemicals and pesticides, water charges (based on the current tariff regime) made up between 4 per cent and 11 per cent of overall input costs (in the sample).



Based on Boyce Study (2003 - 2012)

It is important to emphasise that these proportions are based on the assumption that production takes place. Should production not occur, then these proportion would naturally increase.

In addition, the Boyce study highlighted that in low water years when crop area is also low, the percentage of total expenses for water increases while profits decline. This is best calculated in a \$/Ha value of the total cost of water per hectare of cotton grown, which was as high as \$486/Ha and reducing to \$92/Ha in large crop years (based on the study results). The total cost on an average basis can be calculated as \$236,511 for 2009 and \$172,132 in 2013<sup>8</sup>. The following table provides further information of the percentage of water charges in relation to overall input costs for cotton growers.

	Average water charges ex	Extrapolated average	% Total Exp	Profit/Ha
<b>2003</b>	319 \$	170,636.29	9%	599
<b>2004</b>	364 \$	181,304.76	9%	569
<b>2005</b>	113 \$	116,131.23	4%	1,421
<b>2006</b>	188 \$	175,971.76	6%	415
<b>2007</b>	399 \$	211,920.87	10%	96
<b>2008</b>	439 \$	197,150.51	10%	37
<b>2009</b>	486 \$	236,511.90	11%	534
<b>2010</b>	189 \$	117,401.13	5%	1,026
<b>2011</b>	134 \$	191,148.32	4%	1,919
<b>2012</b>	141 \$	236,269.47	4%	1,192
<b>2013</b>	92 \$	172,132.00	2%	849

Table 2: Summary of Boyce chartered Accountants

However, individual examples in the Gwydir highlighted that the actual costs per ha can be significantly higher. Based on example 2 in this document, the true water cost for a single irrigators during times of low water availability was \$1016/ha rather than the Boyce

<sup>8</sup> For further information, please contact Zara Lowien at Gwydir Valley Irrigators - zara.lowien@gvia.org.au

average value of \$188/ha. If an alternative tariff structure was proposed, this real cost per ha would be even greater again.

However, a study that was submitted by SWC in 2009 as part of their pricing application to IPART showed that the proportion of water charges compared to other on-farm costs can be significantly higher in some valleys<sup>9</sup>;

- Murray: 10.1 to 16.3 per cent
- Murrumbidgee: 4.1 per to 11.3 per cent
- Macquarie: 5.9 per cent
- Namoi: 5.8 per cent

It must be stressed that every irrigation operation is different and the proportion of water charges in relation to other on-farm costs varies for each food and fibre producers. Many irrigators have reported to us that the proportion of water charges in relation to overall input costs are around 20 per cent (in years of production). This highlights that the impact of a shift in tariff structure will impact each individual irrigator differently.

### **Farm Specific Examples 1**

The following example provides a farm level input cost analysis for the 2013/14 water year (obtained from a member of NSWIC located in the southern connected system);

Area irrigated crop: 413 ha

Crop: Annual Crops (Rice, Canola, Wheat, Oats and winter cereals)

Water Entitlements: 4000 Delivery Entitlements, 3300 Water entitlements (GS)

Allocation: 63% AWD

Major Inputs: Water, Fertiliser, Chemicals

Operating Expenditure:

- **Water Charges: \$145,526**
- Fertiliser: \$143,946
- Chemical: \$114,876

It must be acknowledged that a water entitlement attracts a number of related charges. A regulated river entitlement holder will have to pay both licence fees to the NSW Office of Water as well as bulk water charges by State Water. In addition, irrigators who operate in the area of an irrigation corporation also have to hold delivery entitlements and need to pay drainage fees and other water management related charges. So although State Water charges are only one component of the overall 'water costs' on farm, they make up a significant portion of operating expenditure.

If water allocations are low and irrigators decide not to grow a crop, then some of the cost outlined above (table 1) will not have to be incurred. As such, this elevates the impact of fixed water charges on irrigator's financial viability. To gain an understanding of the importance of fixed charges and irrigator's financial viability, the irrigator in example 1

