SUBMISSION

TO THE

QUEENSLAND COMPETITION AUTHORITY

ON THE

DRAFT REPORT

BURDEKIN HAUGHTON WATER SUPPLY SCHEME

ASSESSMENT OF PRICING MATTERS

By: Mareeba – Dimbulah Customer Council

NOVEMBER 2002

1.0 COMMENTS OF A GENERAL NATURE

We understand the reason for the *QCA* to have accepted the 'lower bound costs' given the specific Minister's direction provided to *QCA* in the instance of the Burdekin irrigation water pricing regime. However, we believe this direction compromises the validity of the review process. We seek assurance from the *QCA* that lower bound costs will in fact be the captured within price path reviews.

It is of considerable concern to irrigators in the Mareeba Dimbulah Water Supply Scheme that the *QCA* has in many (if not most instances) ruled in favour of the position adopted by *BRIAC*. This in itself should provide Government with a clear understanding of the reasons for the degree of mistrust that exists between *SunWater*, Government and Irrigators.

The following comments are provided on a 'Section' basis to align with the various sections of the *QCA's Draft Report*.

2.0 BACKGROUND

The Draft Report identifies that the 1980 *Report on Establishment of the Burdekin River Project Undertaking expected a 2.05% real return on the net capital cost of the Scheme*. If this point is to be highlighted then it should immediately be followed by the comments that the scheme in 1980 took on a significantly different development configuration with equally differing revenue streams. It is also noted that discussion of future staging for hydropower generation receives scant mention, yet this also was to be a significant revenue stream for the scheme.

It is perhaps interesting to note that in relation to discussion regarding dividends from irrigation schemes the *Report on Proposals for Water Conservation and Irrigation Development in the Mareeba – Dimbulah Area, Presented to Parliament (MDIA Report), January 1952* states that in this instance that:

> *It is also proposed that the interest and redemption charges on the capital cost of the works shall be met from consolidated revenue and not charged to the Irrigation Area Trust fund.* ***Any*** *surplus of revenue over operation, maintenance and management costs may, unless required by the Commissioner for further construction, works or replacement of works or for payment to a Reserve Fund be paid to the Treasury as a contribution towards interest and redemption charges. (Nimmo, 1952, P vi)*

This report also states that:

> *…experience with large irrigation schemes in other States has shown that it is necessary for the Government to meet all annual charges other than those with respect to maintenance, operation and administration. (P 4)* and that:
> *It is not possible in any large irrigation project to meet all annual charges from direct revenue. Charges for water and drainage must be fixed at rates that farmers can be reasonably expected to meet. (P 11)*

As far as we are aware permanent trading of water entitlements is not yet available in the Burdekin. Perhaps the *Integrated Planning Act* should also be mentioned on page 12 of the report.

3. CAPITAL CONTRIBUTIONS

The *Draft Report* states that, *with respect to the Commonwealth and State funding of the Scheme, available information indicates that the focus of these parties was on funding the Scheme, not providing future pricing benefits to water users. (P15)* Yet in the case of the *MDIA Report* it is stated that:

> *… direct revenue from the proposed Mareeba-Dimbulah project will be sufficient to make some contribution towards annual capital charges but it is considered essential that the remainder of such charges be met by the State or State and Commonwealth together, both of which will receive a substantial indirect return from the Project. (Nimmo, 1952, P4)*

This report goes on to state that:

> *In Victoria and New South Wales it has been found necessary for the State to meet the whole of the capital charges involved in the construction of headworks and conveyance of water to the farm boundary, and this practice is becoming general in all countries….. However, it is on the indirect return represented by the increased value of production that the project should be judged. From the results of irrigation on a large scale in Victoria, it has been estimated that forty (40) percent of the increased value of production from an irrigation project accrues to the Commonwealth and State Governments directly in water charges and indirectly in fares, freights and taxes….. It may perhaps be greater and a substantial proportion of it will go to the Commonwealth Government. (Nimmo, 1952, P12)*

This report then goes on to show the indirect returns to Government as a percentage of capital expenditure. As such it would be reasonable to infer that such benefits were viewed by the Governments of the day to be a contribution to capital.

