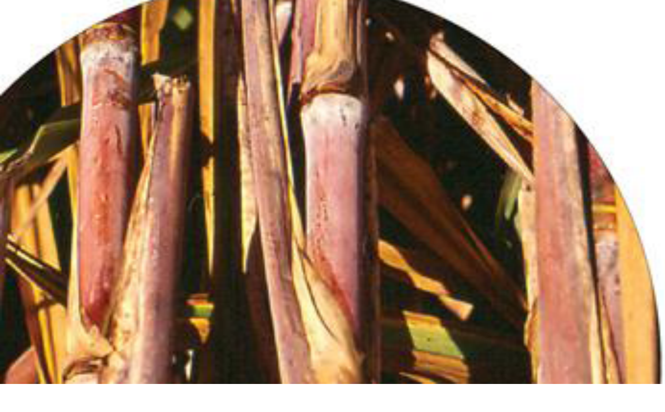
CANEGROWERS

CANEGROWERS Submission, Analysis & Recommendations

in response to

QCA Draft Report SunWater Irrigation Price Review: 2012-17

(Volumes 1 and 2)



About CANEGROWERS

Sugar is one of Australia's most important rural industries, worth around $1.5 - $2.5 billion to the Australian economy annually. Sugarcane is Queensland's largest crop industry and irrigation user. CANEGROWERS is the peak representative body for Australian sugarcane growers, representing around 80% of Australia's sugarcane growers – the highest membership rate of any agricultural lobby, representation and services group Australia-wide. Government and business leaders recognise CANEGROWERS as the authoritative voice of cane growers, with high membership across all Australian cane growing areas ensuring growers' needs are represented at the highest possible levels of industry and government decision-making.

CANEGROWERS safeguards growers' interests on all issues likely to affect their business. Over the past two decades, world sugar production has undergone massive changes. With recent developments in Latin America, Europe and Asia, the pace of change is accelerating. As the global demand for sugar and other sugarcane products increases so does the environmental, social and economic scrutiny of agriculture. CANEGROWERS regards sustainability not as a cost but as a necessity. Queensland's sugarcane growers must drive productivity gains of two to three per cent per annum to maintain their international competitiveness. The drive to improve the productivity and efficiency of production systems includes continuing the pursuit of water use efficiency.

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Executive Summary

CANEGROWERS supports the Queensland Competition Authority (QCA) concept of irrigators and other water users bearing the cost of water supply provided the prices, reflecting costs of supply, are efficient and prudent. Two constraints placed on QCA do not provide irrigators with confidence that recommended prices will be either efficient or prudent. First, the terms of the Ministerial direction, in particular the need to ensure the recommended pricing path maintains past revenues in real terms, limit QCA's ability to fully examine and develop an appropriate regulatory framework for pricing Queensland's irrigation scheme. Second, the inaccurate and incomplete data provided by SunWater has resulted in QCA making a number of untested assumptions in relation to costs.

Although the Ministerial direction cannot be changed, more detail can be collected on SunWater's costs. If SunWater has not provided sufficient data before preparation of the final report, irrigation water prices should not change until the relevant information is available and fully analysed.

It is important that QCA:

- Conduct independent reviews of both the QCA and SunWater pricing models
- Not recommend price increases unless customers and QCA have confidence in the data presented by SunWater
- Conduct a detailed assessment of distribution losses
- Review termination fees
- Assess actual electricity costs annually
- Develop key performance indicators that require SunWater to make efficiency gains and apply cost reductions on an annual basis
- Assess indirect and overhead costs for bulk and channel service contracts at 34%, consistent with the benchmarking for a selection of other utilities and require SunWater to adopt best management practice in accounting for and reporting its costs in a transparent manner
- Require SunWater to consult with users on any proposed over-spends on budget, including for renewals, before seeking a QCA determination on any price adjustment
- Review its treatment of the Queensland government's obligations as a water user to ensure pricing and cost recovery is both prudent and efficient
- Review both water use and water availability in each channel scheme as a basis for assessing optimal asset and service configurations in all channel schemes ahead of the 2016-17 water price review
- Review all revenue sources to ensure that all are allocated correctly and offset against costs and offset all revenue recovered above budget forecasts for current price paths against forecast expenditure in the new price path
- Not include a return on working capital in the price path calculation
- That QCA investigate options to have distribution schemes managed locally. This investigation would include the range of options from independent local management to local involvement in management.

