



MSO10/2427
W10/704

Ms Isabelle Arnaud
Director, Water Market Section
Department of the Environment, Water, Heritage and the Arts
GPO Box 787
CANBERRA ACT 2601

10 SEP 2010

Dear Ms Arnaud

I refer to the letter of 6 July 2010 (reference: B10/1093) from Senator the Hon Penny Wong, Minister for Climate Change, Energy Efficiency and Water, to the NSW Minister for Water, the Hon Phillip Costa MP, inviting comment on the proposed Water Charge (Infrastructure) Rules 2010 in order that Minister Wong can proceed to make the rules.

Attached is the NSW submission on the charge rules, which has been coordinated by the NSW Office of Water. The salient issues relating to Parts 6 and 9 of the rules are discussed in the submission and summarised below.

Part 6 - charge rules for operators

Annual pricing reviews. Rule 34 provides for charges to be varied within a determination period as a result of changes in demand and consumption forecasts. Given the potential for greater revenue stability and more cost reflective annual charges, this approach is generally acceptable, but should not mitigate against the setting of tariffs reflecting the operators' fixed and variable cost components. Moreover, the rules should ensure the annual review process does not impose an increased regulatory burden on the regulator and operator.

Cost recovery methodology. Rule 29(2)(b) provides for government contributions to be decided outside the determination process rather than by the regulator. This approach offers administrative simplicity and avoids the need for the regulator to become involved in jurisdictional policy settings. A concern is that government contributions may be set at widely varying levels, reducing competitive neutrality across the Basin, in conflict with the Basin water charging objectives and principles. It is essential the rules allow for the statewide government contribution and resultant net revenue requirement to be regionally dissected, to ensure cost reflective tariffs can be set and sharp price increases avoided in valleys subject to ongoing subsidies or CSOs.

Part 9 - accreditation of regulators

The rules for accreditation, including Rule 60(2) requiring an application for accreditation to have state government support, are generally acceptable to NSW. A NSW decision on accreditation will be made by mid June 2012 within the timeframe specified in the rules.

I trust this submission will assist you in the consultation process prior to Minister Wong making the rules.

Should you wish to discuss the matter further, please contact Rick Rundle, Principal Policy Officer, Water Pricing, of this Office, on (02) 9895 7445.

Yours sincerely

A handwritten signature in black ink, appearing to read "David Harriss". The signature is written in a cursive style with a large initial 'D'.

David Harriss
Commissioner, NSW Office of Water

**NSW Submission on
Water Charge (Infrastructure) Rules 2010
under Commonwealth Water Act 2007
September 2010**

Introduction

The draft rules contain a number of administrative provisions, including changes proposed by DEWHA. These rules are acceptable to NSW. The salient issues relating to Parts 6 and 9 of the rules are discussed below.

Charge rules for operators (Part 6)

Price variations (Rule 34)

This rule provides for the operator to apply annually to the regulator to vary water charges within a determination period, but only as a result of changes in demand and consumption forecasts.

This rule should assist in maintaining revenue stability for the operator, and obviate the need for supplementary funding, or to incorporate a revenue smoothing device in a pricing determination, either of which could be triggered in times of low allocations. It is also noted that, under the rules, price variations themselves must have regard to price stability, meaning sharp frequent price changes could not be implemented. It is presumed this requirement would override the implementation of price variations that would arise from changes in demand/consumption.

As any price variation is contingent on demand/consumption changes, in NSW the usage charge component of its consumption-based tariff would vary, with the fixed charge component being based on entitlement volume remaining unchanged. Possible pricing impacts may include:

- potential uncertainty for users in their longer term financial (farm business) planning;
- little or no reduction in water bills in times of low allocations when farm profitability may be relatively low;
- potentially perverse price signals when users collectively attempt to reduce consumption in order to reduce their water bills but this action is offset by increased charges; and
- improved budgetary planning for operators because of greater control over their revenue base. This could, at least initially, result in lower, more cost reflective annual charges, as tariffs would not need to be structured for risk averse (lower) consumption levels or for potential reductions in projected consumption over a long term price path.

Given the underlying need to maintain price stability, in conjunction with potential for greater revenue stability and more cost reflective charges, this rule is considered generally acceptable to NSW. However, the fact that this mechanism will be available should not preclude ensuring that price structures appropriately reflect the regulated entities' fixed and variable cost components.

Moreover, the rules will need to ensure that the annual review process does not impose a significantly increased regulatory burden on the regulator and operator.

Asset base (Schedule 2)

Section 3.1 of the ACCC draft pricing principles provides that where a regulatory asset base valuation has been set by a state regulator, this is to be taken as the opening asset base under the Part 6 rules. Once set, this asset base is not to be subject to revaluation. While the ACCC notes that this will avoid price shocks to customers, it should not be the primary aim of the regime, and should not be pursued without due consideration of efficient pricing and jurisdictional equity.

Jurisdictions could be expected to have adopted differing approaches in establishing the regulatory asset base for bulk water utilities. In many cases, they may have opted to write back their utilities' asset bases to reflect existing pricing, with such pricing derived from a range of historical pricing practices.

