

<b>Date</b>	04/07/2017
<b>Title</b>	Supplementary questions and response by the NSW Independent Pricing and Regulatory Tribunal (IPART of 'The Tribunal') - Inquiry into the augmentation of water supply for rural and regional NSW (hearing in Sydney - 5 June 2017)

## Supplementary Questions

### Questions provided to the committee by the Peel Valley Water Users Association

We provide below each of our responses to the supplementary questions raised by the Peel Valley Water Users Association (PVWUA) as part of the hearing that took place in Sydney on 5 June 2017.

We also note that, since IPART's appearance at hearing, IPART has released its Final Report and Determination of WaterNSW Rural's bulk water prices to apply from 1 July 2017, which includes WaterNSW's prices for the Peel Valley. This Final Report and Determination, which were released on 13 July 2017, are available at IPART's website: [www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au).

#### Question

1. What is IPART's definition of a 'perverse pricing outcome'?

On Page 210 of the IPART Draft Report, IPART states that '*We consider that prices in this determination are not perverse, unfair, inequitable or anti-competitive*' and '*We also consider that the prices in the Peel valley do not produce perverse outcomes*'.

Given that a 'perverse pricing outcome' would be a breach of the Commonwealth Water Act, will IPART please provide the Inquiry with the definition of a 'perverse pricing outcome' that IPART has used in order to determine that the proposed prices in the Peel Valley are not in breach of the Commonwealth Water Act?

#### Response

For the Draft Report on WaterNSW's rural bulk water prices to apply from 1 July 2017 (released on 14 March 2017), the Tribunal considered that the draft prices for the

Peel valley were not perverse and would not produce perverse outcomes. This was based on the following considerations:

- ▼ Draft prices were set to reflect the customer share of WaterNSW's efficient costs to store and deliver bulk water to customers, based on the best available information at that point in time.
  - This involved commissioning expert consultants to review WaterNSW's proposed expenditures and make recommendations to the Tribunal on the prudence and efficiency of these proposed expenditures.
  - WaterNSW's proposed expenditures were also made publicly available and public hearings were held so that stakeholders could make comment and WaterNSW could respond.
- ▼ The level of water entitlements had remained stable and there was no markedly observable downward trend in water usage, including the period 2006 to 2016, where prices were increased so that full cost recovery could be achieved. This indicated that as prices reached cost-reflective levels, the total benefit of bulk water services was greater than or equal to the total charges paid in the Peel valley.
  - As a fundamental pricing principle, prices should be set within the efficient pricing band. The upper limit of this band reflects customers' willingness to pay. Where prices are higher than the upper limit, there is a broad change in customer behaviour. This would include the surrender and return of licences and a clear reduction in water use – however, this was not the case in the Peel valley.
- ▼ Analysis of bill impacts showed that, under the draft prices:
  - A typical high security customer would face a bill decrease of 11%, including inflation, over the 4-years to 2020-21, and
  - A typical general security customer would face a bill increase of 1%, including inflation, over the 4-years to 2020-21.<sup>1</sup> The Tribunal did not consider that these bill impacts on general security customers were substantial.

For the Draft Report, IPART maintained the prevailing tariff structure for the Peel valley (and for most other valleys) – ie, 40:60 fixed to variable.<sup>2</sup> This was based on a general preference amongst WaterNSW's customers for a higher variable component to their bills, to better match their own business cashflows.

In response to the Draft Report, certain stakeholders from the Peel valley, including the PVWUA, expressed a preference for a lower usage charge (albeit, offset by higher

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<sup>1</sup> 'Typical' customer bill impacts analysis were based on high security entitlement holders at 100% of usage and general security entitlement holders at 60% of usage – these were standard definitions applied across all valleys.

<sup>2</sup> Under this structure, prices are set so that 40% of the target revenue is expected to be recovered from the fixed entitlement charges (\$ per ML of entitlement held) and 60% of target revenue is expected to be recovered from the usage charge (\$ per ML of water actually taken or used).

entitlement charges). That is, a tariff structure based on a higher fixed to variable ratio.