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<sup>9</sup>[http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Bulk\\_Pricing/Review\\_of\\_Bulk\\_Water\\_Prices\\_from\\_2006\\_to\\_2010/31\\_May\\_2006\\_-\\_Draft\\_Determination\\_and\\_Draft\\_Report/Draft\\_Determination\\_and\\_Draft\\_Report\\_-\\_Bulk\\_Water\\_Prices\\_for\\_State\\_Water\\_Corporation\\_and\\_Water\\_Administration\\_Ministerial\\_Corporation\\_-\\_From\\_1\\_August\\_2006\\_to\\_30\\_June\\_2010](http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Bulk_Pricing/Review_of_Bulk_Water_Prices_from_2006_to_2010/31_May_2006_-_Draft_Determination_and_Draft_Report/Draft_Determination_and_Draft_Report_-_Bulk_Water_Prices_for_State_Water_Corporation_and_Water_Administration_Ministerial_Corporation_-_From_1_August_2006_to_30_June_2010), p.261 (or p.35 of the RMCG consultant)



incurred total fixed water charge of \$56,000 in 2007/08 (4 per cent AWD in February 2008). This fixed cost was incurred under the current 40:60 fixed tariff structure, however with an 80:20 fixed/variable tariff structure, the fixed costs would be closer to \$100,000.

## Farm Specific Example 2

The following example shows that fixed water charges can be the dominant input cost component for some food and fibre producers. The example was provided to us by a cotton grower in northern NSW whose fixed charges include State Water charges, NSW Office of Water charges and valley based member fees.

### 2008:

- 172 ha (cotton production)
- 40 licences were held
  - Fixed costs: \$141,145
  - Variable costs: \$33,730

### 2012:

- 3924 ha (cotton production)
- 40 licences were held
  - Fixed costs: \$245,314
  - Variable costs: \$ 124,074

This example clearly illustrates that this particular irrigator incurred 80.7 per cent of total costs in 2008 in fixed charges and 66 per cent in 2012. As is evident, water costs constitute a significant financial obligation for food and fibre producers in NSW.

## Valley Specific Example3 <sup>10</sup>

Frontier use an extremely simplified analysis of the effect of alternative bulk water charges in their analysis<sup>11</sup>. This table shows the gross margin for irrigated rice in the Murray to be \$785/Ha using an average of 13ML/Ha to produce. Frontier then goes onto show that by changing the tariff structure there would be no change in gross margins during times of 100% allocation and only a -6% change when allocations were 50%. This analysis does not consider the real impact of low water allocations. However, when you comparing the costs versus income in relation to real production the numbers don't align.

Murray Irrigation reviewed the Frontier calculations and percentage of farm costs against real areas planted (surface water) within the Murray Irrigation area of operations and water use between 2006-07 and 2012-13. The realities of the Murray General Security entitlement cropping community is that customers will purchase water on the temporary market in a good season and the below table reflects the highly variable usage patterns across the years.

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<sup>10</sup> For further information, please contact Perin Davey at Murray Irrigation Ltd. - perin.davey@murrayirrigation.com.au

<sup>11</sup> Review of Appendix A, Frontier Economics, April 2014, p11-12.

Year	ML used on rice	Rice area (ha)
2013/14*	464,046	42,595
2012/13	686,412	52,918
2010/11	274,497	33,862
2009/10	41,831	4,196
2008/09		
2007/08		
2006/07	1,854	24,546

\* Estimates

According to the Murray Irrigation Farm Business Survey 43 percent of our farmers produce rice, so for the purposes of example, we estimate 43 percent of our held entitlement volume<sup>12</sup> which equals 598,783. Using the same farm income and variable costs and the same bulk water and alternative bulk water charges as used by Frontier Economics<sup>13</sup>, Murray Irrigation analysed the real impact across the rice growing areas in the NSW Murray.

This analysis clearly shows the significant impact changing tariff structure can have on the percentage of total farm costs represented by water charges, particularly in years where there is zero production and water is the only crop-related cost incurred on a farm.

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<sup>12</sup> ACCC Draft decision on State Water Pricing Application, Attachments, March 2014, P227 – Murray Irrigation entitlements = 1,392,519