- That SunWater be required to establish a regular consultation process with industry body representatives of irrigation scheme users that includes minuted meetings and SunWater to provide feedback including action plans to implement agreed outcomes.
- That documented agreements with industry body representatives of irrigation scheme users be required if SunWater proposes to exceed budget costs assessed by QCA for the price path.
- That in the absence of such an agreement, QCA's approval be obtained before SunWater proceeds with the proposed over budget expenditure.

1. Model reviews

It is questioned whether the QCA and SunWater pricing models correctly analyse and allocate costs and revenues. A number of specific issues have been raised in the scheme consultations which include:

- Using a twenty year period to assess electricity costs will result in an over recovery of these costs over the five years of the next price path.
- Each channel scheme has a number of revenue sources which must be offset against costs. It is unclear whether QCA has accounted for all revenue sources, including drainage and drainage diversion charges and minimum charges for small users. It is not clear whether a charge has been levied for delivering river water through channel infrastructure which occurs in all the schemes and in some cases to major non irrigation users requiring high priority access and how this charge is assessed. For example, distribution customers pay for the cost of 100% of the channel to deliver their allocations. Bulk customers who also use channels to deliver their water should pay for the proportion of the channel required to deliver their maximum requirement. Revenue offsets such as these must also be escalated by CPI.
- Further clarification is required in the channel schemes to differentiate between bulk works and distribution works.

Recommendations: **That independent reviews of both the QCA and SunWater pricing models be undertaken to check that appropriate methodologies have been used. The methodology needs to ensure:**

- **Electricity costs are assessed over a five year price path, as a twenty year period of assessment will over recover electricity costs for the next five years.**
- **Revenue items for each scheme are allocated correctly and offset against accurate costs. CPI adjustments to revenue offsets must also be applied annually.**
- **An appropriate allocation of asset costs between bulk and distribution service contracts.**

- **An appropriate allocation of indirect and overhead costs between bulk and distribution service contracts.**

2. Distribution losses

QCA is recommending that prices reflect the cost of 100% of loss allocations in channels. But these loss allocations significantly overstate actual losses (for example, Mareeba actual losses are less than 70% of allocated losses, Eton 60%, Burdekin 53% Lower Mary 50% and Bundaberg 23%). In contrast, no allowance is made for costs associated with losses in the bulk segments (called transmission losses). If this distinction continues to apply, then the unused portion of distribution losses should be made available for use to those customers that have paid for those distribution losses. The use of high priority losses to fill channels is also questioned, as the only time channels would get filled to provide for high priority losses would be when the announced allocation for medium priority was zero.

Recommendations:

- **QCA adjust recommended prices in their final report to take account of actual losses assessed using the largest recorded distribution loss allocation over the last eight years. If carryover of allocation is allowed in the specific scheme, the loss allocation for carryover should also be included in the assessment.**
- **Subject to the availability of improved bulk metering, DERM should review bulk and distribution losses in each scheme over the term of the new price path to determine and account for actual losses.**
- **A detailed assessment of the need for high priority losses water allocation entitlements in each scheme to be carried out by DERM.**
- **SunWater not be allowed to move water (either allocation or loss allocation) from a channel scheme and allocate it to others outside the channel scheme without paying an exit fee.**

3. Termination fees

Customers wanting to exit or stop receiving water in some channel schemes face very high costs (eg. Lower Mary $1,400/ML, Bundaberg $595/ML, Mareeba $500/ML and Burdekin $450/ML). These barriers to exit discourage irrigators, operating in a highly competitive world market, from optimising their production processes. These fees must be reduced to provide SunWater with further incentive to reduce costs and increase efficiency to meet the demands of price sensitive water users. At the very least, fees should also reflect the differential between shifting water from the channel which may be at or below cost recovery to the river which is above cost recovery. Analysis of this differential for each channel scheme is as follows:

- Mareeba above cost by $10/ML/year - Termination fees should be reduced by $200 ($10 x 20 years)
- Lower Mary above cost by $8/ML/year – fee should be reduced by $160
- Burdekin above cost by $6.17/ML/year – fee should be reduced by $123.40
- Bundaberg above cost by $5.20/ML/year – fee should be reduced by $104.