In response to stakeholders' submissions and further consideration, the Tribunal decided to adopt an 80:20 fixed to variable tariff structure for the Peel valley, from 1 July 2018 onwards. This was on the basis that:

- ▼ an 80:20 fixed to variable tariff structure better reflects WaterNSW's largely fixed cost structure, and strikes a reasonable balance of risk sharing between WaterNSW and its customers, and
- ▼ the relatively low level of water allocations to licence holders in the Peel valley would lead to a high usage charge under a 40:60 tariff, with associated low fixed charges.

The Tribunal's decision of adopting an 80:20 tariff structure means that the usage price in the Peel valley decreases from the current (2016-17) \$58.26 per ML to \$18.36 per ML (\$2016-17) from 1 July 2018 onwards.

For prices in 2017-18, the Tribunal maintained the existing 40:60 tariff structure to allow Tamworth Regional Council (TRC) twelve months to prepare for the change.

The impact of the tariff structure change, along with a reduction in costs, results in the following bill impacts under the 2017 Determination:

- ▼ for a typical high security customer, a bill decrease of about 30%, including inflation, over the 4-years to 2020-21, and
- ▼ for a typical general security customer, a bill decrease of about 57%, including inflation, over the same period.

## Question

### 2. What is IPART's definition of 'price gouging'?

On Page 210 of the Draft Report, IPART states that *'WaterNSW is not price gouging under our determination...'*

However, also on Page 210 of the Draft report, IPART states that *'As a fundamental principle, prices should be set within the efficient pricing band. The upper limit of this band reflects customers' capacity to pay. Where prices are higher than the upper limit, there is a broad change in customer behaviour. This would include the surrender and return of licences and a clear reduction in water usage.'*

The principle of increasing water usage charges in one valley until the point that customers can no longer afford to pay the charges and are forced to surrender their licence certainly appears to be price gouging by a Government-owned monopoly. Given that IPART has stated that *'WaterNSW is not price gouging under our determination'*, will IPART please provide the Inquiry with the definition of 'price gouging' that IPART has used in order to determine that the proposed prices in the Peel Valley are not 'price gouging' by a Government owned monopoly?

Further, the continual increase in the charges imposed by a Government-owned monopoly, until customers are forced to return licences, appears to be highly inappropriate conduct by a monopoly. Will IPART please provide the Inquiry with the justification for permitting this behaviour by a Government-owned monopoly?

## Response

The Tribunal considered that WaterNSW would not be price gouging under its Draft Determination as the prices were set to recover WaterNSW's efficient costs (customer share) of storing and delivering bulk water to customers.

Consistent with the National Water Initiative (NWI) principles, the Tribunal aims to set prices that fully recover the customer share of WaterNSW's efficient costs. As mentioned above, WaterNSW's proposed operating and capital expenditures were examined for their prudence and efficiency. The maximum prices set by the Tribunal reflect its view of WaterNSW's efficient costs (customer share) in providing its regulated bulk water services over the 2017 determination period.

However, we note that for valleys substantially below full cost recovery (ie, the North Coast and South Coast valleys), the Tribunal adopted a different approach to setting prices. At 2016-17 prices and with the historical 10% real per annum increase in prices to full cost recovery (which occurred over previous determination periods), there has been evidence of declining customer numbers and average water sales in

the North Coast and South Coast valleys.<sup>3</sup> This indicated that prices may be approaching customers' capacity to pay in these valleys and that further price increases towards full cost recovery may price customers out of the market before full cost recovery is achieved. As such, the Tribunal decided to set prices with reference to an efficient pricing band in these valleys. The upper limit of this efficient price band reflects customers' capacity to pay for WaterNSW's services and the lower limit represents the costs that WaterNSW would avoid if it did not have to supply those services to those customers.