<sup>13</sup> Review of Appendix A, Frontier Economics, April 2014, p11-12

<b>Input</b>	<b>2006/07</b>	<b>2007/08</b>	<b>2008/09</b>	<b>2009/10</b>	<b>2010/11</b>	<b>2012/13</b>	<b>2013/14</b>
<b>Allocation</b>	<b>Oct: 50% Peak: 50%</b>	<b>Oct: 0% Peak: 0%</b>	<b>Oct: 0% Peak: 0%</b>	<b>Oct: 0% Peak: 10%</b>	<b>Oct: 6% Peak: 100%</b>	<b>Oct: 100% Peak: 100%</b>	<b>Oct: 100% Peak: 100%</b>
Farm Income (\$2,340/ha)	57,437,640	0	0	9,818,640	79,237,080	123,828,120	99,672,300
Total Variable costs (\$1,555/ha)	38,169,030	0	0	6,524,780	52,655,410	82,287,490	66,235,225
Gross Margin	19,268,610	0	0	3,293,860	26,581,670	41,540,630	33,437,075
<b>2012-13 Bulk water charges</b>							
Variable usage charge (\$4.90/ML)	9,084.6	0	0	204,971.90	1,345,035.30	3,363,418.80	2,273,825.40
GS Entitlement charge (\$2.32/ML)	1,389,176.56	1,389,176.56	1,389,176.56	1,389,176.56	1,389,176.56	1,389,176.56	1,389,176.56
<b>TOTAL</b>	<b>1,398,261.16</b>	<b>1,389,176.56</b>	<b>1,389,176.56</b>	<b>1,594,148.46</b>	<b>2,734,211.86</b>	<b>4,752,595.36</b>	<b>3,663,001.96</b>
% Total cost	4%	***	***	24%	5%	6%	5%
<b>Alternative bulk water charges</b>							
Variable usage charge (\$1.44/ML)	2,669.76	0	0	60,236.64	395,275.68	988,433.28	668,226.24
GS Entitlement charge (\$5.78/ML)	3,460,965.74	3,460,965.74	3,460,965.74	3,460,965.74	3,460,965.74	3,460,965.74	3,460,965.74
<b>TOTAL</b>	<b>3,463,635.50</b>	<b>3,460,965.74</b>	<b>3,460,965.74</b>	<b>3,521,202.38</b>	<b>3,856,241.42</b>	<b>4,449,399.02</b>	<b>4,129,191.98</b>
% Total cost	9%	***	***	54%	7%	5%	6%
<i>Difference</i>	2,065,374.34	2,071,789.18	2,071,789.18	1,927,053.92	1,122,029.56	(303,196.34)	466,190.02

## Price Development

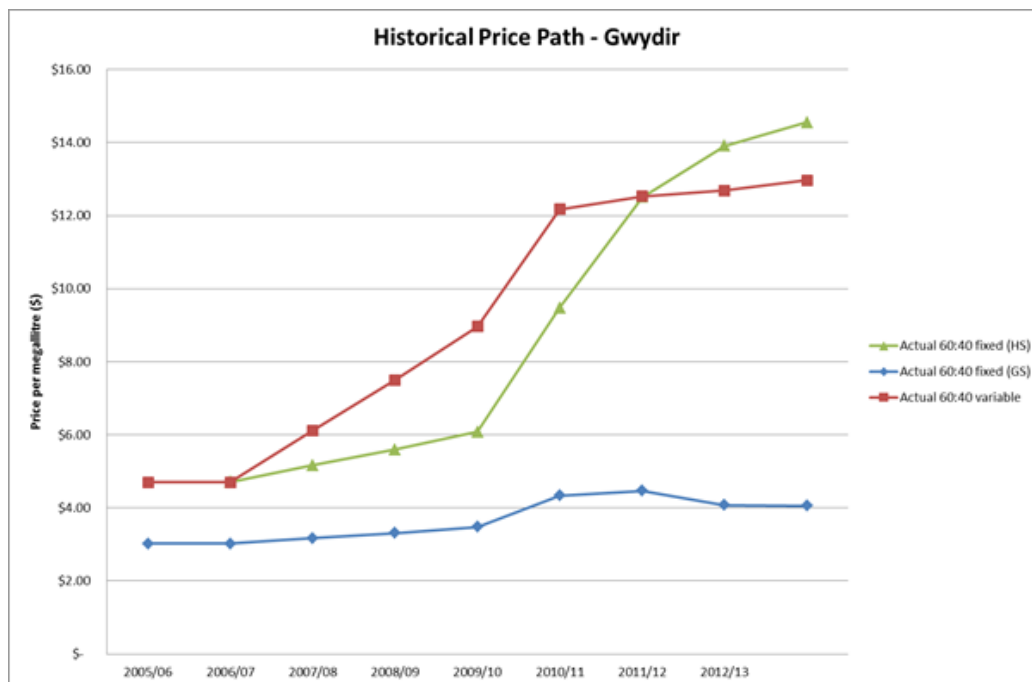
Bulk water charges have increased significantly over the last five years. According to IPART, bulk water charges were to increase by 28 per cent (on average) between 2009/10 and 2013/14 across all valleys. Furthermore, high security entitlement holders with a 500 ML entitlement and a 100 per cent allocation were expected to see price increases between 2 per cent and 73 per cent in NSW. General Security entitlement holders with a 500 ML entitlement and a 60 per cent allocation were expected to experience price increases of up to 47 per cent<sup>14</sup>.