Reference is made to equity in relation to *return on capital for assets that have already been funded by them or by government on their behalf. (P16)* As evidenced above it is apparent that in the case of the Mareeba Dimbulah Irrigation Area (MDIA), capital contributions took on a broader form than that

enunciated in the *Draft Report*. We believe the position adopted by Government in relation to the MDIA is representative of most, if not all, irrigation schemes in the State. We note that in *NSW IPART* valued all bulk water assets developed prior to 1997 at zero *(P16)* i.e. sunk costs. The *QCA* offers no particular reasons why this is not the case for the Burdekin.

> *Sunk costs refer to those costs which have already been incurred, hence they are not incremental cash flows and should not affect future investment decisions. (Levy & Sarnat, 1994, P122)*

Given the above, we believe there is little doubt that *IPART's* position is valid in relation to dealing with long past investment decisions. If the *QCA* maintains its position, then it needs to be supported with sound reasoning.

The *Draft Report* notes that, *the Burdekin Scheme was treated as an integrated Government land and water development project. (P18)* Perhaps it should be highlighted that in terms of the original intent of this project, in addition to the afore mentioned, it was also to integrate hydropower generation, and tourism opportunities.

The access roads referred to in the *Draft Report*, whilst being acknowledged as necessary to the development of the Scheme were always envisaged as being handed over to the Shire Council for the benefit of tourism and the wider community.

Whilst it is pleasing to see the *QCA* supporting the position of BRIAC in that it is an integrated Scheme and surpluses from auctions of land are seen as a contribution to capital, it is of considerable concern that NR&M could have seen it any other way *(P23)*. *NR&M's* position will only further fuel the mistrust that is felt by irrigators.

'Capacity to pay' issues are discussed on page 24 and reference is made to the *Sugar Industry Act 1991*. In relation to this matter the *Draft Report* should reference the *Sugar Industry Act 1999* as this was the current legislation at the time of determining the current 'Price Path'. The deregulation of the Australian sugar industry began in 1989 and was completed dramatically under *National Competition Policy* in 1996.

Previously, farmers received a premium for sugar sold domestically. Since deregulation, the price of sugar to the Australian consumer has increased 26% and the price to the farmer and miller fallen 25%. The trade off for deregulating the industry was that the Government would deliver a 'level playing field' in terms of world trade in sugar. The likelihood of such an outcome in the short to medium term is highly unlikely. As such, one of the largest single actions impacting on cane growers' capacity to pay has been Government action. Increases to water charges whilst at the same time reducing the earning potential of farming operations is at the root of the ongoing dispute over water charges.

The *QCA (P27)* indicates that the Sugar Mill Levies were not capital contributions. The *QCA* suggests that this is supported by the recurrent nature of the levy. We would like to emphasise that just because a charge is recurrent is no evidence whatsoever that it is not a contribution to capital. We would suggest that there is probably 10 million home mortgage holders that would support such an assertion. It was also our understanding that the Federal Court decision in relation to the Mill Levies found the Levies to have no supporting basis in legislation – and as such, was largely illegal. This being the case we would suggest that given that levies were not refunded and given revenue from water sales was more than meeting operational, maintenance and depreciation costs; that these funds should be considered whatever the contributor believed/determined them to be. In this instance they have indicated them to be contributions to capital.

SunWater contends *(P28)* that, the specific purpose of Commonwealth grant funds was to fund the *Burdekin Falls Dam without impacting on other State programs*. To assist clarify this matter the *QCA* sought advice from the *Commonwealth Department of Agriculture, Fisheries and Forestry* that effectively indicated water pricing matters were a matter of the State jurisdictions. Without the contribution by the Federal Government the Burdekin Scheme would never have been undertaken. We would like to highlight that the effect of not considering these contributions as a capital contribution to the scheme is, in effect conferring a further benefit to the State by having these funds considered as part of the capital financing the project. Such a situation would impact on other State programs – albeit positively. As such it would be counter to the *SunWater* position stated above. As with most, if not all, irrigation schemes around the State, Federal funds were used to fund the development of such schemes. We have no doubt that such funding was a clear contribution to capital. It was provided specifically for the development of the Burdekin Scheme i.e. to meet capital costs.