The above behaviour (ie, declining customer numbers and average water sales) was not clearly evident in the Peel valley. Despite achieving full cost recovery in the Peel valley, licence numbers and entitlement volumes have remained relatively stable and there has not been a definitive downward trend in water usage in recent years (eg, compared to the average annual usage over 2006-07 to 2014-15 of about 10,490 ML per year, total water usage in the Peel valley for 2015-16 was about 11,012 ML, which is a 5% increase).<sup>4</sup>

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<sup>3</sup> WaterNSW, *Pricing Proposal to IPART for Rural Bulk Water Services*, June 2016, p 30.

<sup>4</sup> WaterNSW correspondence, April 2017.

## Question

3. Can IPART please justify the imposition of 'Full Cost Recovery' charges in the Peel Valley, when IPART has previously stated that *'full cost recovery could not be achieved without substantial increases in tariffs that would have damaging impacts on users'*?

In its 2006-10 price determination, IPART stated:

*In some valleys full cost recovery could not be achieved without substantial increases in tariffs that would have damaging impacts on users. In some instances (e.g. North Coast, South Coast and Peel), the Tribunal considers that cost reflectivity will never be achieved. In such instance, it considers State Water should review the future of these services and consult with government in those cases where it considers that the service could be recognised as a community service obligation 2*

*IPART has subsequently stated that State Water and the NSW Government should assess the long term viability of its operations in valleys such as Peel Valley that are below full cost recovery.'*

Despite IPART's own declaration that **'full cost recovery could not be achieved without substantial increases in tariffs that would have damaging impacts on users'** (in the Peel), Section 12.4.3 on Page 144 of the IPART Draft Report states that:

*'The Peel valley is now at FCR, achieved in 2016-17.'*

Given that in 2006, IPART recognised that Full Cost Recovery in the Peel Valley would have *'damaging impacts on users'*, will IPART please provide the Inquiry with the justification for imposing charges on customers that are known to have damaging impacts on them?

## Response

The Tribunal aims to set cost-reflective charges. This ensures that customers are faced with the true, efficient costs of the services they receive, which promotes efficient water consumption decisions, and the efficient use and allocation of resources.

At each price review, the Tribunal makes its decision using the best available information at that point in time. We note that circumstances can change and better information can become available in subsequent price reviews, particularly the impact of changes in prices on customers' behaviour.

As the PVWUA has identified, the Peel valley is now at full cost recovery.<sup>5</sup> As noted previously, despite achieving full cost recovery, licence and entitlement numbers have remained relatively stable, and there has been no markedly observable downward trend in water usage.

### Question

4. Regarding valley based pricing:

4 (a) On Page 209 of the Draft Report, IPART acknowledges that *'the small customer base means that the price per ML would be higher for Peel valley users than users in other valleys with a larger customer base'*.

Does IPART agree that it is not the fault of Peel Valley irrigators that there is a small number of users in that valley, and as they cannot change the size of the customer base it is inappropriate to impose substantially higher charges in that valley for a commodity which can only be obtained from one Government-owned monopoly. It would appear to be within IPART's role to state that it is not appropriate to apply the existing charging rules that have been adopted by a Government-owned monopoly across all valleys because the pricing system obviously delivers skewed pricing outcomes based on the number of customers, and the number of megalitres in each valley.

### Response

As indicated by the PVWUA, the small customer base in the Peel valley means that the price per ML would be higher for Peel valley users than for users in other valleys with a larger customer base.

