

Briefing Note

IPART Review of Rural Water Charging System

Final Report

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Introduction

This Briefing Note provides a summary of the Independent Pricing and Regulatory Tribunal (IPART) Final Report on the *Review of Rural Water Charging System*. The report sets out IPART's final recommendations to the NSW Government, taking into account stakeholders' input during the public consultation process.

This Briefing Note will provide an overview of IPART's recommendations, the NSW Government response and NSWIC's of the final recommendations.

The full IPART report is available under;

[http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Rural Water/Review of Rural Water Charging Systems 2012/24 Oct 2012 - Final Report released by Government/Final Report - Review of Rural Water Charging Systems - 24 October 2012](http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Rural%20Water/Review%20of%20Rural%20Water%20Charging%20Systems%202012/24%20Oct%202012%20-%20Final%20Report%20released%20by%20Government/Final%20Report%20-%20Review%20of%20Rural%20Water%20Charging%20Systems%20-%2024%20October%202012)

The NSW Government response to the final report is available under;

[http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Rural Water/Review of Rural Water Charging Systems 2012/24 Oct 2012 - Government response to Final Report/Letter - Government Response to Rural Water Charging Systems Final Report - 24 October 2012](http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Rural%20Water/Review%20of%20Rural%20Water%20Charging%20Systems%202012/24%20Oct%202012%20-%20Government%20response%20to%20Final%20Report/Letter%20-%20Government%20Response%20to%20Rural%20Water%20Charging%20Systems%20Final%20Report%20-%2024%20October%202012)

NSWIC submission to the Draft Recommendations is available under;

http://www.nswic.org.au/pdf/Submissions/120730_IPART_Price_Review.pdf

Executive Summary

In May 2012 the NSW Government asked IPART to conduct a review into Bulk water charges to¹:

- Examine options for the billing of bulk water charges that might be better matched to business cash flows;
- Identify options for determining the NSW Government's cost share for the Australian Competition and Consumer Commission's (ACCC) determined bulk water charges in NSW, which may include a role for IPART;
- Make recommendations that will assist the NSW Government to maintain viable and economically sustainable provision of services to customers, taking into account the potential impact of future pricing arrangements on customer, State Water Corporation (SWC) and the NSW Office of Water (NOW).

IPART has made the following recommendations;

1. An option to conditionally defer the payment of fixed charges, with interest, in times of low water availability.
2. Maintain the current tariff structure for NOW (70:30 fixed to variable where meters are installed) and maintain the current tariff structure for SWC (40:60 fixed to variable), combined with a volatility allowance.
3. Maintain the current cost share framework and cost share proportions until 1st July 2017. After 2017, review cost share ratios prior to every second ACCC determination.
4. From 2014/15 onwards, progressively increase the average Peel Valley bill by 5% per annum until full cost recovery is achieved (residual to be paid through an explicit community service obligation (CSO) by the NSW Government in the interim).
5. SWC to conduct a financeability analysis to submit to the ACCC a case for a financeability allowance.
6. SWC to submit a case to the ACCC to revalue the regulated asset base to account for a change from a pre-tax to a post-tax building block model.

¹ Recommendations were to consider;

1. the cash flows, revenue streams and forward business planning of SWC and NOW
2. the NSW Government's financial position
3. statutory or policy barriers to implementation
4. the NSW Government's Commission of Audit into public sector management.

1. Payment terms

The review examined the relationship between water availability and customer's cash flows to explore ways in which billing of bulk water charges might be better matched to business cash flows.

IPART has separated between options for billing of bulk water charges in times of low water availability and the Government's drought policy.

IPART recommendations²;

- *For both SWC and NOW: in combination with the tariff structure in recommendation 3 and 4, provide regulated river customers the option to conditionally defer the payment of fixed charges, with interest, in times of low water availability:*
 - *the trigger for deferral to be set at 2 consecutive years of less than 5% of cumulative available water determinations (AWDs) at the end of the financial year when expressed as a percentage of the share component of a Water Access Licence.*
 - *interest rate applied to the deferred water charges to be the prescribed rate at which interest is payable under section 101(7) of the Civil Procedure Act 2005 (NSW) plus 2%.*
 - *a deferral period of no more than 2 years.*
- *NOW to develop a conditional deferral of fixed charges policy for unregulated river customers, informed by the following:*
 - *for unregulated river customers that are on the minimum bill - the deferral arrangement is not available.*
 - *for unregulated river customers that have meters installed and are subject to a water sharing plan - an option for customers to defer payment of fixed charges once there are 2 consecutive years where extraction is less than 5% of the long term average extraction limit (LTAEL) as defined in the water sharing plan.*
 - *for unregulated river customers that do not have meters installed - the deferral arrangement is available subject to assessment by NOW on request from customers.*
 - *interest rate applied to deferred water charges to be the prescribed rate at which interest is payable under section 101(7) of the Civil Procedure Act 2005 (NSW), plus 2%.*
 - *deferral period of no more than 2 years.*