Recommendations: **QCA review the following options:**

- **Reduce the termination fee by at least the margin that bulk charges are in excess of cost reflective tariffs.**
- **Treat all distribution losses as a component of channel water access entitlements (not bulk).**
- **Reduce the exit fee through the new price path and not allow SunWater to reset fees to reflect a smaller customer base.**
- **As a monopoly service provider SunWater should take responsibility for meeting the needs of its client base and face a larger share of the commercial risk associated with customers reducing their demand for water or exiting.**
- **SunWater can play a large role in managing and should be provided greater incentives to manage its own commercial risks by optimising its activities and marketing its product and services.**
- **As noted above, SunWater not be allowed to move water (either allocation or loss allocation) from a channel scheme and allocate it to others outside the channel scheme without paying an exit fee.**

4. Electricity costs

The impact of rising electricity prices and forecasts of further price rises on costs is a significant issue in a number of channel schemes. From the consultants' reports commissioned by the QCA, it is clear that actual price rises and increases in electricity costs are substantially less than those forecast when the current water price path was established. In the new water price path the treatment of electricity and other direct, attributable costs needs to be more transparent and accountable.

Recommendations: **That QCA examine the following options for their final report:**

- **QCA assess actual electricity prices and costs for each scheme annually using recorded electricity bills and, using this information, determine an adjustment to the price per ML of metered water use for the year ahead.**
- **Develop key performance indicators that require SunWater to make efficiency gains and apply cost reductions on an annual basis.**

- **Any adjustment of variable tariffs would take account of any actual over or under recovery of electricity costs also at the scheme level that occurred during the review period.**

5. Indirect and overhead costs

There are large differences in the data on indirect and overhead costs presented in consultant reports conducted for QCA. For example, the QCA consultants Deloittes have assessed SunWater's indirect and overheads for all sectors at 34% of total costs and confirmed that this is in accord with benchmarks derived from a range of utilities in Australia & overseas. However the average indirect and overhead costs for the cane schemes are:

- Lower Mary bulk is over 60% and for the channel is over 40%
- Burdekin bulk is over 54% and the channel is over 28%
- Mareeba bulk is over 54% and channel is over 42%
- Bundaberg bulk is over 52% and channel is over 30%
- Eton bulk is over 42% and channel is over 34%.

Overall indirect and overheads for SunWater irrigation schemes is 49% but it is only 25% for the other industry sectors of SunWater's operations. This raises the question of cross-subsidies funded by the irrigation sector being used to support service the growth in mining and urban sectors. QCA has recommended SunWater improve its management accounting processes and procedures for its labour costs but this will do little to improve transparency in regard to indirect and overhead costs. Issues in regard to improving information on these costs and consultation with customers are addressed in item 7 below.

Recommendation: **That QCA assess indirect and overhead costs for bulk and channel service contracts at no more than 34% in keeping with the benchmarking conducted for a selection of utilities.**

That SunWater be required to adopt best management practice in accounting for, and reporting in a transparent manner, its costs.

6. Renewals annuity

As a monopoly water supplier, SunWater has engaged in large, over-budget spends on renewals for most channel and bulk schemes without adequate consultation with customers and without delivering improvements in the efficiency of water delivery. The limited analysis of sampled projects undertaken during the QCA review has identified this as a systemic and systematic issue. As a result of SunWater's failure to adequately assess prudency and efficiency or provide sufficient information for analysis, QCA has recommended a reduction in costs for nominated projects across schemes. For all non-sampled items QCA has applied a 10% cost reduction.

There is also an asymmetric treatment by SunWater on its over and underspends against budget. For renewals, over the last five years all overspends on budget have been passed onto growers through higher water prices. These higher charges have not been offset by savings on budget. For example, the $15 million saving on budgeted electricity expenses and over recovery of $10.5 million on revenue offsets have been retained by SunWater, not passed back to water users as an offset to the higher renewals charges. QCA has recommended SunWater undertake more analysis of renewals expected to occur over the planning period and the price path term. QCA also recommends that SunWater base their consultations on network service plans enhanced to include analysis of renewals as outlined above and annual updates. Reflecting best practice, the QCA recommendation should not add additional business costs. Nonetheless SunWater's response to this requirement will have to be monitored closely. Scheme level consultation should be limited to proposed renewals spending over budget.