In its Draft and Final Report, the Tribunal considered it appropriate to maintain valley based pricing. Setting a uniform price across WaterNSW's valleys (or a move away from valley-based pricing to more aggregated pricing in general) would mean that prices are less cost-reflective and less transparent. In turn, this would mean that:

- ▼ Prices would not signal to customers the cost of servicing their locations, thereby distorting location-based consumption and investment decisions. Cost-reflective prices are important to provide efficient pricing signals to users and subsequently promote the efficient use of water.
- ▼ Lower cost valleys would subsidise higher cost valleys – ie, users in some valleys would pay prices that are higher than the efficient costs of supplying services to

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<sup>5</sup> All valleys to which WaterNSW's regulated bulk water charges apply are at full cost recovery with the exception of the North and South Coast valleys (which the Tribunal applied a different approach for its 2017 Determination, as discussed under Question 2).

them, so that users in other valleys could pay prices that are lower than the efficient costs of servicing them.

### Question

4 (b) If it is the genuine intention of IPART to impose cost reflective charges in all valleys, can IPART please justify the reason that Peel Valley water users pay 100% of the Full Cost Recovery charges of the Peel Valley in return for access to just 5% of the water in the Peel River?

It appears totally inappropriate that water users in the Peel Valley pay Full Cost Recovery charges on the 95% of water in the Peel River *that they can never access*, and which then flows downstream into other river systems, from which WaterNSW then progressively recoups full cost recovery charges in each successive river system.

### Response

IPART sets WaterNSW's prices to recover the customer (or entitlement holder) share of its efficient costs of storing and delivering bulk water to entitlement holders. Water entitlement holders are not paying for the water itself, as they own this through the entitlements system. Rather they are paying their share of the efficient cost of storing and delivering water to them.

Customers in the Peel valley, like customers in all other valleys, pay their share of the efficient costs of water storage and delivery infrastructure and services in their valley. The water entitlement and usage charges for a valley are simply a way of allocating the customer share of the efficient water storage and delivery costs in the valley amongst water users in that valley.

As previously mentioned, the customer share of WaterNSW's total efficient costs is estimated using the impactor pays principle. For IPART's recently released Determination of WaterNSW's Rural prices to apply from 1 July 2017, prices were set using a customer share of 67% of WaterNSW's total efficient costs. The remaining 33% of WaterNSW's costs will be funded by the NSW Government, on behalf of the broader community.



## Question

4 (c) In the Peel Valley there is an Environmental Contingency Allowance of 5,000ML annually (in addition to 1,257ML of Environmental Water currently held by the Commonwealth Environmental water Holder). Does IPART accept that it is unreasonable for the irrigators and Tamworth Regional Council to be charged full cost recovery charges on this water, when they are neither the impactor nor the beneficiary?

## Response

As mentioned above, customers do not pay for WaterNSW's full efficient costs. Rather, they pay a share, where the customer share is determined according to the impactor pays principle (ie, those that incur the need for the activity or cost should pay for it).

Once the total efficient customer share of costs is determined for a valley, these costs are allocated out amongst individual customers within the valley via prices according to the volume of entitlement held (\$ per ML of entitlement) and the volume of water actually taken or used (\$ per ML taken) by individual customers.

For rules-based environmental flows (where a dam has been constructed on a natural waterway to store and deliver bulk water for irrigation) regulations require that some water is continued to be released to maintain some continuity for the natural environment and other users.<sup>6</sup> Consistent with IPART's current cost sharing framework, in the 2017 Determination the Tribunal allocated the costs of constructing and maintaining the specific assets used to mitigate environmental impacts at about 50:50 between water access licence holders and the NSW Government.

In the Final Report for the 2017 Determination, the Tribunal has stated that it will undertake an extensive review of the cost shares used to allocate WaterNSW's efficient costs between WaterNSW's customers and the NSW Government before the next WaterNSW price determination in 2021.

We also note that the Commonwealth Environmental Water Holder (which holds water access licences for environmental purposes) is treated the same as irrigators and other licence holders. That is, it pays the same entitlement and usage charges per megalitre as irrigators and other entitlement holders, and thus pays for its share of WaterNSW's customer share of efficient costs.

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<sup>6</sup> <http://www.water.nsw.gov.au/water-management/water-sharing/environmental-rules/rivers>, accessed 22 June 2017.

