**LACHLAN VALLEY WATER**

**May 2001**

# SUBMISSION TO IPART ON WATER PRICING

## EXECUTIVE SUMMARY

Lachlan Valley Water believes the DLWC submission does not meet the requirements outlined by IPART in previous determinations. Not all information identified as necessary for a medium term pricing path has been supplied and there has been a lack of consultation about the overall process of developing the submission and on critical aspects including the principles for cost sharing in relation to compliance works.

The operation of State Water as a commercial unit within DLWC faces a fundamental difficulty in that it cannot provide bulk water delivery services with the transparency, efficiency and accountability required.

We believe a better process for determining prices would be achieved through:

IPART approves increases in bulk water supply costs of no more than the CPI increases until DLWC can adequately provide the information and implement the recommendations listed in the 1998 and 2000 IPART determinations.

A process be commenced to complete the separation of State Water from DLWC.

Additional consultation be undertaken between State Water and customers on TAMP as a prerequisite to a determination on sharing of asset costs.

DWLC and State Water be directed to undertake consultation on cost sharing principles in regard to compliance costs before any determination can be made on sharing of asset costs.

The user share of water management planning and implementation program costs be 0%.

User share of environmental compliance costs to be 0%.

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## INTRODUCTION

Lachlan Valley Water represents water users in the Lachlan Valley and presents this submission on behalf of our members. Our approach to the pricing submission has been to review the process undertaken by DLWC in presenting their medium term submission and to make a recommendation on whether the overall process meets IPART requirements. We have then considered the detail of the submission and made recommendations on the framework of principles and the data and projections used by DLWC in arriving at its proposal.

### 1. Process

An overview of the DLWC's medium term pricing submission reveals fundamental deficiencies where the submission has not provided the full set of information requested by IPART in earlier determinations. It also indicates that the operation of State Water as a "commercial" business unit of DLWC does not deliver the transparency, efficiency and accountability required.

#### 1.1 Provision of Information

In its 2000 determination IPART listed 64 categories of information required from DLWC for a medium term pricing submission, including 16 items of financial information. IPART also stated in that determination that it believed State Water's accounts should be separately audited on a valley basis and a full set of financial statements reported.

The submission has not complied with these requirements.

Audited previous year, current year and 5 year forecast Profit and Loss accounts were required but have not been provided. The only current 2000/01 year figures appear to be the gross operating cost and net operating cost figures shown in Tables 2 1 – 24 in Appendix 4. If full cost recovery is sought State Water must be able to provide sufficient information to enable customers to determine they are paying only the efficient costs for provision of the service, not for resource management costs or other community service obligations that are a responsibility of the DLWC.

It should be possible to provide Profit and Loss accounts by product (Regulated, Unregulated, Groundwater etc) and by valley.

Timeliness of reporting is important. It took State Water until April 2001 to produce the final Lachlan Valley Bulk Water Services Financial Report for the year ended 30

June 2000 including the DLWC Resource Management costs. The delays leave customers with little confidence that the figures in the final report included in the DLWC submission are correct.

At the very least, for the purposes of accountability and control, a commercial entity should be able to produce quarterly reports of income and expenditure and budget versus actual comparisons. We understand that the CSC has requested this information and it has not been forthcoming.

The DLWC submission refers to a review of financial accounting procedures underway which, it is envisaged, will enable financial reports to be presented to CSCs on a more regular basis. While this is promising, we note that the DLWC submission in 2000 stated that an upgrade of the accounting system was undertaken in 1999 and that costs and revenue were now reported in special purpose financial reports and provided to CSCs.

We believe DLWC have had sufficient time to implement appropriate accounting procedures for accountability and timely reporting. Their ability to do so should be a key indicator of whether or not State Water is genuinely operating as a commercial business unit.

### 1.2 COAG Requirements

The DLWC submission states that pricing for full cost recovery is required under the COAG framework. Performance in accordance with COAG requirements should entail meeting all requirements rather than selectively implementing those which result in increased cost recovery without concurrently implementing obligations such as property rights backed by clear specification of entitlements.

### 1.3 Customer Service and Consultation

IPART's last determination requested input from Customer Service Committees regarding their progress in determining service levels and costs.