In addition for some schemes, such as the Lower Mary for example, QCA consultant investigations have indicated that assets such as pump stations are well in excess of what is required to service demand. Planning for future renewal spends in distribution schemes need to be adjusted to take account of assets that substantially exceed the scheme's demand and service requirements. This issue is addressed under item 8.

Recommendations: **That QCA:**

- **Review the pricing model to ensure all efficiencies identified flow into prices.**
- **Ensure consistency of treatment of cost overspends and above budget revenue collection in the new price path calculation.**
- **Develop an optimised approach to future renewals spends to ensure the renewals investment does not exceed requirement and therefore the irrigator's ability to pay.**
- **Ensure the above lower bound margin recovered during this price path is reduced as an offset against overspends on renewals.**
- **Conduct further analysis to explain how schemes identified as above lower bound in the current price path can face a negative or reduced renewals annuity.**
- **Consultations should be conducted by SunWater and a documented agreement reached with schemes for any proposed over-spends in the renewals budget.**

7. Forecast costs

SunWater's forecast total costs are well above the targets for costs set for the current price path. The QCA draft report identifies the following significant differences between forecast and actual costs for all bulk and distribution schemes from 2007 to 2011 in 2010/11 dollars:

- Operations $11.4 million or 16% less than forecast.
- Electricity $15 million or 36.7% less than forecast.
- Preventive/Corrective Maintenance $8.8 million or 17% over-spend.
- Revenue offsets $10.5 million or 250% over-recovery.
- Indirect and overheads $17 million or 19% over-spend.
- Renewals annuity $30.9 million or 80% over-spend.

The end result sees the total of operations, preventive maintenance, corrective maintenance, indirect and overheads costs for 2011 alone (the last year) being $12 million or 33.5% above the budget forecast agreed to by SunWater. CANEGROWERS supports QCA's proposal that SunWater should improve its information systems. Unless detailed explanations can be provided for these significant variations irrigation users will have little confidence in a new price path that is based on inaccurate and incomplete information provided by SunWater.

Differences between actual total costs and forecasts in individual schemes are also significant.

Recommendations:

- **QCA assess SunWater's total costs based on the forecast costs from the last price path.**
- **QCA review SunWater's performance against industry standards given their performance over the current price path. For example, controllable costs such as operations, preventative and corrective maintenance and indirect and overhead costs were 33.5% over budget forecast.**
- **During the course of the new price path QCA systematically review and independently audit SunWater's actual costs structures.**

8. Scheme optimisation

All channel schemes have been assessed at below cost reflective prices with some remaining well below cost reflective prices in 2016-17. All channel schemes are expected to face difficulties achieving cost recovery targets given the expected burdens of further reform implementation and increasing SunWater costs over the new price path.

QCA's recommended prices are unlikely to help channel schemes to adjust for a number of reasons. Just allowing these schemes an extended period to achieve lower bound (which in some cases may be well in excess of the new price term) is unlikely to address adjustment problems. For some schemes, like the Lower Mary, such an approach would raise significant uncertainty for customers and dependent industries regarding the longer term viability of the scheme. Also QCA has set the variable charge for schemes at average use. This approach penalises users who consume water in excess of the average. It is a concern that QCA has not been able to investigate opportunities to 'optimise' scheme assets and associated servicing standards to achieve greater efficiencies. This is a significant issue for the Lower Mary.

Recommendation: **QCA review both water use and water availability in each channel scheme as a basis for an assessment of adjustments that can be made to scheme assets and services to allow all channel schemes to be able to recover costs moving into a new price post 2016-17.**

9. Revenue offsets

As noted above (item 6), above-budget recovery of revenue during the current price path should be carried forward to be offset against cost blow-outs. There needs to be a consistent approach for minimum charges for small users in the bulk and distribution segments and cost reflective charges for delivering bulk water through distribution system in all schemes.