The *QCA* contends *(P30)* that 'capacity to pay' is the principle basis for pricing determinations, i.e. ahead of commercial pricing principles. This is supported by the previous extracts from the *MDIA Report (Nimmo, 1952)*.

The *QCA (P33)* agrees with the position stated by SunWater, that irrigator payments were never linked to any particular water infrastructure asset. This would appear to be at odds with previous statements in relation to meter outlets (P26 Section 3.6). In these cases irrigators made specific payments to cover the purchase and installation of water meters or *PA* outlets associated with the irrigator's property.

4. UNACCOUNTED FOR CAPITAL

In Section 4 *(P35)* of the *Draft Report* a methodology is discussed to 'strip out' the redundant assets, over-engineering and excess capacity. It is duly acknowledged that such a process is fraught with difficulties. Rather than attempting to remove such excesses from the equation, we believe a more valid approach would have been to leave these elements in the equation, but, in addition add the other expected revenue streams (e.g. additional water and land sales, hydropower, tourism, etc) and costs (land resumptions, etc) that constituted the basis on which funding of the project was provided.

For example the unutilised yield from the Burdekin Falls Dam means that the storage volume could be significantly reduced to meet the current required yield. As such a reduced Full Storage Level would translate to less land needing to be resumed, less survey needs, fewer Real Property Plans, less clearing, smaller main embankment, smaller saddle dam, less foundation treatment, changes to road deviations etc. This would require a redesign of the most elements associated with the storage and its associated infrastructure. I would consider this well outside the brief provided to SKM.

Once again the *Draft Report* acknowledges the NSW approach in valuing all assets in place prior to July 1997 as $0 (P37). As noted previously we support *IPAT's* position. It is noted that there is no discussion in regard to the approach taken in Victoria, Western Australia or South Australia. We understand that their approach roughly aligns with that adopted by NSW. As such the Queensland approach tends to be totally out of step with the rest of Australia.

The *Draft Report (P39)* notes that some assets were not included in the DORC prepared by *Arthur Anderson*. Whilst we accept this principle we maintain these to be also sunk costs. In addition we would like to highlight that whilst these costs could be attributed against the project their relative costs should not solely be slated against costs associated with providing irrigation water to irrigators i.e. there is a wider community benefit that must be acknowledged if this line is to be pursued. The *NCP's Third Tranche Assessment Framework (2001)* clearly has the need for the removal of cross-subsidies as an outcome. In this sense to follow the same line irrigators would in effect be subsidising a wider community benefit that under the *NCP's Third Tranche Assessment Framework* has the capacity to be acknowledged with an appropriate *Community Service Obligation (CSO)*.

> *Where cross-subsidies continue to exist, they are to be made transparent. (NCC, 2001, P8.4)*

It would seem then if the *QCA* does not treat costs as sunk that they should at least make transparent those wider community benefits that are effectively paid for by irrigators. We maintain that the establishment of a *CSO* as discussed above would *not undermine the overall policy objectives of the strategic framework for the efficient and substantial reform of the Australian water industry. (NCC, 2001, P8.9) In fact we believe the establishment of a CSO for such community benefits would enhance the policy objectives.*

We also maintain that a *CSO* should also be acknowledged for costs associated with roadwork to both Burdekin Falls Dam and 'general access roads, flood mitigation and recreation'. By the same token revenue from recreational assets should also be considered. As such references such as, *"The Authority considers that, for irrigators in the Burdekin Scheme, the capital not accounted for by capital contribution was $207.0 million as at October 2000," (P55)* would be more accurate if reference to irrigators was removed, i.e. *The Authority considers that, in the Burdekin Scheme, the capital not accounted for by capital contribution was $207.0 million as at October 2000.*

What has been highlighted in the discussion regarding 'capacity to pay' *(pp 56-60)* is that all parties' projections on future sugar price have proven to be considerably inaccurate. However, the authority draws no conclusion as to the irrigators' capacity to pay based on the actual prices achieved over the past few years since the development of the 'Price Path' and current projections over the life of the Price Path. To imply that such an approach would be invalid because SunWater did not have the opportunity to benefit from past better performances of the world sugar price is of no relevance. We believe this is a significant shortcoming of the Draft Report.

