Draft Position Paper Number 2

Should SunWater be able to charge BRIA irrigators a rate of return in respect of its Burdekin assets?

1. Background

Submissions have been received from certain stakeholders that SunWater should not be able to charge BRIA irrigators a rate of return in respect of its Burdekin assets because BRIA irrigators were not advised at auction, or upon the sale of land, that this would be the case. In addressing this issue, the Authority has considered:

- the capacity of governments to make and change policies;
- previous government water pricing arrangements;
- the nature of irrigators' price expectations; and
- current government policies and policy directions on rural water pricing.

BRIA irrigators also generally contend that irrigators should not be required to pay a rate of return as a result of issues such as sunk costs, the existence of externalities and capital contributions. These matters have been addressed in the individual responses and Draft Position Papers 1 and 3.

2. The Capacity of Governments to Make and Change Policies

Stakeholder Comment

Some stakeholder responses to the Authority's Draft Report contend that the Queensland Government is bound by its past policies in respect to water pricing, and these previous policies limit the current Government's capacity to change its position with respect to the recovery of a rate of return in irrigation water prices.

BRIAC submitted to the Authority that there are specific legal constraints - separate from the powers of Government to change policies from time to time - that prevent SunWater from now or ever seeking to recover a rate of return through water prices. These related to issues such as whether SunWater would be constrained from charging a rate of return under legislation prohibiting misleading or deceptive conduct, equitable estoppel and negligent misstatement.

BRIAC also commented that, as the Government did not state at auction that it intended to charge a rate of return in irrigation water charges, a private sector entity in SunWater's position would be legally prohibited from so charging:

> Private enterprise indulging in such behaviour would find itself before the courts (BRIAC submission in response to the Authority's Draft Report, p. 13).

QCA Analysis

Government policy frameworks determine the regulatory environment for both government-owned and commercial businesses. These policy frameworks are subject to ongoing change. Through the democratic process, Australian governments are elected to adopt, modify or replace existing policies. Within their elected terms, governments make decisions on an ongoing basis that change the business environment.

While policy changes may produce adverse consequences for individuals or communities, there is no explicit constraint on governments to not change a particular policy *solely* because to do so would be detrimental to the welfare of an individual or group of individuals.

As outlined in the Authority's Draft Report (page 97), the Authority's legal advice is that, following a review of past and current water legislation and the representations made by the State during the relevant period, the relevant Ministers are not constrained in specifying water charges for BRIA irrigators and that they have a broad discretion in setting such charges. This broad discretion includes the ability to require that SunWater recover a rate of return in such charges.

While this is the general position based on the available evidence, the Authority accepts that there could be individual cases where this general position does not apply due to the specific circumstances of the case, although the Authority is currently unaware of any such cases. However, the Authority does not consider that the Ministerial Direction envisages an assessment of the circumstances of each individual case to determine if there are any exceptions to the general position.

BRIAC has raised concerns about the particular circumstances relating to the Burdekin. In respect to these matters, after taking legal advice the Authority has concluded that there does not appear to be any evidence to support general claims for:

- misleading or deceptive conduct [as the material in the auction kits did not create the impression that the Government guaranteed not to increase water charges to include a rate of return at any time in the future];
- equitable estoppel [as the representations in the auction kits did not amount to a 'promise' that water charges would not be increased in the future to reflect a rate of return]; or
- negligent mis-statement [as it is not evident that the information provided by advisers breached their duty of care].

Furthermore, the Authority considers that the same general conclusions would apply in relation to a private sector service provider in the same circumstances.

Again, there could be individual cases where the particular circumstances of the case are such that this general position does not apply, although the Authority is currently not aware of any such cases.

Finally, the Authority recognises that governments have from time to time provided assistance to groups to adjust to the new policy framework either in recognition that industry may not be able to achieve the desired goals without such assistance or in recognition of the community's desire for an "equitable" sharing of the burdens of reform. Whether the government should do so is outside the Authority's mandate and is considered more appropriate for government to consider (see page 103 of the Draft Report).