The cost of delivering water to bulk customers through the channels has been established using the IQQM (Integrated Quantity and Quality Model) with an average requirement. However the IQQM was set up to establish water allocation entitlements and their reliability, not capacities of channels required to deliver them. For example, distribution customers in the Burdekin are paying for the cost of the channel to deliver 100% of their allocation when at present they only require 76.3% of the allocation. To ensure they are treated in a consistent manner with distribution customers, it is important that bulk customers such as NQWater, who require the channel to deliver water, pay for the percentage of the channel required to deliver their maximum requirement. In lower usage schemes this difference is more significant. For example the Lower Mary only makes use of 40% of channels and Bundaberg 47%.

Recommendations:

- **QCA review all revenue sources (minimum charges, use of channel capacity, drainage charges etc) to ensure that all are allocated correctly and offset against costs.**
- **QCA offset all revenue recovered above budget forecasts for current price paths against forecast expenditure.**

10. Scheme consultation

Irrigation scheme users do not believe that their needs are being taken into account in SunWater's management of the schemes and are looking to investigate options to have greater local management involvement.

QCA has made a number of recommendations that require SunWater to improve its scheme consultation. The recommended changes will improve the efficiency and effectiveness of SunWater's consultation process, bringing it closer to best management practice. It is important that implementation of the recommendations improves the transparency of SunWater's operations and user's understanding of cost structures.

Recommendations: **That QCA investigate options to have distribution schemes managed locally. This investigation would include the range of options from independent local management to local involvement in management.**

That SunWater be required to establish a regular consultation process with irrigation scheme users that includes minuted

meetings and SunWater to provide feedback including action plans to implement agreed outcomes.

That documented agreements with industry body representatives of irrigation scheme users be required if SunWater proposes to exceed budget costs assessed by QCA for the price path.

That in the absence of such an agreement, QCA's approval be obtained before SunWater proceeds with the proposed over budget expenditure.

11. Working capital

QCA has included a return on working capital item into the cost calculation. At this stage, the costs SunWater would incur to establish this cost item have exceeded the proposed revenue. The recommendation overlooks the fact that all irrigation customers are billed three months in advance for all fixed costs. The cash flow received from billing fixed costs in advance significantly reduces the need for a special working capital allowance.

Recommendation: **No return on working capital charge. With quarterly bills paid in advance and the use of renewals annuity such a charge is redundant.**

12. Market risk costs

Making cost allowances for market risk and renewals annuities poses a significant risk for cost blow out if left without a strong consultation process in place with customers who have to pay the cost.

Recommendation: **QCA to recommend that any new cost item that has not been identified and priced as part of this review require consultation with customers and approved by the QCA before the item is priced against the scheme.**

Appendix

i. Review of issues raised in scheme consultations

a) Growers in all channel schemes face significant price increases in the proposed price path. QCA recommendations include, for example:
   - Bundled prices in the Lower Mary and Bundaberg increasing by 51% and 45% respectively on current prices, to over $110/ML.
   - In the Mareeba scheme, the increase on current prices for the re-lift segment is 33%, to over $100 per ML.
   - Growers in Mareeba with entitlements of more than 500ML face a 29% increase to over $50/ML.
   - Eton scheme growers also face a 29% increase on current prices to over $90/ML.

b) Despite QCA recommendations and the concerns raised in the draft report, there is little incentive for SunWater to optimise its operations and improve efficiency in order to reduce cost structures per unit of water delivered. The current QCA methodology suggests upward pressure on prices will remain for all sugarcane irrigation schemes beyond the present price path. It is important that:
   - New disciplines in the form of operational and financial key performance targets be developed taking account of international best practice and used as a benchmark to assess SunWater's ongoing performance.

c) The removal of declining bulk tariffs has caused concern in some regions. In most competitive markets, efficient pricing results in users receiving, and suppliers providing, price structures that feature lower prices as product use increases. If adopted, the QCA proposal would introduce a barrier to efficient water use and deny users an opportunity to capture the benefit of scale economies. More efficient price structures would:
   - Encourage increased off-take in the very low usage schemes such as Lower Mary (43%), Bundaberg (47%) and Eton (55%).
   - Provide improved incentive structures in those schemes such as Mareeba-Dimbulah which is characterised by irrigators with very different water use needs.