5. WEIGHTED AVERAGE COST OF CAPITAL

Section 5.1 and *5.2 (pp 61-62)* discusses the concept driving 'rate of return'. We would like to highlight that the Burdekin as with the MDIA is based around past investment decisions by the Government of the day. The discussion regarding supply and demand concepts for past investment decisions are irrelevant, as the capital was attracted many years ago (early 1950's in the case of the MDIA).

We would like to highlight that in many cases the infrastructure (such as dams etc) is long life assets and that calculations on depreciation of such assets is extremely theoretical. For example we may pick 200 years as the operational life of Burdekin Falls Dam – but with a suitable maintenance program it could well be 300 or even 400 years. As such the timing for major investment decisions is far from precise.

We suggest that whilst acknowledging wider community benefits there still remains a significant gap between the costs of maintaining storage and distribution systems in perpetuity to setting a rate of return that effectively provides *SunWater* capacity to fund major investment decisions into the future. We prefer the concept of maintaining the infrastructure in perpetuity as the later provides *SunWater's* with the capacity to provide a dividend to Government without tying funds to a necessary infrastructure investment. This later arrangement has the capacity for Government to double dip i.e. at some point in the future a major pipeline may require replacing, but over the previous 10 years *SunWater* has provided a dividend to Government making it unable to fund such a project. Does Government then tell *SunWater* that

they will need to increase prices or garner further contributions from irrigators?

Given the lack of trust that exists between irrigators, SunWater and Government, maintaining storage and distribution systems in perpetuity sets the appropriate intent. The Deputy Prime Minister in a speech to the National Party Federal Council on the 15th September 2002 said,

> *This financial year, we* [the Federal Government] *will pay the States, as we have for several years, getting on $1 billion under the National Competition Policy. The States do not appear to have grasped the moral and political imperative that they should be prepared to use that money, or parts thereof at least, to provide compensation and adjustment assistance to the affected industries, not just spend it in their State capitals…..*
>
> *the Government is seriously considering recasting the National Competition Policy system, to require the States to recognise the legitimate property rights of farmers and their communities. It is time the States met their responsibilities in the interests of fairness, of justice, of equity…….*

The Deputy Prime Minister acknowledges the general drift of the States away from the intent of *NCP* reforms and in so doing supports the irrigators' position. He followed up his previous comments in this regard with his address to the *Salinity and Water Quality Roundtable* at Mildura on the 28th October, when he said in relation to water reforms;

> …one of the reasons that we haven't made the progress that some people would like us to have made, is that a proper framework for the fair and equitable treatment of affected communities was not properly hammered out. It's having economic, social, and, I think, environmental impacts. So far the States have essentially refused to compensate landholders for their loss of water rights or provide them with adjustment assistance……They are expecting rural Australia to bear the full cost of moving Australia agriculture toward sustainability, even though we have all benefited from the wealth generated by the farm sector…. I want to say to you that the moral responsibility for compensation lies with the States….In the face of what I see as a serious failure of political and moral will, we are seriously considering recasting the National Competition Policy system, to require the States to recognise the legitimate property rights of farmers and their communities. The States would have to meet their responsibilities, or put their ongoing funding at risk.

Queensland Treasury has established guidelines for investment decisions in water infrastructure.

> *These guidelines apply to Queensland Government departments, statutory authorities and commercialised business units that are contemplating investments in water infrastructure. The guidelines are also applicable to a Government Owned Corporation (GOC) or a private sector entity where a request is made to the Queensland Government or where the Queensland Government is requested to assume some level of project risk. (Queensland Government, 2002, P2)*

These Guidelines also identify opportunities for *CSO* contributions to projects. We see no reason as to why SunWater should be considered outside these existing guidelines for future investment decisions. We also note that these Guidelines were in place at the time of developing the Price Path.

The *QCA* on page 64 indicates that:

> *Government equity investments are not costless or riskless. The Government does face an implicit cost or opportunity cost from funds invested in BRIA infrastructure and these investments do involve risk.*

We would like to highlight that the *Treasury Guidelines* previously mentioned provide the framework for this. However, we would ask that the *QCA* keep this concept in context and perhaps consider those Government investments in the footbridge over the Brisbane River, upgrade to Lang Park, investment attraction package to Virgin Blue, investment attraction package to Queensland Magnesium etc.

