

Submission to QCA re Issues Papers released as at 29th November 2010

1. Issues Paper – Form of Price Control: SunWater Water Supply Schemes prepared by NERA Economic Consulting

This paper examines the application of price caps or revenue caps paying specific attention to the risk of revenue shortfalls in SunWater schemes due to highly variable demand patterns. In the first instance it needs to be recognised that SunWater is able to manage the risk of revenue shortfalls across portfolio of schemes located in areas with differing climatic conditions.

Also seasonal allocation systems in most resource operations plans need to be improved to encourage SunWater to better manage for water supply variability and the consequential impacts on water use and revenue. Improved seasonal allocation systems will also help irrigation customers address the risk of water supply variability.

SunWater also must redefine its' service provider role to encompass better managing for the impact of demand variability on revenue:

- a. Through the implementation of a range of efficiency measures in channel schemes
- b. Through implementing efficiencies to reduce variable cost eg variable costs associated with scheduling and delivery of water, electricity for water delivery, corrective maintenance and weed control comprise 25 to 32% of total costs across schemes.
- c. Through monitoring and measuring demand and water usage to inform day to day management of schemes.

By securing SunWater a risk free revenue stream through higher fixed tariffs or other measures to cap revenue will only discourage SunWater from improving its level of servicing to better manage for demand variability. This outcome will limit customer's capacity to manage for the risk of variable water supply and cost on farm.

The implications of the inclusion of a rate of return in Part A tariffs also needs to be examined particularly as this could mean a substantial increase in income to SunWater but provide little motivation to the water provider to improve the level of servicing as a result.

Recommendations:

1. The form of price control should be a price cap which is set to encourage SunWater to better manage for the impact of demand variability and drop in services initialisation on revenue.
2. Tariff structures should reflect fixed and variable costs for each scheme and the implications of a rate of return in Part A tariffs should also be assessed.
3. A clear determination of SunWater's role to manage its own risk.

2. Review of Issues Paper - Pricing Principles for Dam Safety Upgrades prepared by PricewaterhouseCoopers

The Qld Government has required QCA to recommend pricing principles for the inclusion of capital costs of spillway upgrades in scheme prices which would include funding for a share of the costs and a rate of return on that share.

QFF submits that the State Government has regulated to protect the community from dam failure and therefore should take responsibility for spillway upgrade costs. If QCA must examine this issue the following issues need to be considered:

- a. Achieving consistency with NSW Government approach which is funding 100% of spillway upgrades for dams constructed before 1997. This involves an expenditure of nearly \$300M by the end of the new price path in 2016.
- b. A clearly defined program for spillway upgrades for all schemes needs to be provided including those where works are completed or proceeding and confirming whether costs are only for spillway upgrades or other purposes eg future dam development (Burdekin) or dam repair (Kinchant).
- c. Definition of tolerable levels of risk for spillway upgrades which are consistent with risk standards for other infrastructure such as roads and railways
- d. Achievement of tolerable levels of risk to justify proposed spillway upgrades for each dam. If tolerable levels of risk cannot be achieved proposed upgrades should not proceed.
- e. Take account of what upgrades can be justified to provide protection against risk of failure over shorter time periods more in keeping with investment risk profiles facing farmers. Irrigation customers cannot afford to fund upgrades to protect against very long term events.
- f. Share the costs of spillway upgrade costs between medium and high priority customers for each scheme by applying headworks utilisation factors.
- g. Application of a beneficiaries pays approach taking into account the 'benefit' of protecting the Qld community from claims arising from spillway failures. Irrigation customers should only pay for benefits they directly receive from spillway upgrades
- h. If an impactor's pays approach is to be examined attention must focus on who requires the upgrades not on the customers of the scheme.
- i. Assess capacity to pay for each scheme based on a share of the capital costs and the payment of a rate of return on the investments.
- j. Communities are more concerned to assess the capacity of scheme infrastructure to deal with the risk of flooding that arises from a range of flow events and not just focus attention on major infrequent flow events that may require costly spillways upgrades.
- k. Clarification is sought on whether QCA should be determining pricing principles which will distinguish between works that may be required for flood mitigation and costs of works to address the risk of spillway failure.

Recommendation:

- The State Government has taken action in the interests of the Qld community and therefore should take full responsibility for spillway upgrade costs to address the risk of dam failure.
- The risk to communities of flood events of all sizes in schemes needs to be assessed to determine what program of works to be funded by the State Government to provide the maximum benefit for projected efficient costs.

3. Review of Issues Paper – Renewals Annuity or a Regulatory Depreciation Allowance prepared by SAHA

This paper examines the application of a renewals annuity (currently applied by SunWater) or a depreciation allowance to recover SunWater’s expenditure on renewing and rehabilitating existing assets.