d) Very high termination fees payable to trade water out of channels to river segments will discourage the optimal use of water. These fees will stifle the signals received by SunWater to optimise the configuration of its assets and discourage cane growers from optimising their farm activities, potentially locking in higher cost structures than might otherwise be achieved.
   - For example, high termination fees reduce the value and tradability of water entitlements. Some irrigators, already struggling to meet their costs, are locked into channel schemes because the proposed exit fee exceeds the current value of their water allocation entitlements.

e) Disciplines must be imposed on SunWater's capital expenditure program and to reduce its overheads:
   - There is a significant negative renewals balance in many schemes, which in most cases is the result of large over-budget spends on renewals without adequate consultation with customers. In some cases capital upgrades to automate channel flows has simply not worked.
   - There are very high indirect and overhead costs in bulk and distribution schemes. Excluding the renewals annuity, these account for up to 61% of total costs.

f) Many growers questioned whether high fixed tariffs would encourage trading to improve usage. The significant gaps in the QCA benchmarking of indirect and overhead costs for Pioneer scheme were also revisited.

g) Users in most of the channel schemes expressed concern about the impact of QCA recommendations on irrigation customers and the viability of schemes. Particular concern was expressed at how channel scheme users would meet future burdens such as metering upgrades and increasing SunWater overheads and other operating costs without significant offsetting efficiency gains being achieved.
  - Questions are also being raised in regard to SunWater's ability to achieve efficiency gains and meet operational cost targets set by this review unless these are accompanied by strong disciplines. Following previous reviews, SunWater has been rewarded for demonstrating little financial discipline by being able to pass undisciplined cost increases onto water users in the next price path.

ii. Scheme-specific issues raised in the consultation meetings

a) Bundaberg:
  - Impacts of high volumetric prices and the implications of higher expected water availability in the coming years.
  - Accounting for unsold Paradise Dam water and the capacity of the channel system used for Paradise Dam supply.
  - Use of the Gin Gin main channel.
  - Questions regarding the analysis of electricity costs and insurance costs.

b) Burdekin
  - Implications of higher fixed charges.
  - Determination of termination fees beyond the price path.
  - Burden of pre-dam allocations.
  - Impact of recommended price increases.
  - Potential charge for channel water harvesting.
  - SunWater should pay recommended prices for their water entitlements.

c) Eton:
  - Impacts of cost pass throughs and high volumetric charges.
  - Impact of recommended prices.
  - Difficulties facing customers in exiting the system and provision for customers to be able to return their entitlements to SunWater.
  - Implications of variable seasonal water availability for water usage in the scheme.
  - Impact of recreation costs on the scheme.
  - Implications of the lack of SunWater data for the QCA investigations.

d) Lower Mary:
  - Impacts of the overall costs of the scheme.
  - Impacts of the high termination fees.
  - Poor level of assessment of the efficiency of scheme assets such as pump stations.
  - Accounting for distribution losses.
  - Lack of trust that SunWater will manage the scheme in the interests of customers.
  - Implications of the centralisation of SunWater management.
  - Impact of recommended prices.
  - Poor SunWater scheme data.

e) Mareeba-Dimbulah:
  - Impacts of a significant increase in fixed charges, from 70 to 83%.
  - Concern over the efficiency of capital expenditure and claims for additional expenditure on unproven systems, eg. Scada.
  - Questions re water usage.
  - Implications of termination fees.
  - Improved benchmarking of operating costs.

- Implications of the removal of the declining block tariff and the impact of recommended prices.
- Community impacts of prices.

f) Pioneer:
- Implications of the removal of the fabridams.
- Implications of the government policy to maintain revenues.
- Questions re specific renewals items.
- Inadequacy of the benchmarking analysis of the Pioneer Board.
- Consultation arrangements if recommended prices change significantly in the final report.

g) Proserpine:
- Implications of a low Part B charge.
- Questions re high percentage of non-direct costs.
- Recognition of past capital contributions made by Kelsey Creek Water Board.
- Implications for changes to recommended prices.