Valley specific observations have confirmed this exponential price increase. In the Gwydir valley, high security entitlement charges have increased by 68 per cent since 2005/06 and general security entitlement charges have risen by 26 per cent. In addition, variable charges have fluctuated by up to 64 per cent since 2005/06.

The Gwydir valley<sup>15</sup> is characterised by a high variable water availability, where the long term reliability (likely allocation) is 36% and is measured mainly through very large water years followed by low water years. As such, it is highly likely that Gwydir irrigators under a 80:20 fixed/variable tariff structure would find themselves needing to pay for a resource that they will not be able to utilise. NSWIC is not aware that there is another business where customers would pay for services that may or may not utilise.

Whilst irrigators generally accept some level of annual cost associated with maintaining their asset, the potential shift in tariff structure will place considerable undue pressure on customers and jeopardise the industries sustainability in the long-term.

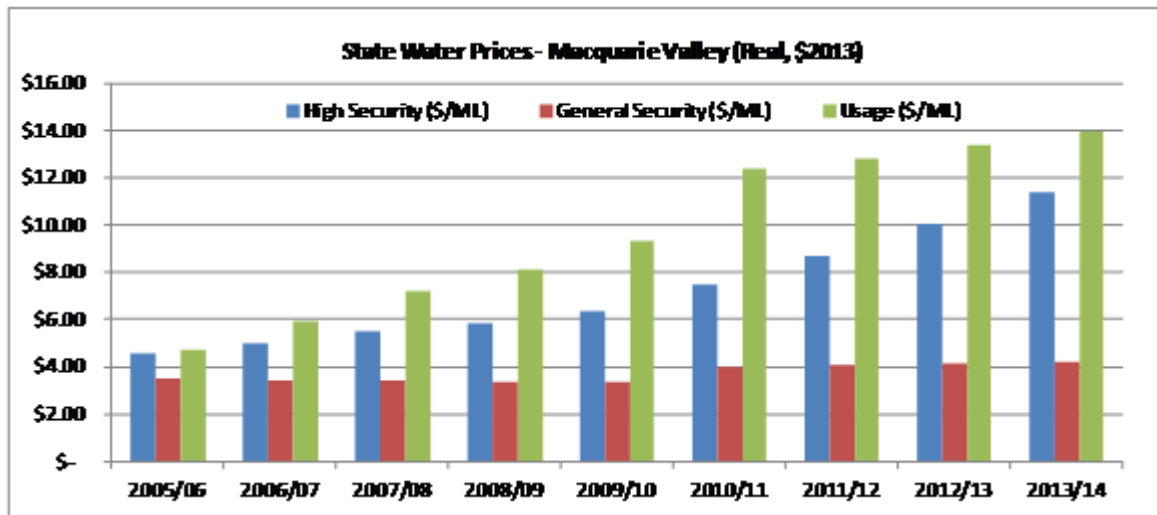
The graph below outlines the bulk water price developments over the last eight years in the Gwydir valley;



<sup>14</sup> file:///C:/Users/Stefanie/Downloads/Fact\_Sheet\_-\_Review\_of\_Bulk\_Water\_Charges\_for\_State\_Water\_Corporation\_-\_Richard\_Warner\_-\_7\_July\_2010\_-\_Website\_Document%20(2).pdf

<sup>15</sup> Please contact Zara Lowien at Gwydir Valley Irrigators' for more information.

A similar picture can be observed in the Macquarie valley<sup>16</sup> as outlined below;



In both examples, the increase in both entitlement and usage charges are significant and surpass to a large extent price increases indexed by consumer price inflation.