QCA should give priority to the practical implications of implementing either approach for SunWater assets in making a selection. Key issues that need to be considered include:

- a. Renewals annuity is suited to the irrigation industry where assets are refurbished and enhanced over the long term rather than being replaced and involves less costly external financing.
- b. Renewals annuity already provides for a rate of return and assumes the value of the existing assets (ie the Regulatory Asset Base (RAB)) to be maintained in perpetuity.
- c. SunWater customers support the existing SunWater renewals program established since 2000 because it provides them certainty into the future in regard to expenditure on renewing and rehabilitating existing assets and can be quantified in the field.
- d. SunWater customers want to see the further development of asset management planning in consultation with scheme customers to underpin a continuing renewals annuity with accountability for the efficient investment of the renewals reserve as was provided for in the original customer service charter.
- e. Customers should approve the 5 year renewals program for the proposed price path and should review the implementation of the program annually. Costs of renewals that exceed program allocations require customer approval.
- f. The implications of changing to a depreciation approach will involve consideration of how positive or negative renewals reserves are to be distributed which is likely to prove difficult at the scheme level even if there are positive balances to distribute. This process will be complicated by other considerations such as pricing implications for depreciating scheme assets and data availability to support regulatory depreciation calculations.
- g. Depreciation is not appropriate for schemes with assets that have a lives well in excess of 100years.

Recommendation:

QCA continue with the SunWater renewals annuity for the reasons outlined in this paper.

4. Review of Issues – Tariff Structures prepared PricewaterhouseCoopers

A range of issues are examined in this paper including two part tariffs, inclining and declining block tariffs, seasonal pricing, marginal cost pricing, and differential pricing. Other charging issues are also addressed including drainage charges, channel water harvesting charges, recovering recreational costs, forecasting demand, price indexation and the implications of free allocations.

QCA should examine the following issues:

- a. Apply a standardised two part tariff across all schemes unless specific schemes propose an alternative. Also apply tariff options suited to particular schemes such as the declining block tariff in Mareeba
- b. Tariff structure must not impede the implementation of seasonal transfers and carry over, assessment of exit fees and conversion factors and all other scheme rules that may apply.
- c. Examine the implications of the tariff structure for:
 - Extended periods of low or no supply
 - Improving low usage rates

- Achieving water use efficiency gains
 - Competitive outcomes
 - Consistency across schemes
- d. Review options for drainage charges to assess which approach is best to recover costs in effected schemes.
 - e. Effectiveness of current drainage charges in dealing with for example salinity problems. Should a charge continue to be applied if it is not effective in addressing these issues? It may be impediment to addressing salinity problems.
 - f. Limited value of forecasting demand if Part B charges reflect marginal costs
 - g. Further investigate price indexation and cost escalation to determine preferred options to apply.
 - h. Application of price indexation factors which account for productivity improvements or provide for incentives for SunWater to meet service obligations
 - i. State Government to meet the costs of free water in the Barker Barambah and Burdekin schemes.
 - j. Channel water harvesting should be based only on the variable costs of providing this service
 - k. Communities to meet the cost of recreational services
 - l. Adopt use of water over the last ten years as a basis for assessing demand
 - m. Implications and transparency of the addition of rate of return to fixed tariffs
 - n. Fixed tariffs should only recover lower bound costs in poorly performing schemes.

Recommendations:

1. Apply existing two part tariff structures to reflect the fixed and variable costs for each scheme.
2. Recreation costs should not be recovered from SunWater customers but from the communities that benefit from the use of these facilities.

5. Rate of Return prepared by SAHA

QFF is opposed to the Government's decision to apply rate of return on bulk assets for the following reasons:

- a. Schemes that will have to pay much higher prices to cover a rate of return on existing bulk water supply assets (i.e. dams and other headworks) are unlikely to agree to further investment, with the addition of a rate of return, to modernise and to address environmental issues.
- b. The approach to rate of return is not consistent with that adopted in southern states and is likely to result in water prices in SunWater schemes that are not competitive with southern schemes. There are also State and Commonwealth Government investment programs which are helping southern schemes to modernise and be competitive.
- c. Agricultural schemes do not have a capacity to pay a rate of return
- d. Application of a rate of return makes the future of irrigation industry more uncertain particularly for schemes that are subject to capacity to pay constraints.
- e. There is significant risk that application of a rate of return will force the closure of irrigation schemes leaving government with the financial burden of unproductive assets.