The DLWC submission refers to consultation with Customer Service Committees and the improvements since 2000, however, the reality is that CSCs have little opportunity to provide timely input into determining costs because they meet once a quarter and are reliant on State Water to provide information. The preparation of DLWC's current submission illustrates the problem.

The Lachlan CSC had no input to the DLWC pricing submission except for a verbal briefing it received on 12 March. While the CSC provided some feedback on the day it was limited because the Committee had no written information on which to provide informed comment and little time to consider the issues.

The Customer Service Committees' terms of reference state that "CSCs will represent customers in their valley in providing advice to State Water in:

- negotiating water pricing strategies for recommendation to IPART

- determining asset management priorities, including asset renewal and maintenance; and, ensuring that minimum expenditure is sufficient to meet safety standards and limit system failures.
- developing an appropriate performance reporting framework"

Clearly the process undertaken by DLWC in preparing their current submission does not constitute "negotiating water pricing strategies" with CSCs and indicates that the CSCs are currently not operating according to their terms of reference.

The DLWC submission also refers to consultation undertaken on TAMP. Again the reality is that the consultation so far has been limited and without customers being fully informed. The TAMP is a comprehensive and complex document of 5 volumes which takes considerable time and effort to understand. True consultation will take some time and a number of workshops to achieve.

## Summary

The above indicate key areas where DLWC has failed to meet IPART's requirements for implementation of previous recommendations or for provision of information.

In a number of cases the DLWC submission states that processes are underway, eg, their Staff Consultative Committee is reviewing a draft of a Customer Service Charter prior to it being presented to customer service committees. However, many of the areas where processes are underway are ones that have been identified by IPART in either 1998 or 2000 as aspects requiring improvement.

We believe that as a minimum DLWC should meet these longstanding requirements and provide the information necessary to ensure transparency in accounting before any medium term pricing path is approved.

We also believe the present deficiencies indicate that State Water is constrained in its ability to operate efficiently as a supplier of bulk water services while it still a business unit of DLWC.

We note that the DLWC submission rejects the proposal for contestable Service Agreements on the basis that State Water, as a business within DLWC, relies on these services to comply with departmental protocols and policies. The most transparent accountability and pricing arrangement would be for State Water to be separated from DLWC. Service agreements could then be contestable, and State Water financial reports would show direct service delivery costs and Service Agreement costs.

**Recommendation 1:**

**That IPART approve increases in bulk water supply costs of no more than the CPI increases until DLWC can adequately provide the information and implement the recommendations listed in the 1998 and 2000 IPART determinations.**

**Recommendation 2:**

**That a process be commenced to complete the separation of State Water from DLWC.**

## 2. Principles

### 2.1 Water Management Planning Costs

The DLWC submission seeks to recover 50% of surface water planning and 70% of groundwater planning costs from customers.

The preparation of Water Sharing Plans that is now underway is taking place as a result of the new Water Management Act 2000, which is central to the Government's water reform program. The Act clearly states that water for the environment is the first priority (Section 20, Water Management Act 2000), with provision of water for basic landholder rights as the second priority and provision of water for extractive use subject to the first two requirements.

Having regard to the priorities specified under these plans, it is clear that the primary beneficiary of the planning process will be the general community through the provision of water for environmental health requirements, the provision of water for basic landholder rights and the shared government and community responsibility for water management planning.

Implementation of Government policy is a Government responsibility and the current planning process is part of the water reform process. The costs should be borne 100% by Government on the same principles as the decision on cost sharing for River Quality/Flow Reforms in the 1998 determination.

**Recommendation 3:**

**That the user share of water management planning and implementation program costs be 0%.**

### 2.2 Asset Costs

#### 2.2.1 Total Asset Management Program

The TAMP has been used as the basis for much of the asset costing in the DLWC submission and provides a much more detailed framework for this costing.

However, as noted in 1.3 above there has been limited discussion with CSCs on the contents of TAMP, the asset management priorities, implications of the required safety standards, and other possible strategies for risk mitigation. Additional consultation and presentations by State Water Asset Engineers are required to enable customers to gain a better understanding of TAMP.

The submission notes that DLWC has identified a substantial capital works program for regulated rivers over the next thirty years. The question is whether customers are being asked to pay for works that should have been carried out earlier but which were deferred. Customers should not be required to meet costs that under a well managed asset renewal program would have been met in previous years by the owner of the assets.