We do have a few issues in regard to the *QCA's* discussion on *Market Risk Premium* (pp 70-73). We believe that this concept is already reflected in the afore mentioned *Guidelines* with further details available in the *Queensland Treasury Project Evaluation Guidelines (March 1997)*. It would seem illogical that the *QCA* usurp the existing Guideline documents that reflect Government policy. We also fail to see the relevance of utilising information from the UK in assessing market risk premium as the UK water industry operates within a significantly different market environment.

6.0 EXCESS RETURN ON CAPITAL

As previously stated, we do not believe a review of 'Pricing Matters' can be adequately undertaking without considering the veracity of the 'Lower Bound Costs'.

Consultants were engaged by the *Water Reform Unit* to undertake a Benchmarking Study of what was then *State Water Projects' (SWP)* operation. *SWP* was benchmarked against *Golburn Murray Water* and *Southern Rural Water*. Irrigators in the MDIA were advised that schemes all over Australia were looked at and these two were picked for a wide range of reasons, other than just because the

consultant was more familiar with them. There is clearly more to benchmarking than customer numbers.

Table 1

We note that ultimately the benchmarking process as adopted by Government effectively meant that *SunWater* had to reduce its costs by 15% by the end of June 2005 to ensure that they aligned with the determined ‘efficient business costs’ as defined within *CoAG’s Water Reform Agenda*. Advice to our Customer Council from *SunWater* indicates that *SunWater* has effectively reduced costs by 14% as of the 1st July 2002, with a further 1% reduction over the next three years. The ease with which this 14% reduction was achieved over such a short timeframe could be the result of a number of outcomes including, the benchmarking process was significantly flawed and efficient business costs are significantly less than those identified by the *WRU*. We believe the *QCA* needs to look at the benchmarking process in considerably more detail.

Government currently transfers funds to *SunWater* (as a *CSO*) equivalent to the difference between the predetermined efficient business costs and *SunWater’s* planned operational costs based on a straight-line regression that sees 15% diminish to 0% over the 5 years of the current price path. In any event the cost reductions achieved by *SunWater* currently sees the *CSO* paid by Government being significantly more than the difference between the

predetermined efficient business costs and *SunWater's* operational costs for 2001-02 and inevitably for 2002-03.

Discussion on *CSO's* as outlined by *CoAG* should also be discussed in *Section 6.1* of the *Draft Report*.

7. APPROPRIATENESS OF POSITIVE RATES OF RETURN

In relation to the discussion in this Section regarding the future investment decisions, we draw the *QCA's* attention to the *Guidelines for Financial and Economic Evaluation of New Water Infrastructure in Queensland* and *Queensland Treasury Project Evaluation Guidelines (March 1997)*.

Once again there needs to be discussion of the role that a recognised *CSO* can play in future investment decisions, consistent with the State Government's *Community Service Obligations: A policy Framework* and *CoAG*.

We fail to see the relevance of statements such as, *'As the current price paths do not provide a mechanism by which SunWater can capitalise on past capacities to pay, it would be inappropriate to reduce the return when the capacity to pay is low.' (P 92)* As previously stated, in times past *SunWater* did not even exist and the Government of the day clearly were cognisant of other economic and community drivers of investment decisions of Government.

Documents obtained under a Freedom of Information (FOI) application indicated that the *WRU* in its price path determination acknowledged the capacity for the price path to be modified or updated during its life where better-cost information enables a more accurate reflection between schemes. Where this might mean higher prices such costs should be borne by the Government. This is contrary to current Government advice provided to irrigators. Equally we believe that this provides Government with the capacity to review capacity to pay issues based on inputs since the implementation of the price path e.g. sugar price. We note that *Hildebrand's* optimistic scenario of $35/tonne would appear to be **extremely** optimistic given continued plantings in Brazil and other nations such as Costa Rica. There is currently significant world over production and there are no market indications that this situation will change over the life of the current price path.