## Question

5. Erroneous statements by IPART on the effect of excessive water charges in the Peel Valley:

On Page 210 of the Draft Report, IPART makes the statement that:

*'Where prices are higher than the upper limit, there is a broad change in customer behaviour. This would include the surrender of licences and a clear reduction in water usage. However, despite gradual increases in bills over the last three determination periods to reach Full Cost Recovery, licence numbers and entitlement volumes have remained stable and there has been no observable downward trend in water usage in the Peel Valley'.* (Emphasis added)

5 (a) Does IPART now accept that this statement is incorrect because the surrender and return of licences would only occur if the entitlement charge was excessive – that is, if the cost of keeping the licence was so great that it was uneconomical to continue to hold the licence? In the Peel Valley the General Security entitlement charge is currently at a reasonable level, so there is no reason for IPART to expect Peel Valley licence holders to surrender their licences due to excessive pricing.

## Response

The above statement was made in the Draft Report in the context of the potential impact of **total bulk water bills** (under WaterNSW's regulated charges) on customer behaviour. Customers are likely to surrender their entitlements (and hence there would be a decrease in water usage) if prices and hence the total bill involved in purchasing bulk water was higher than the upper limit.

As mentioned previously, despite gradual increases in bills over the last three determination periods to reach full cost recovery, licence numbers and entitlement volumes have remained stable and there has been no markedly observable downward trend in water usage in the Peel valley. Therefore, we considered that prices were not higher than the upper limit.

We consider that customers are likely to examine their total bill, not just the entitlement charges, when considering whether it is economical to continue to hold their licence.

As previously mentioned, IPART's Final Report and Determination of WaterNSW's prices, released on 13 June 2017, will result in substantial reductions in the usage price in the Peel valley from 1 July 2018 onwards, and substantial reductions in typical bills over the next four years.

## Question

5 (b) Does IPART now accept that there has already been ‘an observable downward trend in water usage in the Peel Valley, (as highlighted in the figures on page 7 of the Peel Valley Water Users Association’s response to the IPART Draft Report), and therefore the above statement by IPART is incorrect?

## Response

On page 7 of the PVWUA’s submission to IPART’s Draft Report, average usage from general security customers is shown to decline by:

- ▼ 7.7% over the period ‘1995-1996 to 2005-2006’ (average general security usage of 7,013 ML per year) relative to ‘1991-1998 benchmark’ (average general security usage of 7,600 ML per year), and
- ▼ 22.2% over the period ‘2006-2007 to 2016-17’ (average general security usage of 5,914 ML per year) relative to ‘1991-1998 benchmark’ (average general security usage of 7,600 ML per year).<sup>7</sup>

However, we note that the 22.2% decline in general security usage over the period ‘2006-2007 to 2016-17’ relative to the ‘1991-1998 benchmark’ incorporates a large proportion of the previous drought period. This includes 2007, which has been described as the most severe reported water shortage experienced by the Peel valley to date (as at June 2010).<sup>8</sup> Given the shortage of water available during the drought period, and hence the lower level of water allocations as a result, we would expect there to have been declining average water usage levels compared to the 1991-1998 period, as reported by the PVWUA.

On page 9 of its submission, the PVWUA has provided annual general security water usage for each year, over the period 1995-96 to 2016-17 (to 15 March 2017). It shows considerable fluctuation in water usage over this period and ranges from 3,468 ML in 1996-97 to 9,269 ML in 2005-06, 10,366 ML in 2012-13, 12,018 ML in 2013-14 and 5,257 ML in 2015-16. Therefore, this also shows that, despite increases in prices in recent determination periods, there has been no markedly observable downward trend in water usage by general security customers in the Peel valley.

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<sup>7</sup> Peel Valley Water Users Association submission to IPART Draft Report, April 2017, p 7.