## Hypothetical Example

To illustrate the financial risk that State Water's pricing application would impose on General Security entitlement holders in 2014-15, NSWIC has prepared customer bills based on the ACCC draft decision and the SWC pricing application. The bills are based on 500 ML entitlements and low AWD (5 per cent);

500 ML entitlement & 5% allocation	ACCC	State Water	Difference
Border	\$ 1,271.25	\$ 1,787.00	\$ 515.75
Gwydir	\$ 1,974.00	\$ 2,773.75	\$ 799.75
Namoi	\$ 4,485.25	\$ 6,327.00	\$ 1,841.75
Peel	\$ 2,654.00	\$ 4,653.50	\$ 1,999.50
Lachlan	\$ 2,062.25	\$ 3,020.00	\$ 957.75
Macquarie	\$ 2,107.75	\$ 3,137.00	\$ 1,029.25
Murray	\$ 565.00	\$ 796.50	\$ 231.50
Murrumbidgee	\$ 689.50	\$ 994.00	\$ 304.50
Lowbidgee	\$ 439.50	\$ 589.00	\$ 149.50

The difference in cost is even more evident in the case of larger general security entitlement holdings;

3000 ML entitlement 5% allocation	ACCC	State Water	Difference	% difference
Border	\$ 7,627.50	\$ 10,722.00	\$ 3,094.50	40.57
Gwydir	\$ 11,844.00	\$ 16,642.50	\$ 4,798.50	40.51

<sup>16</sup> Please contact Susan Madden for further information - mrf@bigpond.com

Namoi	\$ 26,911.50	\$ 37,962.00	\$ 11,050.50	41.06
Peel	\$ 15,924.00	\$ 27,921.00	\$ 11,997.00	75.34
Lachlan	\$ 12,373.50	\$ 18,120.00	\$ 5,746.50	46.44
Macquarie	\$ 12,646.50	\$ 18,822.00	\$ 6,175.50	48.83
Murray	\$ 3,390.00	\$ 4,779.00	\$ 1,389.00	40.97
Murrumbidgee	\$ 4,137.00	\$ 5,964.00	\$ 1,827.00	44.16
Lowbidgee	\$ 2,637.00	\$ 3,534.00	\$ 897.00	34.02

As the examples above illustrate, State Water's proposed tariff structure imposes a significant higher financial burden on irrigators in case of low AWD.

## State Water's Financial Position

Despite State Water's continuous claim that the tariff structure has led to significant 'under-recovery' of allowed revenue over the last decade, it must be stressed that State Water has nevertheless achieved a profit over this time period. On page 120 of State Water's pricing application to the ACCC, State Water stated that its net profit before tax is \$50 million in 2012-13 and is expected to be positive in every year of the next determination. In addition, State Water anticipates a \$21.6 million profit after tax in 2016-17.

As such, a claim that 'under-recovery' has led to a significant deterioration of State Water's financial position must be assessed in light of sustained profits that have been achieved.

An analysis of allowed revenue vs. actual revenue completely ignores State Water's underlying cost basis. As State Water has over the last two determinations significantly underspent on its capital expenditure, its actual expenditure has not exceeded achieved revenue. This shows clearly that the current tariff structure has not caused significant financial impasses for SWC despite the fact that we have seen some of the lowest water sales on record over the last decade. In addition it must be stressed that State Water was able to recover 77.5 per cent of their allowed revenue in the period 2007-10 despite the fact that water sales were only 31 per cent. This shows that State Water has recovered a significant amount of revenue under the current tariff structure.

Furthermore, the last two years have led to a significant financial gain for State Water who has seen the highest water sales on record and significant 'over-recovery' in their revenue. A shift in the tariff structure that would lead to even greater protection of State Water's revenue is highly inequitable and inappropriately protects a monopoly operator.

## Equitable Risk Sharing

Central to the discussion of an adequate cost recovery mechanism is a consideration of an efficient and equitable risk sharing arrangements between State Water and its customers. Under the current arrangements, State Water receives a proportion of its revenue from the NSW Government. Over the next determination, the NSW Government has guaranteed to maintain current cost share arrangements.

In addition, State Water would also receive 40 per cent of its user share revenue in fixed charges. This revenue is independent of water sales and hence is also 'guaranteed' for

SWC. Under such an assessment, State Water already receives 65 per cent of its revenue in fixed charges. This argument stands in stark contrast to SWC's claim that no 'risk protection' mechanism is available to SWC. It must be stressed that such a revenue security is not available to irrigators in any form.

As such, NSWIC questions the rationale that a move to a 80 per cent fixed charge regime would be an equitable risk sharing arrangements. Should such a system be implemented, it must be noted that 88 per cent of revenue will be guaranteed for SWC due to the cost sharing arrangements with the NSW Government. This means that a monopoly operator would be allowed to nearly recover 90 per cent of its revenue irrespective of water availability and demand.