² IPART Final report, p.24 and p.25

IPART analysis for regulated rivers:

It is IPART's view that a waiver of fixed charges would not meet the requirements of the Terms of Reference for the review as it would negatively impact on SWC's finances and the State Budget. A waiver would comprise elements of drought response policy which is for the NSW Government to determine and therefore outside of the scope of this review.

IPART analysis for unregulated rivers:

IPART has assessed that water availability in unregulated river is highly variable and depends more on local conditions. Entitlement holders in unregulated rivers are generally credited with an available water determination (AWD) of 100% to begin the season. As various rules affect the availability of water over the season, a trigger based on AWDs was not regarded as appropriate.

Furthermore, IPART determined that about 60% of unregulated customers are on the minimum bill, which will be \$95 by 2013/14. IPART has considered it unlikely that customers on the minimum bill would require a deferral arrangement.

NOW's response³:

During periods of extended low water availability, NOW's regulation and management of water resources requires increased resourcing and therefore any deferral of payment will lead to fiscal challenges to deliver required services.

As a Government agency, NOW cannot carryover funding from one year to the next to assist in any adjustment to such a deferral proposal. Alternatively budget supplementation from NSW Treasury would be required to address revenue volatility, but this may not be supported.

IPART assessment for groundwater:

It is IPART's view that groundwater is less sensitive than surface water to short term variability driven by seasonal conditions. Due to the very high reliability of groundwater, IPART does not consider a deferral of fixed charge arrangement to be necessary for users in groundwater sources.

Government Response:

- **While the NSW Government response indicated an 'agreement' to IPART's recommendation, NSWIC has sought confirmation for the NSW Government that fixed charges will be waived following two years of zero allocations. This confirmation was given to NSWIC.**

³ http://www.ipart.nsw.gov.au/files/619fb48e-28fb-40c7-88a4-a0af010487e4/Online_Submission_-_NSW_Office_of_Water_-_Department_of_Primary_Industries_-_D_Harriss_-_2_Aug_2012.zip

NSWIC Evaluation:

NSWIC has throughout this review advocated for a waiver of fixed charges in case of low water availability as it was a key election commitment of the NSW Government.

We have continuously voiced our concern that a deferral of fixed charges with interest is, insufficient as a drought relief measure. In times of extreme hardship, fixed charges are a significant impost to survival. When irrigators are not able to receive the benefits of the infrastructure for a significant time period, the payment for its maintenance should be viewed as a public service obligation by government.

In recent years, the NSW government has assisted with payment of fixed charges for irrigators in particular valleys. These 'once off' support mechanism seem to be a reaction to specific circumstances rather than part of a consistent policy framework to support irrigated agriculture in times of drought.

Irrigators respond to drought by reducing their own operating costs. The current bulk water pricing system requires water licence holders to bear the cost of running the rivers to provide water for non-paying beneficiaries. The cost of meeting this obligation rises steeply under severe drought conditions when most of the flow in the river is to meet these obligations and very little is available for water access licence holders.

NSWIC does not believe that a deferral of fixed charges to be paid with interest is an adequate response to mitigate the financial impact on irrigators in case of very low water availability. While reducing the total costs to irrigators during the drought, it does not solve the overall problem that irrigators pay for services that will not be provided to them but for other beneficiaries. Furthermore, IPART's suggestion that this deferral should then trigger interest payments (under the current condition to be 11.25%) cannot be supported by NSWIC. We re-emphasise that these fixed charges should be treated as a CSO in case of extreme low water availability.

2. Tariff structure

IPART has examined tariff structure options to mitigate the negative impact of water charges on customers' cash flows in times of low water availability. The recommendations have to be evaluated in line with the recommendations in part 1 (payment terms).