3. Previous Water Pricing Policies and Irrigator Expectations

Stakeholder Comment

BRIAC has stated that as irrigators were not explicitly advised at auction that a rate of return would be charged, a rate of return should not now be charged (BRIAC submission in response to the Authority's Draft Report, pp. 2, 13). For example:

> … charging a positive rate of return is rejected by BRIA irrigators and amounts to moving the goal posts once investors have committed to purchase (p. 13).

And further:

> To suggest that Irrigators investing in the BRIA Scheme would have done so knowing that they would be required to pay an unknown rate of return on a yet to be determined value defies logic and fundamental business principles. It is significant that even at the last auction of BRIA farms in 1998 no advice was provided to prospective purchasers that there was a requirement to provide a rate of return as a component of water charges (p. 2 of BRIAC's submission in response to the Authority's Draft Report).

Similarly, CANEGROWERS stated that, as Government did not make their intention to seek a rate of return clear to growers at the time of sale, it is unreasonable to assume that growers factored this into their bids when purchasing land and water (CANEGROWERS in response to the Authority's Draft Report, p. 9).

BRIAC suggested that, as the Government had changed the policy environment for BRIA irrigators subsequent to their purchase of land, compensation should be payable to BRIA irrigators.

Various individuals who were involved in policy development at the time of the development of the Scheme and subsequent land sales have advised the Authority that, at no time during this period, did the Government indicate that irrigation water charges would include a rate of return. Statements to this effect have been provided to the Authority by:

- Mr Chapman, former Manager of the Burdekin District Canegrowers Executive from 1973 to 1989 and Secretary of the Committee responsible for lobbying and negotiations for the construction of the Burdekin Dam from 1976 to 1981;

- Mr L. Hall, former Chairman of the Queensland Rice Marketing Board, Chairman of the Lower Burdekin Rice Producers Co-operative, Chairman of the Queensland Council of Agriculture, Chairman of the Queensland Farmers Federation, Member of the Burdekin Dam Project Advisory Group from the mid 1980s to 1993;

- Mr L. Searle, former Chairman of the Burdekin District CANEGROWERS Executive from 1982 to 1992, Member of the Burdekin Dam Project Advisory Committee Executive from 1976 to the completion of the Dam; and

- Mr J. Smith, former regional engineer for the Department of Natural Resources at Ayr from 1984 to 1991.

QCA Analysis

Neither the Ministerial Direction nor the *Queensland Competition Authority Act* 1977 explicitly require the Authority to have regard to past policies. However, except in the case of a legislative prohibition, the Authority does not consider that a government's right to change policy precludes the Authority from taking account of a government's past actions and statements where this is relevant to efficient and equitable pricing, and in the public interest to do so. Such an approach has been adopted by the Authority in how it recognises capital contributions from land and water sales receipts (see Draft Position Paper Number 1).

The Authority's view is that it would be appropriate for it to have regard to the Government's past actions and statements, where:

- there is sufficient evidence of a government's intentions;

- these intentions create a reasonable expectation by parties of a certain outcome; and,

- recognition of this intention and expectation is consistent with, and promotes, the public interest.

The Intent of Government Policy

The intent of a government's policies might be inferred from a number of sources. The primary reference, of course, should be actual government policies, articulated policy statements and authoritative suggestions for the direction of policy development.

The following publicly available information on charging a rate of return in irrigation water charges was found that was relevant to the issues raised by BRIAC:

- in 1980, the Report to Parliament outlined that the continuation of existing prices in real terms would result in a 2.05 per cent real return on capital.[1] The 1980 report was integral to the Parliamentary approval of the Scheme, and was extensively publicly debated in Parliament. Local Burdekin media reports at the time also referred to the report and its findings;

- in 1987/88, DNRM commenced a five-year plan whereby all schemes would individually provide a surplus over direct local costs of operation and maintenance. For some schemes, increases in excess of inflation were approved by Government under this strategy and grower groups were advised of these intentions[2];

- in 1989, the enactment of the *Water Resources Act 1989* which included wide ranging powers to levy irrigation water charges, including for the purpose of raising moneys to defray principal monies and interest on borrowings, any other payment required by law to be made by it, and costs, charges and expenses for or in connection with the construction or acquisition or the maintenance, repair, administration, control, extension or renewal of works constructed by it or placed under its control (s. 9.39);