Establishing national water rules for bulk water pricing provides an opportunity for the asset bases of the various bulk water operators to be reset, and a consistent methodology, preferably Modern Engineering Equivalent Replacement Asset (MEERA) value, could be adopted. Once established, this methodology could be 'locked in' and subsequently adjusted for indexation, depreciation and new capital. The resultant price impacts on customers could be progressively adopted so as to avoid price shocks.

Cost recovery methodology (Rule 29(2)(b))

A key DEWHA policy change is in the way charges will be set under the rules:

- the regulator assesses an operator's total (government and user) efficient costs, from which the total revenue requirement will be derived;
- revenue contributions from government will be subtracted from the total revenue requirement, to enable the regulator to ascertain the net revenue that charges need to recover; and
- charges are set based on this amount.

Thus costs will continue to be assessed for efficiency, as is currently done by the Independent Pricing and Regulatory Tribunal (IPART) in NSW, except that government contributions will be decided as an independent input outside the determination process, rather than by the regulator.

This approach to determining revenue requirements has some advantages in terms of administrative simplicity and avoids the need for the regulator to become involved in jurisdictional policy settings.

An overarching consideration will be the assessment of efficient costs. If this is stringent, the scope for increasing charges could be constrained, or if less stringent, the scope for increasing charges could be enhanced.

However, within the efficient cost framework, government contributions may still be set at low levels, resulting in higher user charges revenue, meaning prices could increase above existing levels. Governments could then elect to provide supplementary funding (or fund other bulk water related activities) outside the efficient cost framework, in part to offset their lower efficient contributions. Alternatively, government contributions may be deliberately set at high levels to reduce user charges. In either case, there may be a reduction in the competitive neutrality across the Basin - because the bases of developing tariffs will be different - that may otherwise prevail if costs were to be apportioned by an independent regulator.

The new rule signals a move away from the commonly adopted and longstanding approach of recovering costs through cost sharing - either from those who cause the costs to be incurred (impactors) or from those who benefit from the activities (beneficiaries) concerned - to a utility style of cost recovery. 'Cost sharing' has been favoured for bulk water largely because of the difficulties in direct cost attribution for the activities concerned. In NSW, the cost sharing criteria applied by the regulator involves a legacy versus current/forward costs test applied to total costs, followed by an impactor pays test applied to current/forward costs, resulting in a split up of costs to be recovered from users and from government contributions. This means the regulator effectively sets the notional level of government contributions over the price path.

In practice, the level of government contributions may be decided before and outside the determination process, possibly with collaboration between the agencies concerned, which could utilise a cost sharing process for this purpose as appropriate. However, this approach would not apparently be enforceable.

The proposed approach suggests there would not be a transparent relationship between the government contributions and an allocation of the costs incurred by the bulk water provider. This would appear to conflict with one of the water charging principles in the *Water Act 2007* (Commonwealth), that "pricing policies should ensure consistency across sectors and jurisdictions where entitlements are able to be traded" (Part 3 Section 3 Clause 7).

It is also unclear how the proposed approach towards the treatment of government contributions would progress the principle in the Act that if "full cost recovery is unlikely to be achieved and a community service obligation (CSO) is deemed necessary:

- the size of the subsidy is to be reported publicly; and
- where practicable, subsidies or community service obligations are to be reduced or eliminated (Part 3 Section 3 Clause 6)".

It is considered that the ACCC should be asked to review how the new rule could better reflect the abovementioned pricing principles.

As the proposed approach is essentially a 'single till' pricing arrangement, it may discourage bulk water businesses from engaging in profitable activities outside of their regulated business.

Other than indicated above, it is not possible to assess the full impact of the proposed change on government, operator or water user at this stage. It should in summary facilitate administrative simplicity and avoid the need for the regulator to become involved in jurisdictional policy settings, potentially reducing the regulator's price setting role.

If the proposed rule is adopted in its current form it will need to allow for government contributions and resultant net revenue requirements to be dissected into valleys (or catchments, aquifers, or water sharing plan areas). This will ensure tariffs are set on a cost reflective basis and that sharp price increases are avoided in valleys that are subject to ongoing subsidies or CSOs. While the rules do not explicitly make the relative provisions, the ACCC and DEWHA have advised that regionally-based cost recovery would be allowed to continue.

Accreditation of regulators (Part 9)

Accreditation rules

The accreditation framework provides for state agencies to set bulk water charges. In NSW, IPART currently sets bulk water charges for the Part 6 operator, State Water, while Part 7 operators (irrigation corporations and districts) set their own prices. Under ACCC regulation, the ACCC will determine or approve prices for the NSW bulk water infrastructure operators within the Basin, or on a statewide basis with referral of powers. The Part 9 rules for accreditation covering these arrangements are considered acceptable to NSW.

Rule 60(2)(c) on state government support for accreditation

This rule provides that an application for accreditation of a state regulator must have state government support. This would ensure a state regulator does not make a unilateral application without the concurrence of government. This rule is acceptable to NSW.

NSW notes that an application for accreditation of a state-based regulator is required to be made two years before the expiry of the current price determination. As the current price determination for State Water will expire in mid-2014, NSW will make a decision on whether to pursue accreditation for a state regulator prior to mid June 2012.