IPART recommendations⁴:

- *Tariff structure for NOW:*
 - *Maintain the existing tariff structure (key tariff feature being 70:30 fixed to variable for customers where a meter is installed and 100% fixed charges where no meter is installed).*
- *Tariff structure for SWC:*
 - *Maintain the current tariff structure (key tariff feature being 40:60 fixed to variable), combined with a volatility allowance. The volatility allowance should be calculated for the holding cost of an appropriate period, for example 1 year under ACCC's annual review process.*
 - *Maintain a rebate to large users (irrigation corporations).*
 - *Consult with government environmental water holder on a higher fixed to variable tariff structure (90:10), before submitting the proposal to the ACCC for the 2014 price determination. State Water to also explore extending higher fixed to variable structure to other specified customers in time.*

IPART Analysis for regulated river:

IPART considers the current tariff structure (with a volatility allowance) to provide an appropriate sharing of risk between SWC and its customers. The current tariff structure combines a structure that matches customers' cash flows with a mechanism to provide SWC with additional revenue for taking on more revenue risk.

IPART has determined that SWC revenue is more volatile under a 40:60 fixed to variable tariff structure than a 90:10. The mean absolute deviation of State Water's revenue over the last 20 years, under a 40:60 tariff structure, is 18% of the estimated average annual revenue over the same period. Under a 90:10 tariff structure, the MAD of State Water's revenue is 3% of the estimated average annual revenue over the same period.

State Water response⁵:

SWC submitted that the volatility allowance should be redesigned to account for lower level of revenue that is likely to result from the price determinations under the ACCC's post-tax framework. SWC offered an alternative calculation for the volatility allowance,

⁴ IPART final report , p.38

⁵ IPART final report, p.39

where revenue shortfalls are capitalised into the regulated asset base and the notional revenue building block would provide a return on and for the capitalised revenue shortfalls. IPART has responded that the loss capitalisation approach is a more complex approach which does not transparently estimate the costs to SWC of revenue shortfalls. Also, IPART added that SWC had not yet made a case that over the long term, the volatility allowance approach leads to an under recovery of revenue.

IPART Analysis for unregulated river:

IPART recommend that the current tariff structure is maintained for NOW in unregulated and groundwater systems. Given that NOW's charges are lower than those of State Water's in regulated rivers, and until more users are metered in unregulated rivers and groundwater sources, the case for a change of tariff structure for NOW would not be practical nor advocated by stakeholder.

Government response:

- **NSW Government agrees with IPART's recommendations for NOW tariff structure.**
- **NSW Government agrees to IPART's recommendations for SWC tariff structure;**
 - **Qualifications:**

SWC will seek to maintain its existing tariff structure if it can be maintained in a commercially sound manner allowing it to maintain a consistent level of services to customers.

SWC in their submission to the ACCC should seek to reduce or mitigate any large price shocks that may be experienced in times of low water availability, which may be experienced if IPART's recommendations are adopted in full, and may have potential to impact on farm business viability.

NSWIC Evaluation:

NSWIC has supported the continuation of the existing tariff structure however we have voiced our concern over the impact given the ACCC pricing framework.

NSWIC has determined that due to the involvement of the ACCC, there will be a negative impact on bulk water user - an inverse relationship between water charges and water availability. In the case of a 40:60 fixed to variable tariff structure under an ACCC framework, bulk water users will experience more volatile year-on-year price fluctuations should water availability be highly variable. Given the associated variability of farm cash inflow and the high dependency of irrigated agricultural production on the availability and cost of other input factors, such a price increase is unnecessary and undesirable.

NSWIC has suggested that further work should be conducted to explore alternative tariff structure options that balances the increased risks and costs of irrigators. We indicated that this alternative option might include the provision of alternative tariff structure options with varying fixed and variable ratios for different bulk water customers. While insufficient information remains on what impact this will have on irrigators, we emphasize that this suggestion could be a possibility and should be explored thoroughly in terms of its feasibility and cost effectiveness. SWC has responded that given the remaining timeframe available, such an evaluation will not be possible before the submission to the ACCC in 2013.

In order to allow bulk water customers in NSW to make an informed decision, NSWIC however recommends that further modelling should be conducted to assess the viability of multiple tariff structure options for consumer of bulk water services in NSW. IPART seems to concur with this assessment.

3. NSW Government Cost Share

IPART has developed a method for cost shares between the NSW Government and users of SWC over several determination, based on the 'impactor pays' principle. Using this method, costs were allocated to users according to the contribution they make to the costs of activities being incurred.

According to IPART the ACCC will set prices for SWC activities in the Murray Darling Basin under the Water Charge (Infrastructure) Rules from 1st July 2014. The ACCC expects the NSW Government's cost share to be known at the time it sets SWC's prices.

There is a potential role for IPART to continuously advise the NSW Government on the amount of government cost share of activities for SWC under ACCC's price review process.

