AI001
File: 3429

Western Murray Irrigation Limited's response to the NSW Department of Land and Water Conservation Submission to IPART On Bulk Water Pricing 2001/02 – 2003/04

May 2001

Background

Western Murray Irrigation Limited (WMI) is responsible for supplying water to the Buronga, Coomealla and Curlwaa irrigation areas, all located in the far south-west corner of NSW.

In the six years since privatisation from the DLWC, WMI has implemented substantial changes to ensure it meets the principle of full cost recovery. This ensures that WMI is able to meet its operation, maintenance and long-term infrastructure requirements, completely independent of any outside funding sources (beyond commercial arrangements that the company may wish to enter into with finance providers).

Preceding and coinciding with the change in ownership, the areas that WMI serve have also undertaken an enormous change. Over 50% of the irrigable area has been redeveloped to more productive intensive horticultural pursuits, serviced by highly efficient on-farm application systems. The enormous changes in farming practice have been brought about by buoyant markets for horticultural produce.

WMI's Key Points

WMI's most vital points on the DLWC IPART Submission are as follows:

1. the efficiency of the Department must again be reviewed by IPART as work practices are far from world's best practice and glaring inefficiencies and duplication remain;
2. IPART must continue to apportion the efficient costs of the Department across users according to their merits (i.e. adopting the beneficiary pays principle);
3. the Return on Equity and Cost of Capital notions in the submission need to further scrutinised to ensure their robustness and appropriateness, and should only be applied to the contribution to infrastructure made by government;
4. IPART needs to emphasise to the Department that the prices set in this review process are for nothing other than cost recovery (and that prices are in no way meant to be a proxy for resource management tools);
5. the Department must look at the imposition of developer charges to ensure that the beneficiary pays principle applies to all tasks performed;
6. the funds collected from customers for future capital works must be preserved, protected and enhanced; and
7. the differential rate struck for high and normal security entitlements should be eliminated.

WMI's Detailed Response

This part of the WMI response addresses the content of the DLWC Submission in detail.

Section 1.4 – Medium Term Pricing Proposal

(1) Cost Recovery – not enough detail of the proposed works and projects is provided in the Department's submission to allow a clear conclusion to be drawn as to the cost efficiency of the delivery of bulk water services. Increased scrutiny has to be applied to the three-year program proposed by the Department to ensure it is appropriate and cost effective.

The privatisation of WMI from the Department brought about substantial changes in the way the irrigation areas were run. The most important of these was significant changes to work practices. The changes made to this area alone have allowed WMI to make substantial real reductions in the cost of delivering services to shareholder customers in the face of increasing input costs (e.g. electricity). At the same time it is glaringly obvious that the work practices of the Department remain unchanged – rendering a cost burden on users that would not have to be carried if the functions performed by the Department were truly market-tested (tendered to private enterprise) or performed in a more business-like fashion.

(3) Minimise Dislocation – the final paragraph contradicts itself. "Significantly higher prices … would be required for this purpose" (to achieve ESD), and then goes on to say "the implementation of prices which recover direct bulk water service operating and capital costs is the minimum necessary to the achievement of ESD".

The contradiction is of only secondary importance, the key point is that water prices should in no way be used as a way of achieving objectives beyond the recovery of appropriate costs. The demand for water is becoming increasingly price inelastic as the use of technology in farming becomes more prevalent. Water is an input to production like fuel and fertiliser. An increase in its price may reduce the profitability of the farming enterprise, but it is unlikely to halt the farming activity altogether.

2.6 – Business Development and Service Standards

i Best Practice and Culture Change – COAG reforms require water administration to be conducted in a commercial manner and to standards reaching world's best practice. The fact that State Water remains ring-fenced within the Department ("State Water is developing its Customer Service Areas as self-managed teams that act in a cohesive way within the context of DLWC policy and business strategies") must render the achievement of this aim almost impossible, rendering the costs of an inefficient organisation upon customers.

3.0 – Resource Management

A number of comments are made in the opening paragraph of this Section that allude to the use of water pricing as a way of "arresting continued environment degradation". Prices must be set at levels that recover the fair costs of delivering water etc. and not to achieve any other policy targets.

The Department has at its disposal a licensing system that can account for the impact of resource mismanagement. To date these powers have not been used widely (if at all). Instead, the Department chooses to focus on price to achieve its resource management functions. This also implies that the Department chooses to manage the resource to the lowest common denominator. If price has to be used as the tool for environmental change, then those users who have and/or are implementing world's best practices on-farm should receive credit for that investment.

3.1 - Recoverable Resource Management Functions

The third paragraph states that "The total cost of resource management and environmental management of rivers and groundwater systems is far greater that that reported in this submission." No credence should be given to this comment – only the costs that are presented for scrutiny should be considered by IPART, the size of the other costs that are not/cannot be presented for scrutiny are irrelevant.