- in 1993, the release by the Queensland Government of a water pricing policy options paper *What Price … Water?*. One option outlined in the paper was for irrigation water charges to including a rate of return on capital of up to five per cent;[3]

- for Burdekin land auctions on 3 November 1993 (auction 12), 3 February 1994 (auction 13) and 29 June 1994 (auction 14), the release of material by the Department of Natural Resources which stated, under the heading of 'Water Charges' that, amongst other things, 'The State Government is conducting a review of water pricing policy options across Queensland'. Interested parties were invited to seek further information from the relevant contact officer. The contact officer has confirmed that she typically provided a copy of the policy options paper in response to queries posed in relation to future irrigation water charges;

- in 1994, the Queensland Government's agreement to the national strategic water policy framework under the Council of Australian Governments (COAG). Under this framework, the Government committed:

  – to the adoption of pricing regimes based on the principles of consumption-based pricing, full-cost recovery and desirably the removal of cross-subsidies which were

[1] Queensland Water Resources Commission. 1980. *Report on Establishment of Burdekin River Project Undertaking*.

[2] Letter of advice from DNRM to the Authority, 10 February, 2003. Note letter to Member for Burdekin regarding removal of rebates, 1 December 1987. Letter from then Minister for Water Resources and Maritime Services to Invicta Mill Suppliers' Committee, 20 October 1988.

[3] Department of Primary Industries. 1993. *Water Price … Water?* Executive Summary, p. 5 and Water Pricing Policy - Options Paper, p. 35

not consistent with efficient and effective services, use and provision. Where cross-subsidies continue to exist, they were to be made transparent; and

- in relation to rural water supply, to achieve a positive real rate of return on the written down replacement cost of assets, wherever practicable;[4]

- in 1995, the Queensland Government's commitment to National Competition Policy through COAG.[5] This agreement re-affirmed the original 1994 COAG agreement, which was rolled into the National Competition Policy. The effective implementation of this reform became a precondition of competition payments to the Queensland Government;

- in 1996, the Queensland Government release of a water pricing policy paper which acknowledged that 'For more recent schemes such as the Burdekin River Project, irrigators have met a component of the capital costs as well as other costs.'[6] The 1996 paper proposed the following water pricing policy in relation to existing irrigation schemes:

  - water prices for existing schemes will continue to be adjusted annually in line with any cost changes for providing the services;

  - the medium-term objective is to ensure water revenue for each sector (ie urban, agricultural and industrial) covers operating and refurbishment costs of providing supply by 2001; and

  - where the medium term objective is already being achieved, this situation will, as a minimum, be maintained.

The Authority also notes that there was a lengthy and public policy debate on these matters (although not necessarily restricted to the Queensland Government). For example:

- in 1992, the release of an Industry Commission (IC) report *Water Resources and Waste Water Disposal*, to which the Burdekin Dam Project Landowners Committee and particular BRIA irrigators made submissions. The IC report made several recommendations in regards to irrigation water prices, including that:

  - a rate of return should be charged in relation to existing schemes, where demand for water is sufficiently strong;

  - the rate of price increases faced by irrigators, and the combination of price increases and cost reductions required to provide a commercial rate of return, should be determined by negotiations between governments and bulk water suppliers; and

  - until such time as charges to irrigators are sufficient to provide commercial rates of return, the shortfalls in revenues should be directly funded by the owner government.[7]

  The IC report was widely reported in local Burdekin media, as well as in State-wide and national media sources. An article on front page of the Townsville Bulletin was headlined

[4] COAG 1994. *Council of Australian Governments Communique 25 February 1994 (Hobart)*. Available from http://www.premiers.qld.gov.au/about/igr/communiques/cag25294.htm

[5] COAG 1995. *Council of Australian Governments Communique 11 April 1995 (Canberra)*. Available from http://www.premiers.qld.gov.au/about/igr/communiques/cag11495.htm

[6] Department of Natural Resources. 1996. *Rural Water Pricing and Management*. Brisbane: Department of Natural Resources.p.6.

[7] Industry Commission. 1992. *Water Resources and Waste Water Disposal*. Report no. 26. Canberra: Australian Government Publishing Service.