IPART recommendation⁶:

- *Government to pay State Water, until 1 July 2017, a community service obligation equivalent to the government's share of efficient costs as calculated using the same cost sharing ratios determined by IPART in the 2010 price determination for State Water. After that, IPART would review the cost share ratios and activities prior to every second ACCC determination (i.e. every 8 years) starting in 2017.*

IPART analysis:

IPART considers reviewing the cost sharing ratios every second pricing determination period is a suitable balance between the need to ensure that the cost sharing ratios remain appropriate, and the additional costs imposed in undertaking a separate review of cost shares at every pricing determination. The last review of cost shares was conducted in 2010.

IPART has further noted that the issue of user base (i.e. basic rights holders) cannot be addressed until NOW completes its action associated with the 2011 Determination. Furthermore, IPART has mentioned that there may be a case to expand the customer base to include environmental contingency allowances but information on costs associated with the environmental contingency would need to be identified to assess whether changes to the legislation are appropriate and cost effective.

IPART has also responded to concerns raised by stakeholders with regards to the Murray Darling Basin Authority. IPART emphasized that it made recommendations that signatories to the Murray-Darling Basin Agreement should ensure that the MDBA's costs are efficient. While IPART's legislation does not extend to the review of the efficiency of the MDBA's expenditure, in IPART's past pricing determinations, IPART has applied general efficiency targets to the MDBA related costs that SWC seeks to recover from users.

⁶ IPART Final Report, p.52

Government response:

- **NSW Government agrees with IPART's recommendation noting that the review of cost shares should be complete well in advance of the completion of SWC's 2014 price determination period.**

NSWIC evaluation:

NSWIC has strongly supported the continuation of an independent and transparent cost share framework that is determined and administered by IPART. Members of NSWIC have however continuously voiced their concern about the current cost share proportions. We have highlighted in our last submission that we do not consider the current cost share proportions to accurately reflect the conditions prevalent in NSW.

Individuals who currently pay bulk water charges are only a subset of all those who benefit from the provision of bulk water services in NSW. NSWIC has therefore submitted that a review of the current cost share proportions will be necessary to accurately reflect the conditions in the State. Also a consideration of an appropriate user base should be conducted.

NSWIC understands that the timeframe and complexity makes it difficult for IPART to review the cost share proportions and the user base for the next determination of SWC's charges, however NSWIC believes that an urgent review of the cost share proportions and user base will be necessary. The costs for the provision of bulk water services should be shared between all bulk water users of NOW's and SWC's services.

NSWIC concurs with IPART's assessment that an eight year revaluation of the cost share framework is an appropriate and cost effective approach to set cost shares in NSW.

4. Valleys not at full cost recovery

IPART has considered whether an explicit CSO should continue to be made by the NSW Government to recover those SWC costs that are not recovered from users. The Peel is the only valley in the Murray-Darling Basin where State Water does not fully recover users' share of costs. SWC's charges in the Peel Valley currently recover 90% of the users' share of costs.

According to IPART, SWC's operations in the Murray-Darling Basin will be subject to the ACCC framework from 1 July 2014. Under section 29(2)(b) of the *Water Charge (Infrastructure) Rules*, an operator's prices are to be set so that they are reasonably likely to recover full cost of service delivery, less subsidy or other revenues.

IPART recommendation⁷:

From 2014/15, progressively increase the average Peel bill by 5% per annum until full cost recovery is achieved, with the residual of the full efficient costs not recovered from users in the interim period to be funded by a community service obligation.

IPART analysis:

First of all, IPART considers a valley based pricing methodology to be appropriate to avoid cross subsidies between valleys. Differences in prices between valleys are a necessary consequence of valley based pricing.

In this review IPART has explored methods for setting the value of government provided CSO for SWC Peel Valley services in a way that is consistent with the *Water Charge (Infrastructure) Rules* and the *National Water Initiative*. Competition agreement by COAG in 1994 and the *National Water Initiative* (NWI) in 2004 were key initiatives introduced to encourage cost reflective pricing, including the removal of cross subsidies between different users.

IPART's indicative analysis from the 2010 Determination has suggested that the average general security bill represents around 3.7% of total cash costs for a typical farm business in the Peel Valley. Given this and the fact that the Peel Valley is already at 90% cost recovery, IPART considers a slow transitioning to full cost recovery at 5% per annum to be an appropriate balance between the users in the Peel Valley and the need to achieve full cost recovery as agreed in the NWI pricing reforms.