<sup>8</sup> NSW Office of Water, Water Sharing Plan for the Peel Valley regulated, unregulated, alluvial and fractured rock water sources: background document, June 2010, p 12.

### Question

5 (c) As a consequence of the above two significant erroneous statements by IPART, does IPART now accept that there is an urgent need to completely overhaul the approach to charging for water usage in the Peel Valley?

### Response

As mentioned previously, in response to stakeholders' submissions to IPART's Draft Report, including the PVWUA submission, and further consideration, the Tribunal decided to adopt an 80:20 fixed to variable tariff structure for the Peel valley from 2018-19 onwards (from the existing 40:60 structure). This, along with other decisions IPART made in relation to WaterNSW's efficient costs, will result in a substantial reduction in usage prices in the Peel valley from July 2018 onwards and significant reductions in typical bills over the next four years.

### Question

6. Impact of excessive water usage charges:

The committee of the Peel Valley Water Users Association has evidence that due to high water usage charges production has decreased, demand for irrigation properties in the Peel Valley has declined, and real estate agents have found irrigation properties are hard to sell - which is the corollary of what would normally be expected.

In view of the above, does IPART accept that the water usage charges in the Peel Valley are excessive?

### Response

We note that the usage charge for the Peel valley as set out in our Draft Report of \$54.97 per ML per year (\$2016-17) over the period 2017-18 to 2020-21 was higher than other valleys.

IPART aims to set prices to recover WaterNSW's efficient costs of storing and delivering bulk water to users. The relatively large fixed costs involved in storing and delivering bulk water and the relatively lower amount of water allocations and users to spread these costs amongst in the Peel valley does mean that overall the charges are higher in the Peel valley compared with other valleys.

As mentioned previously, the Tribunal's final decision was to restructure tariffs from the current 40:60 fixed to variable split to 80:20 from 2018-19 onwards. This means

that the usage price in the Peel valley will be \$18.36 per ML per year (\$2016-17) from 2018-19 to 2020-21.

### Question

7. Entitlements and extraction limits:

On Page 210 of the IPART Draft Report, IPART states that:

*‘There is a mismatch between the entitlement volumes (which users must pay a fixed charge for) and the Long Term Average Annual Extraction Limit (LTAAEL) in the Peel Valley. However, both the volume of entitlements issued and the LTAAEL are not set by IPART. These are set out in the Water Sharing Plan for the Peel Valley.....’*

Does IPART accept that an increase in the LTAAEL would have the effect of significantly lowering the water usage charges in the Peel Valley, and if so, will IPART therefore recommend that this potential solution to the problem of excessive water usage charges in the Peel Valley should be further investigated during the formulation of the Water Resource Plan for the Peel Valley?

### Response

Under the *Water Management Act 2000* (NSW), extraction limits are set for the purposes of protecting the environment. The extraction limit sets out the long term average annual volume of water that can be extracted as a means to protect the major share of water for the environment.<sup>9</sup>

In terms of setting water usage prices, IPART has adopted the use of a 20-year rolling average of actual extractions as its basis for forecast water usage over a 4-year period for its 2017 Determination. Therefore, changes in actual water extractions would lead to changes in the water usage price, holding all else constant (ie, a higher 20-year rolling average would lead to a lower water usage price, and vice-versa). This is because higher forecast water usage means that there is more water usage from which to recover a portion of WaterNSW’s efficient costs.<sup>10</sup>

Therefore, changes in actual water extractions currently have a direct impact on the water usage price. If changes in the LTAAEL are appropriate (which we consider is a matter for DPI Water and the Minister for Regional Water), it would eventually impact the water usage price if it impacts actual water extractions in the Peel valley.

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<sup>9</sup> <http://www.water.nsw.gov.au/water-management/water-sharing/environmental-rules/rivers>, accessed on 16 June 2017.

<sup>10</sup> The other portions being recovered from entitlement charges, and the NSW Government on behalf of the broader community.