QCA should examine the following issues:

- a. The assessment of rate of return should take into account that SunWater is a significantly low risk enterprise because:
 - It is a monopoly supplier
 - It operates under a low risk 'decentralised regime' to provide bulk water, channel delivery and drainage services
 - Renewals annuity significantly reduces risk

- Part A charges cover fixed costs
 - Low risks re non payment of water charges
- b. SunWater has established a renewals annuity for the period 2000 to 2011 so there should be no increase in the Regulated Asset Base (RAB) for this period. The assessment of the RAB should also take into account the return on capital paid as part of the renewals annuity during this 11 year term.
 - c. Investigate the application of a defined WACC to apply for assessment of RAB values, renewals and working capital. This WACC should reflect that SunWater is low risk enterprise.

Recommendations:

1. Application of a rate of return on bulk assets is not justified and should be zero.

6. Capital Cost Allocation prepared by PricewaterhouseCoopers

This paper examines the utilisation of headworks for irrigation as a means of allocating the capital costs of bulk supply assets between scheme users (irrigation, urban, industrial users) with different supply priorities. SunWater has prepared a Technical Paper which assesses headworks utilisation factors for each scheme. This paper needs to be released and reviewed before any definitive comment can be provided on this proposal.

Issues that QCA needs to examine include:

- a. A clear definition of bulk assets to distinguish bulk from distribution assets
- b. Entitlement share for headworks – nominal entitlements supplied by headworks for irrigation, urban and industrial use
- c. Reliability of entitlements taking into account the capacity requirements of headworks to meet the requirements of high and medium priority entitlements taking into account the implications of focusing particularly at the application announced allocation rules defined in Resource Operations Plans over periods of low flows and the implementation of drought management strategies and cut offs to irrigation access.
- d. Resource Operations Plan conversion factors which apply in different schemes and the implications of the capital cost allocation being different from the conversion factors.
- e. Headworks Utilisation Factors should be determined based upon the contiguous 15 year period that recorded the lowest water supply for medium priority use over the full hydrological term for each scheme. This principle best reflects the rights high priority users have to utilise schemes for the purposes of allocating headworks capital and operating costs.
- f. Detailed scheme by scheme review of the application of proposed Headworks Utilisation Factors.
- g. Application of the Headworks Utilisation Factors for the allocation of headworks capital and operating costs and spillway upgrade costs.
- h. Purchase of land and water entitlements in many schemes has already compensated the State Government for the capital costs of establishing these schemes
- i. Capitalised value of water entitlements has an impact on farmers borrowing levels. Higher tariffs means lower capital value/equity and reduced financial security
- j. Consistency with other jurisdictions – NSW has sunk legacy costs as at 1997 how will the approach adopted for SunWater schemes deliver a consistent and competitive outcome.
- k. Upper bound pricing cannot be applied to old headworks because such headworks have no effective capital value in the hands of SunWater.
- l. In channel schemes where the two part tariff reflects the fixed and variable cost split these costs should be allocated equally between high and medium priority customers.

Recommendation:

Headworks utilisation factors should be assessed on the basis of the performance of each scheme over the 15 year term which reflects the poorest hydrological performance for supply for medium priority use.

7. Capacity to pay being prepared by ABARE

QFF submits that capacity to pay investigations will not be given the time or funds necessary to adequately assess the differences between channel and river based schemes, between the range of agricultural products grown in each scheme and between growers. Variations in the market value of agricultural produce into the future will also have to be assessed.

At the time of drafting this submission there has been no issues paper tabled by QCA

Issues that were identified from the scheme and regional consultation meetings for QCA to examine include:

1. Agriculture usually achieves a 0 to 2 % rate of return so there is no capacity to pay. There has been a 22% fall in production in the sugar industry in 4 years to 2009 which clearly indicates that this industry does not have capacity to pay.
2. Capacity to pay must take into account the yearly cost of owning supplemented allocation, as a large percentage of irrigation water used is purchased as seasonal transfer water, which has an opportunity cost component of owning the allocation embedded in it.
3. SunWater irrigation customers need to earn a risk free return on farm capital investment plus a minimum profit level before they can be assessed as having a capacity to pay
4. Assessed scheme prices should not cause negative impacts on schemes or industries
5. Accurate data must be used to implement a consistent approach to assessing capacity to pay from scheme to scheme.
6. Opportunities to adjust prices if conditions that affect the capacity to pay change significantly in a scheme or industry over the 15 year term.

Recommendation:

1. QCA must undertake industry based assessments of capacity to pay which focus on farm gate price impacts within each scheme.

8. Review of SunWater Network Service Plans (Capital & Operating Expenditure)

It is understood that QCA is preparing to review the prudence and efficiency of the proposed capital and operating expenditure in SunWater's Network Service Plans. This will cover scheme capital and operating costs and head office and regional office costs.

At the time of drafting this submission there has been no issues paper tabled by QCA covering these items. QFF does not propose to submit on the reviews of NSPs at this stage.