Reference is also made to the need to recover costs from users for the planning and implementation process established by the Water Management Act. What the submission fails to mention is that users represent a small proportion (two of eleven, depending on its final composition) of those

stakeholders who will be represented on the new Committees. This makes clear the beneficiaries of the new processes – the community – which is set to reap the majority of the benefits (about nine elevenths) generated by this process. This should be reflected in the cost split apportioned to this activity by IPART.

3.1 – Water Use Compliance

Where costs can be apportioned to a customer or group of customers directly, then those costs should be apportioned directly to those necessitating that expenditure. It appears from the text of this section that all customers are required to fund the enforcement and prosecution strategies for a small number of customers. This type of cross subsidy must cease.

Such a methodology should be extended to anyone seeking permission for new works to be assessed by the Department. For example, in the south west region of the state, the assessment of significant new horticultural developments would require a significant amount of staff time. Instead of this cost being apportioned across all customers, the Department should set a charge to be levied against developers that recovers the cost (plus an appropriate margin) of the cost of the services provided. This further enhances the adoption of the beneficiary pays principle, and places a reduced burden on other (non-beneficiary) customers.

The adoption of consistent and transparent development guidelines along the length of the River Murray would also go a long way to giving the Department more credibility with users. As described above, the rigour applied to new developments in this region is quite extensive. Unfortunately there are reports from other regions where the rigour applied is less extensive, with the result being less than optimal environmental and social outcomes. Again, water use would need to be rationed by price (lowest common denominator) according to the Department, despite the fact they contributed (created?) the problem in the first place.

3.2 – Cost Sharing

"The prices proposed in this submission are based on the efficient level determined". Determined by whom?? Much scrutiny needs to be applied to comments like these, as they seem to assume certain things as given from the IPART inquiry process.

4.2.2 – Cost Sharing

"No changes to the cost sharing ratios are proposed in this submission". Again the Department is assuming that IPART will accept that costs previously divided in one fashion will continue to be divided in that manner. Again greater scrutiny needs to be applied to the nature of the additional expenditures proposed in each category to ensure that the cost sharing ratios adopted through this IPART inquiry are appropriate for the costs presented, not just a rollover of ratios adopted in previous hearings.

4.4.2.1 – Total Asset Management Plan

The finalisation of the risk assessment process must be completed prior to the imposition of any charges associated with the proposed compliance annuity. While deferral may lead to a steeper price increase at some point in the future, it is essential that appropriate rigour has been applied to all costs that will be imposed on customers through this inquiry process. This is not the case for this cost at present.

The cost that is borne by users also needs careful scrutiny in the light of the fact that present dam safety standards require dams to be able to sustain a one-in-one million years water inflow, and concurrently, a one-in-one million years earthquake event. The likelihood of such events occurring concurrently is miniscule, yet the consequences of the failure of a dam would be catastrophic.

However, the standards set have been imposed to protect nearby townships, not to preserve the resource for irrigation purposes.

The River Murray provides Normal Security entitlement holders with a full allocation approximately 80 years in 100. Users might say they are comfortable with dams capable of sustaining one-in-one thousand year events. Any cost to be incurred by the Department that exceeds the basic requirements of users must be borne by the beneficiaries (cities and towns).

4.4.2.2 – Cost of Capital

This section requires far greater scrutiny than the explanation provided in the submission. For example, the Office of the Regulator-General, Victoria, set a Weighted Average Cost of Capital (WACC) of 6.8% for the electricity industry in its 2001-05 Electricity Distribution Price Determination. The WACC was set at such a level to "ensure that the returns implied by the final price controls are sufficient to attract new investment to the industry. However, it must also ensure that the interest of customers are protected and that price levels are more reflective of the outcomes expected from a competitive market than those that might arise in a market served by a monopoly".

This further emphasises the need for closer scrutiny of the assumption made by the submission that 7% is appropriate.

As current water users are funding 90% of the cost of future asset refurbishment requirements via an annuity, it is unnecessary for the same users to provide funds for the generation of a rate of return on that sunk investment. WMI adopts a similar approach in its pricing policies – shareholders pay for the cost of replacing the infrastructure over time, but are not required to pay a dividend on their own investment.

4.4.2.3 – State Water Renewals Annuity – Category 2

While the establishment of a separate sinking fund may not be required (i.e. thought necessary by Treasury), it is vital that these funds are protected from the whims of the day to day funding challenges of government.

Customers must be assured that the funds raised by the Department will be preserved for the exclusive use to which they were collected for. This could be achieved via the reporting of the accounts balance to appropriate user group meetings. It is also highly unlikely that in the hands of Treasury the balance of the invested funds will grow over time (as it would in a normal business).