'Water users 'must pay up''.[8] The same article noted comments by Irrigation Council and Canegrowers State Leader on the proposal, stating that 'many cane growers would be crippled if the State Government adopted the price increases recommended by the Commission.'

The Queensland Government's immediate response to the IC report was outlined by a spokesman for the (then) Primary Industries Minister: 'These recommendations are just that - they are recommendations…The Queensland Government is taking action on a water pricing review. When the review is finished early next year then we will look at the IC report and probably blend the two to come up with a new policy';[9]

- in 1993, the release of the Hilmer Report *National Competition Policy*, which envisaged the implementation of a monopoly prices oversight regime which would include provision for a normal commercial profit.[10] Whilst irrigation water charges were not specifically identified in this context, the Authority notes that Canegrowers - Burdekin District provided a submission to this review;

In regard to historical irrigation water charges in general, a recent information paper released by DNRM noted that, 'Prices charged for irrigation water rarely covered costs, and reflected a policy of government subsidies to encourage regional development through irrigated agriculture.'

DNRM advised the Authority that this statement reflected the situation that for many irrigation projects throughout Queensland, the full costs associated with capital invested by Government as well as on-going costs of operation and maintenance were not recovered from revenue from water charges – and, that projects were established to provide additional water supplies with a view to ensuring continued economic growth. There is no evidence that the Queensland Government committed to maintain such a policy in perpetuity.

The Authority has concluded that while there was no clear statement from government that a rate of return would be charged, it was evident that governments were changing their direction in respect to pricing towards more commercial pricing practices. Initially such statements related to the Queensland Government seeking in excess of local costs of operation and maintenance, and more recently took the form of national agreements under COAG to include a rate of return, where practicable. Grower representatives were advised of these changes in December 1987 and again in October 1988. The first auction sales of land in the BRIA were undertaken in March 1988.

Were Irrigators' Expectations Reasonable?

In principle, parties purchasing water rights should not be required to pay higher prices where it was originally clearly represented to them that prices would not increase. From an efficiency point of view, future responses of growers to new government policies might have unintended and undesirable effects if the parties no longer have confidence that the new initiatives will be respected. For these reasons the expectations of irrigators are considered to be relevant to the matter to hand.

While it is possible that irrigators' *actual* expectations may differ markedly from the Authority's view of *reasonable* expectations, the Authority considers that it is only appropriate to recognise those expectations that are considered to be reasonable. To do otherwise would remove the incentive for parties to seek to negotiate clear and unambiguous arrangements into the future.

[8] Cahill, A. 1992. Water users 'must pay up'. *Townsville Bulletin*. Saturday, September 26:1.
[9] Cahill, A. IC report 'not the final work on Burdekin'. *Townsville Bulletin*. September 26:3.
[10] Report by the Independent Committee of Inquiry (Hilmer Report). 1993. *National Competition Policy*. Canberra: Australian Government Publishing Service. p. 285.

The Authority accepts the statutory declarations provided by particular individuals that state that rates of return on irrigation charges were not explicitly discussed with growers during the auction period.

However, the Authority considers that growers were or should have been aware, that irrigation charges would increase in the future to exceed the direct local costs of production and maintenance. In this regard, the Authority notes that, over the period of development of the Scheme and subsequent BRIA land sales:

- there was significant public debate on this matter; and

- irrigators had access to various representative groups with specific responsibilities for information gathering and representative responsibilities, including for issues of water pricing. Indeed, irrigators have made cogent submissions to various inquiries and assessments of water pricing over the period under assessment, suggesting a relatively sophisticated level of understanding of the issues and ongoing policy debates.

Accordingly, the Authority considers that it was not reasonable for irrigators to have assumed that water prices, and the basis for determining water prices, would remain unchanged for ever.

While the Authority has noted in the Draft Report in respect of capital contributions (page 23) that available information indicated that certain payments were contributions "towards the capital costs of the schemes", the Authority has not found any evidence that SunWater (or its predecessor organisations) committed to never charging a rate of return in irrigation water charges for BRIA irrigators. However, the circumstances of individual growers may need to be considered where issues of particular and individual nature are considered relevant.