Government Response:

- **The Government has not provided a response to this issue and noted that they will reserve comment until the completion of the coastal valley regulated river review in October/November 2012.**

⁷ IPART, Final Report, p.59

NSWIC evaluation:

NSWIC does not concur with IPART's assessment. To the contrary, NSWIC strongly supports an ongoing financial support of the Peel Valley through CSO provided by the NSW Government. Given the low number of bulk water users in the Peel Valley, the costs of bulk water is significant in this valley. Further cost increases will not be financially viable as unit costs would be prohibitively high. NSWIC believes this argument will be further supported by the Coastal Valley Regulated River Review that is currently being finalised. The review will provide additional information on the current social and economic costs imposed by the current water charges in the Peel Valley.

Full cost recovery in the Peel Valley is not financially viable and would place individual irrigators in this region at a substantial competitive disadvantage.

NSWIC suggest an upper bound pricing approach (strictly less than 100%) that is implemented gradually. To mitigate the impact of bulk water users in the Peel Valley, NSWIC suggests that the upper price is close, if not identical, to the current 90% cost recovery. The remaining 10% should be covered through adequate CSO provided by the NSW government.

5. Impact of future pricing arrangements

Through the course of the review, IPART has suggested there are issues relating to SWC's short term financial viability and its transition to pricing determinations regulated by the ACCC.

Identified Impacts;

- low market interest rates which result in lower return on capital in the revenue building block.
- shift from a pre-tax building block framework to a post-tax framework which result in the tax allowance not to be part of the weighted average cost of capital.

IPART recommendation⁸:

State Water to perform a financeability analysis and if necessary, submit to the ACCC a case for a financeability allowance (temporary adjustment to notional revenue that will be returned to customers in subsequent price determinations).

State Water to submit a case to the ACCC to revalue its regulated asset base to account for the change from a pre-tax to a post-tax building block model.

IPART analysis:

IPART considers a financeability allowance to be a transparent mechanism used by economic regulators to provide a temporary adjustment to notional revenue in certain circumstances - especially if it can be shown that a reduction in notional revenue (up to 17% according to IPART's analysis) over the next regulatory period could lead to a higher cost of debt and reduced ability to fund capital programs.

IPART also considers there to be a case for adjusting the value of state Water's RAB for the change from a pre-tax to a post-tax framework. In 2006, IPART determined State Water's RAB using a converted annuity approach using a pre-tax weighted average cost of capital (WACC). A higher initial RAB value would have been calculated if a post-tax WACC was used. IPART indicated that there would be small increases in the RAB as at 2012/13 that should not cause large price shocks if implemented.

Government response:

- **The NSW Government has agreed that SWC should consider a financeability analysis and submit to the ACCC a case for a financeability allowance.**
- **The NSW Government has agree that SWC should consider submitting a case to the ACCC to revalue its regulated asset base to account for the change from a pre-tax to a post-tax building block.**

⁸ IPART Final Report, p.65 and p.66

NSWIC evaluation:

NSWIC does not support the introduction of a financeability allowance as it would simply be another risk compensation factor for SWC. The suggestion that a further financeability allowance should be considered for SWC in order to compensate for any potential changes in the WACC is inadequate and will place further unnecessary financial burden on bulk water users.

In NSWIC's view, such a financeability allowance would effectively be an advancement paid by bulk water customers to compensate any notional revenue shortfalls by SWC. This is simply a further risk transfer from a monopoly service provider to customers who are by definition the most vulnerable. Instead, SWC should implement alternative risk management strategies or defer expenditure to mitigate volatility in revenue.

Furthermore, as there is no confirmation on changes in the WACC, a discussion on further risk compensation measures paid by customers is not appropriate. Should a change in the WACC materialise, then this would be a result of the regulator's assessment that the underlying systematic risk of SWC is different to previous conditions. It should be emphasized that any changes in the WACC could be a result of changes in overall economic environment and not simply a result of changes in calculations. Other financial variables that are required for the calculations of the WACC are in constant flux and hence careful consideration should be given as to which factors would substantiate changes in the WACC. Simply to suggest that a financeability allowance should be introduced due to potential changes in notional revenue under the ACCC framework is not conclusive.

NSWIC also does not concur with IPART's recommendation that SWC has a substantive case to ask for a revaluation of the regulated asset base. Not only is there no information currently available as to whether the ACCC will adjust the current WACC value. Furthermore, IPART has correctly pointed out that there is little scope to change the RAB under the *Water Charge (Infrastructure) Rules*. If the ACCC act according to its pricing principle, NSWIC expects that the current RAB value will be adopted from the previous determination process.