The prospect of debt funding the replacement of major items of infrastructure must also not be discounted. The community is increasingly comfortable with entering into debt funding arrangements for productive purposes – the Department should be no different. In fact, significant benefits would come from debt funding such works, including:

- the increased transparency in water pricing experienced by having a debt to service for works completed; and
- the elimination of the need to set aside large amounts of money over time, which would be better used for productive purposes (by users) than for non-productive purposes (by Treasury).

4.4.2.4 – State Water Renewals Annuity – Category 3

Rather than have a community consultation process to determine the minimum level of capital required to mitigate water infrastructure risks (an engineering decision), it would seem more appropriate to consult on the level of risk the community wishes to accept (with the accompanying $ trade-off for greater or lesser risk).

4.4.3.1 – MDBC Renewals Annuity

WMI believes that if there can be no scrutiny by NSW water users of the costs of the MDBC, then there should be no contribution. Pressure needs to be brought on to the Commission to be more forthright in its provision of information to stakeholders. Until this information is presented, it is difficult to argue that any user should be paying anything for the services provided by the Commission.

4.4.3.3 – Groundwater Monitoring Bores

WMI submitted to the Department 18 months ago a proposal to amend the piezometer network required to be monitored by it to comply with the conditions of its Licenses. Part of the motivation for WMI having a consultant's report prepared was to avoid the unnecessary duplication of monitoring that is presently taking place in this region. To date WMI has received no substantive response from the Department.

Furthermore, WMI continues to monitor the network advised by the Department at privatisation, despite the fact that the wheel marks of the Department's vehicles often precede (by as little as a few hours) WMI's to the same piezometers and at the same time of the year. This is a startling waste of valuable resources, both for WMI and the Department.

The folly of the situation described above renders the Department's claim that the full cost of the program be recovered from customers difficult to swallow. Glaring inefficiencies are revealed in that the Department's monitoring program is duplicating WMI's.

4.4.3.4 – State Water Return on Capital

The calculation of the return on capital includes a return on proposed capital investment over the proposed price-ruling horizon (three years). It is important that such returns be only charged for on the basis of works completed – it would be ludicrous to allow a return to be factored into prices on an item of capital proposed to be built sometime in the price path, but not completed.

Again the methodology for the calculation of the asset base on which to charge the return on capital is raised in this section. Major refurbishment and replacement expenditure are cited as two areas requiring the application of a return. Again, COAG states that the return on investment must be based on the written down replacement value of those assets – it seems that the Department's application of the return varies from that proposed by COAG.

5.2.2 – High security/low security ratios

In the past WMI has supported the differential struck between high and normal security licenses. However, the changing nature of the river management system renders the differential no longer valid. Instead, WMI believes that an identical rate should be struck for both high and normal security entitlements.

Historically the differential rate was adopted because of the Department's reduced ability to sell normal security entitlement because of the air-space consumed by the high security water in carrying it over from one season to the next. This is far less often the case now as the MDBC Cap on diversions places greater constraints (resource based) on the ability of water to be carried over from season to season. High security water entitlement is no longer the restriction on air space that it was - resource constraints are more likely to impose 'costs' on the Department.

Furthermore, the Department now provides normal security entitlement holders with the ability to carry over up to 20% of their nominal entitlement from one season to the next. High security holders have their entitlement for next season preserved for them by the Department. The

administrative cost to the Department of accounting for all the normal security entitlement holders who wish to carry over their 20% of unused entitlement (WMI understands that nearly all eligible entitlement holders carry over their full 20%) would be much larger than the cost of accounting for a notional high security entitlement (as one number).

The historic reasons for the presence of the differential are now gone. The differential prices set for high and normal security entitlements should be abandoned too.

5.2.3 – Fixed and Variable Costs

The mix of fixed and variable costs incurred by the Department must be reflected in the pricing structure adopted by it. For that reason WMI supports the introduction of an appropriate minimum charge that reflects the cost of servicing all (especially small) accounts. Water entitlement and/or water use is a crude measure of the cost imposed on the Department to service a particular account. This is particularly the case for smaller licenses that require the same level of service as larger accounts, but whose charge is significantly less because of their lower entitlement/consumption.

5.2.4 – Wholesaler discounts

WMI commends to IPART the wholesaler discounts concept because of the significant savings generated for the Department by having to serve one customer instead of 400 (as in the case of WMI). This is also reflected in the comments made above about the need to charge small customers an appropriate amount.

Other Points

Thought must also be given by IPART to the potential for penalties being imposed on the Department for the failure to meet its obligations to customers. For example, no discount is offered to customers for the fact that during algal outbreaks water quality declines significantly and may be unfit for some purposes. This is particularly the case for the lower reaches of the River Murray where Blue Green Algae blooms are becoming the norm over summer months.

Industry based research may prove that such water is unfit for use in some crops. While this is an extreme example, WMI believes that such a penalty system would ensure that water quality in this reach of the river is preserved or heightened, rather than ignored (as happens at present).

AC
11.05.2001