Irrigators have also claimed they would have bid lower amounts at land auctions, were it not for the expectations they had formed that water prices would not increase in the future to provide for a rate of return to SunWater. In this regard, the Authority notes that, even if irrigators were to have bid less at auction for BRIA land on the basis that they foresaw that water prices may increase in the future, there would be a corresponding reduction in the capital contributions implied in land/water sales revenues. Lower auction prices would therefore cause a higher "unaccounted for capital" value for the purposes of assessing whether or not SunWater's charges include an excess return on capital.

4. Current Water Pricing Policies

Under current legislative and policy settings, SunWater is subject to a range of commitments and legislative provisions:

- under the COAG water reform agenda, the Queensland Government has committed:

  - to the adoption of pricing regimes based on the principles of consumption-based pricing, full-cost recovery and desirably the removal of cross-subsidies which are not consistent with efficient and effective services, use and provision. Where cross-subsidies continue to exist, they are to be made transparent; and

  - in relation to rural water supply, to achieve a positive real rate of return on the written down replacement cost of assets, wherever practicable;

- under water pricing guidelines agreed to by all jurisdictions, full cost recovery under COAG water reforms is achievable through a band of prices. At one end of the scale, prices are intended to ensure ongoing viability of the service provider. At the other, prices are intended to avoid the recovery of monopoly rents. Flexibility was built into pricing so that

jurisdictional regulators could take the circumstances peculiar to each water service provider into account when setting prices within the agreed band. At any point other than lower bound there is some positive return on equity capital.

- under the *Government Owned Corporation Act 1993*, one of the key objectives of a corporatised entity is to be commercially successful and to act in accordance with its Statement of Corporate Intent (SCI). SunWater's SCI requires it to increase the value of its business to its shareholders.

- one of the key principles of corporatisation under the *Government Owned Corporations Act 1993* is to ensure, wherever possible, that each corporatised entity competes on equal terms with other business entities and that any special advantages or disadvantages of the corporatised entity because of its public ownership or market power be removed, minimised or made apparent. This principle is consistent with the Government's agreement to the principle of competitive neutrality under National Competition Policy;

- under the *Queensland Competition Authority Act 1997*, SunWater's declared irrigation water services provided to BRIA irrigators are regulated under monopoly price regulation. This requires the Authority to have regard to the protection of consumers from abuses of monopoly behaviour, the promotion of competition, the efficient use of resources, and other identified public interest concerns.

Thus, on the basis of current Government policy and the Ministers' Direction, the Authority considers that:

- SunWater is able to charge a rate of return in irrigation water charges for BRIA irrigators; and

- in calculating the maximum allowable revenues that may be achieved by SunWater in the BRIA, the Authority should include a rate of return component, calculated using the weighted average cost of capital.

At the same time, however, the actual prices charged by SunWater should have regard to a variety of factors, including the capacity of users to pay.

5. Summary

In summary, the Authority has concluded that:

- governments do have the capacity to make and change policy without, in general, providing compensation. However, there could be individual cases where the particular circumstances are such that this general position does not apply, although the Authority is currently not aware of any such cases;

- successive Queensland Governments indicated to irrigators that changes to pricing policy were being envisaged from about the time of the first auction;

- it was not reasonable for irrigators to have assumed that prices, or the basis for determining prices, would remain unchanged forever. Irrigators were or should have been aware, of the possibility that prices could increase in the future; and

- SunWater does have the capacity to incorporate a rate of return in its maximum allowable revenue (subject to a variety of factors, including the capacity of users to pay).

REFERENCES

Department of Primary Industries. 1993. *What Price… Water? Water Pricing Policy – Options Paper*. Brisbane: Queensland Government.

Department of Natural Resources. 1996. *Rural Water Pricing and Management.* Brisbane.

Industry Commission. 1992. *Water Resources and Wastewater Disposal.* Report No 26. Canberra: AGPS.

Queensland Competition Authority. 2000. *Statement of Regulatory Pricing Principles for the Water Sector*. Brisbane.

Queensland Competition Authority. 2002. *Burdekin Haughton Water Supply Scheme: Assessment of Certain Pricing Matters Relating to the Burdekin Irrigation Area: Draft Report*, Brisbane.

Queensland Water Resources Commission. 1980. *Report on Establishment of Burdekin River Project Undertaking*, Brisbane: Queensland Government Printer.