**Table 1 – Fixed proportion of SWC's current and proposed revenue requirement**

	<b>\$2013/14, \$million</b>			
	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>
Total Revenue Requirement	126.23	111.64	118.85	121.54
Government Share	54.26	44.24	49.11	50.81
User Share – Fixed	28.788	53.92	55.792	56.584
<b>Fixed revenue as a proportion of total revenue</b>	<b>65%</b>	<b>88%</b>	<b>88%</b>	<b>88%</b>
Operating costs	41.64	49.05	48.5	47.81
Forecast RAB		766.06	871.92	917.97
<b>Net return on assets</b>		<b>6.4%</b>	<b>6.5%</b>	<b>6.5%</b>

The constant pressure from paying 80 per cent fixed charges does stand in complete contradiction to the reliability of water in many of NSW valleys. As we have outlined in our above, irrigators revenue is highly dependent on water availability, which is one of the most important inputs to production. When water is not available, revenue for irrigators is low, whilst their charges would remain fixed.

## **Efficiency**

The ACCC must consider whether a move to a higher fixed charge tariff structure would promote the economically efficient use of water infrastructure. Where charges are fixed, rather than related to use, there is no incentive for water users to invest to improve efficiency or for State Water to respond to changed business circumstances. Further, where income to State Water is fixed, there is little incentive for them to adjust their business costs to reflect times of hardship as is required by non-regulated business.

## **Additional Risk Protection Mechanism**

NSWIC believes that the ACCC has provided SWC with ample risk protection mechanisms in its Draft Decision. In addition to the fixed/variable tariff structure, the annual adjustment mechanism and the ‘unders and overs’ mechanism, the ACCC has **also** proposed a 20 year moving average consumption forecast approach.

Given that the consumption forecast is based in large part on the millennium drought years there is a significant downwards adjustment in the overall consumption forecast values which benefits State Water significantly. This downward adjustment has a direct effect on bulk water charges.

In addition, State Water makes the point they are “capital-constrained”<sup>17</sup> saying that they cannot borrow unlimited amounts of money. However they also note that they borrow from NSW Treasury Corporation who determine fees and interest rates based on State Water’s credit rating. This is another facility not available to State Water customers who must negotiate with corporate banks operating in the competitive market place.

Frontier then goes onto say that the ACCC’s position that smaller enterprises do not have easy access to capital markets and often face borrowing constraints “stretches credulity”<sup>18</sup>. It is poor debating practice to apply an argument to one side but dismiss the same argument when used by the other side.

While we accept that there are other instruments for farmers to manage financial risks, we do not accept that State Water’s charges do not have a material risk for farmers particularly in dry years.

## **Administrative Issues**

Any amendments to the ACCC proposed tariff structure would cause significant cost to irrigation operation who are - by law - required to provide customers with information on future bulk water charges within 10 business days notice prior to implementing charges to fees and prices. To allow irrigation corporation to process these fees for the 1 July deadline, decisions by the boards have to be made by mid May. Should the ACCC final decision be significantly different to the Draft Decision, large additional costs will have to be incurred by the irrigation operation (including administrative, postage etc).

Further, there is a risk that irrigation operation will either be wearing the differences in charges until regulatory obligations are met and new charges are allowed to be implemented.

In addition, should any amendments to the tariff structure be considered prior to the 1<sup>st</sup> July deadline, further valley specific consultation must take place to outline the impacts of this change on individual irrigators and irrigation operation.

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<sup>17</sup> Analysis of aspects of ACCC Draft Decision on State Water Application, Frontier Economics, April 2014, p8

<sup>18</sup> Analysis of aspects of ACCC Draft Decision on State Water Application, Frontier Economics, April 2014, p15



Given the additional uncertainties surrounding other aspects of the next determination (final values for OPEX, CAPEX and MDBA/BRC charges), NSWIC strongly urges the ACCC to consider this issue carefully.

## **Conclusion**

NSWIC is deeply concerned about an amendment to the existing tariff structure. As we have outlined throughout our analysis, a shift to a 80:20 (fixed:variable) charge regime would cause significant financial pressure on irrigators, in particular those with low reliability.

In addition, we have outlined that each irrigation operation is different and hence statements that '*water charges only constitute a small proportion of irrigator's operating expenditures*' is incorrect. As irrigators incur a range of water related fixed and variable charges, the overall cost of water is often understated. In addition, the proportion of water cost in relation to other input cost increases significantly in times of low water availability.

We request that the ACCC maintains the existing tariff structure and proposed cost recovery mechanism.