The TAMP notes that "by far the most material costs included in the 30 year capital plan are those for dam safety" (Section 8, page 3 1). In the case of the Lachlan, $14.9 million out of a total $26.7 million over the 30 year period of TAMP is for safety and security compliance.

Customers do not accept that they should pay 50% of the cost of safety compliance works until there has been consideration of other options for risk mitigation. There also needs to be a process of identifying who the beneficiaries are and who should pay when the community requires a higher standard of safety than was previously acceptable.

### 2.2.2 Safety Compliance Annuity

In discussing the State Water Compliance Annuity, the DLWC submission (p 17) states that "A community consultation process will be used to determine the minimum level of capital required to mitigate such risks rather than eliminate them". Clearly the appropriate time for such consultation to take place is before the pricing submission is developed rather than afterwards.

Also required is a detailed consideration of the principles that should underpin the overall application of cost sharing. There needs to be a much clearer understanding of the costs and benefits of compliance work, who bears the costs, who receives the benefits and who should pay. The issues were discussed at a meeting between State Water, DLWC and CSC chairs in 2000 but there was no agreement reached on the critical areas.

Until DWLC and State Water can demonstrate their implementation of consultation processes that genuinely incorporate stakeholders we recommend safety compliance costs should be borne by the owner of the structures, DLWC.

**Recommendation 4:**

**DWLC and State Water be directed to undertake consultation on cost sharing principles in regard to compliance costs before any determination can be made on sharing of asset costs.**

The next issue regarding the compliance annuity is that the majority of the costs are loaded into the first 10 years of the TAMP. In the case of the Lachlan $25.5 million, or 95% of the total projected compliance expenditure, is programmed for the first 10 years. This has the effect of considerably increasing the annuity required to cover these costs.

As before, customers believe there must be consultation about the works program, and whether it is achievable to complete the proposed works within the time frame.

### 2.2.3 Environmental Compliance

As with Safety Compliance, there has been no meaningful attempt to identify the costs and benefits, and to allocate costs in proportion to the benefits received.

Changes to structures to improve environmental outcomes clearly benefit the environment and this cost should be borne by Government on behalf of the community. We note that dams and other infrastructure were constructed in accordance with Government policy and to meet society's demands at the time. If society's demands have changed and additional costs are to be incurred to meet current standards, then the community as a whole benefits and the community as a whole should meet the cost.

**Recommendation 5:**

**User share of environmental compliance costs to be 0%.**

### 2.2.4 Annuity Funding

The DLWC submission states that annuity funding is the preferred approach for recovering asset costs. There has been no consideration as to whether debt funding would be a more appropriate method of funding, particularly for compliance works.

Customers have concerns about annuity funding when funds are managed centrally rather than retained in a separate sinking fund account. Many valleys, including the Lachlan, have had previous experience with accumulated funds in their River Operations Accounts during the life of the River Advisory Committees. In the case of the Lachlan River Advisory Committee a surplus of approximately $1,500,000 was accumulated in the River Operations Account. When the Committee was dissolved these funds were not accounted for and have remained so, despite the CSC repeatedly requesting an explanation.

**Recommendation 6:**

**Customers to be consulted regarding the most appropriate method of funding compliance costs.**

**Recommendation 7:**

**Any annuity payments should be retained in a sinking fund and State Water should be clearly accountable for such funds.**

2.2.5 Return on Capital

The DLWC submission calls for a return on capital on the basis that this is necessary to give the correct signals regarding investment in infrastructure. The rate selected is 7%, on the basis that this is similar to the rate used by other comparable organizations – Sydney Water Corporation etc. The return on capital is calculated on both the Government contribution to asset costs and the customers' contribution to asset costs, which appears to be double dipping.

There has been no consultation as to whether customers believe a rate of return should be earned on the capital they contribute to asset costs.

**Recommendation 8:**

**No rate of return be required on customers' contribution to new capital investment.**

## 3.0 Data and Projections

### 3.1 Impact Assessment

3.1.1 Gross Margin Impacts

The DLWC submission in 6.1 attempts to assess the impact of increased water prices by means of a gross margin impact study on irrigated crops. This is not an appropriate method to use because, as noted in the submission, the purpose of gross margin analysis is to enable comparisons of relative profitability between different enterprises rather than to assess the profitability of a farm business (ie, a water user).

The gross margin impacts for different crops quoted by DLWC are meaningless in terms of assessing impacts because they do not include the impact of the increases in fixed charges, which are as significant as the increase in usage charges. This method significantly understates the financial impact on water users.

3.1.2 Farm Enterprise Impacts

The study by NSW Agriculture quoted in 6.2 does attempt to assess the impact on the farm enterprise but understates it in the case of the Lachlan. It overlooks the impact of current allocation policies on farm profitability. The MDBC Cap limits usage in the Lachlan Valley to approximately 50% of entitlement. DLWC manages the Lachlan to stay under the Cap by allowing carryover from one season to the next of up to 50% and by limiting the maximum carryover and allocation announcement to 100% of entitlement, ie, if carryover is 50% then allocation will be 50%.

The NS W Agriculture study looks at 6 "representative farms" and makes the assumption that on all farms except Nos. 2 and 3 (large) the irrigators will use more than 70% of their entitlement. Under current allocation management policies an irrigator who wants to consistently use this proportion of entitlement will need to buy additional water on either a temporary or permanent basis. The study has not included this additional expense in the enterprise costs.

The costs of obtaining extra water will vary according to whether it is permanent or temporary transfer, and in line with the seasonal demand in the case of temporary transfer. For this exercise we have assumed that an irrigator will buy in the additional water required in excess of 50% of entitlement on a temporary transfer basis for a cost $7/ML in 1999/2000 and for a price of $12/ML in 2003/04. We have recalculated the costs and impacts on this basis.

**IMPACT OF WATER PRICE INCREASES ON FARM ENTERPRISES**

| | | FARM | | | |
|---|---|---|---|---|---|
| | | 1 | 3 (small) | 4 | 5 |
| **Entitlement (ML)** (includes groundwater) | | 600 | 972 | 6000 | 1400 |
| **Av. Use (ML)** | | 454 | 731 | 4838 | 1353 |
| **Reqd. to Buy In (ML)** | | 154 | 245 | 1838 | 653 |
| **Cost $/ML** | 1999/2000 | 7.00 | 7.00 | 7.00 | 7.00 |
| | 2003/04 | 12.00 | 12.00 | 12.00 | 12.00 |
| **Total Purchase Cost ($)** | | | | | |
| | 1999/2000 | 1078 | 1715 | 12866 | 4571 |
| | 2003/04 | 1848 | 2940 | 22056 | 7836 |
| **1999100** | | | | | |
| Farm GM | | 93692 | 112014 | 444570 | 160676 |
| Op. Overheads | | 55524 | 61968 | 215992 | 135898 |
| Net Farm Income | | 38168 | 50046 | 228578 | 24778 |
| Business Return | | -482 | 11946 | 155228 | -6972 |
| **2003/04** | | | | | |
| Farm GM | | 92502 | 110098 | 431894 | 156531 |
| Op. Overheads | | 57458 | 65070 | 233542 | 141179 |
| Net Farm Income | | 35044 | 45028 | 198352 | 15352 |
| Business Return | | -7506 | 6928 | 125002 | -16398 |
| **Relative Impact** | | | | | |
| Total farm GM | | -1.3% | -1.7% | -2.9% | -2.6% |
| Total Op. Overheads | | 3.5% | 5.0% | 8.1% | 3.9% |
| Net Farm Income | | -8.2% | -10.0% | -13.2% | -38.0% |
| Business Return | | -53.7% | -42.0% | -19.5% | -135.2%) |

Adapted from Economic Impact of irrigation Charges in the Lachlan Valley - NSW Agriculture

The revised figures indicate that reductions in net farm income can be expected to be in the range of 8.2% to 38.0%, compared with the 5.2% to 19.3% reductions quoted in the NSW Agriculture study.

Full cost recovery pricing will result in significant reductions in net farm incomes. The adjustment pressure will be severe for some farms and we believe more time is needed for irrigators to adjust to price changes. This could be achieved by limiting price increases to 10% per year,

## 3.2 Data on Annuities

In reviewing the figures in Appendix 4 there is insufficient information to reconcile the figures shown in Tables 8, 10, 12 and 14 with the Renewals Annuity and Compliance Annuity shown in the Summary of Asset Costs in Table 20.

If the annuities in Table 20 include an annuity for Capital Development Expenditure – Category 4 (Table 16) this should be identified.