We also note that the sugar prices used by the Department of Natural Resources and Mines (NR&M) in developing the Draft Water Resource Plan for the Barron catchment utilise a less than 'optimistic' sugar price. We would like to see some consistency in how NR&M interprets and applies projected sugar prices.

In relation to the comment on page 95 of the *Draft Report* regarding *NCP* payments by the Federal Government to the States, we draw attention once again to the speech made by the Deputy Prime Minister as previously quoted.

We concur with the statements by BRIAC in relation to such payments and also to comments regarding past investments by Government.

We also agree with *Davco Farming's* comment *(P95)* in relation to *SunWater's* central office being located in Brisbane. In terms of efficient business costs we urge the *QCA* to seriously look at this matter, as we believe central office costs would be significantly reduced if relocated to a regional centre. We believe this would also enhance service provision.

We also suggest that the QCA Draft Report does not consider a relationship between price and water demand i.e. increasing price would lead to less usage and ultimately lead to lower returns to SunWater. To argue otherwise would require the existence of a ready market capable of paying more for the resource. Discussion regarding the opportunity cost is irrelevant in terms of past investment decisions. In such cases the opportunity cost is $0.

If the QCA sees this as a disincentive for Government, then further serious consideration should be given to Local Management. We understand that the Burdekin Irrigators did express serious interest in taking over the management of the scheme. If the *QCA's* view in this regard reflects Government's opinion then the Burdekin should make the transition to local management and be used as a test case.

In relation to the Section relating to *Public Interest (pp 99-101)* the *QCA* notes that wider community benefits are best assessed by Government. We would be pleased to be advised as to which arm of Government is providing it with the necessary information to make an informed decision in this regard. We believe the *QCA* has a role to play in this area, as it remains an unfunded and unacknowledged role of Government.

The *QCA* notes that:

> *..acceptance of the argument that a particular activity generates other benefits to the economy which can then be taxed would see all activities in the economy subsidised; and…. (P100)*

Whilst the *QCA* goes on to acknowledge linkages with other elements of the economy, we further support BRIAC in their assertions of broader community benefits.

> *From the results of irrigation on a large scale in Victoria, it has been estimated that forty (40) percent of the increased value of production from an irrigation project accrues to the Commonwealth and State Governments directly in water charges and indirectly in fares, freights and taxes….. It may perhaps be greater and a substantial proportion of it will go to the Commonwealth Government. (Nimmo, 1952, P 12)*

> *The Authority notes that the return to SunWater above lower bound only accounts for 2 to 3% of the cost of sugarcane production in the BRIA. (P103)*

In the case of growers, they have no options other than to absorb cost increases. This is particularly the case in terms of legislative cost imposts that have been a regular feature of recent Governments that have effectively chipped away at margins. As such, 2 to 3% may well be the entire profit margin of the farming operation.

8.0 CONCLUSIONS

1. The majority of determinations made by the *QCA* support the *BRIAC's* position.
2. The Ministerial Direction for the *QCA* to accept 'lower bound costs' for the Burdekin compromises the veracity of the review.
3. It is not the role of this Government to change the investment parameters of previous Governments without due compensation being made from Commonwealth *NCP* payments.
4. Past Government investment decisions were made for a number of reasons other than solely economic returns from sale of land and water.
5. Past Government investments are sunk costs as acknowledged by *IPART*.
6. Federal Government funding was in fact a contribution to capital.
7. The approach adopted by the *QCA* to strip out costs associated with redundant capacity of the Burdekin scheme is inaccurate and does not represent the intent of the investment decision. A more accurate approach would have been to incorporate those planned revenues that did not eventuate.
8. The determination of the benchmarked efficient costs for *SunWater* is flawed.
9. The 'capacity to pay' issue must be reviewed since the implementation of the Price Path based on actual realised sugar price over the last two years and more accurate estimates of sugar price over the next three years.
10. It is irrelevant that *SunWater* did not have the opportunity to take advantage of irrigators' greater capacity to pay in years prior to its existence.
11. A significant gap exists between the funding required to maintain irrigation schemes in perpetuity and achieving a rate of return that ultimately provides a dividend to Government. This matter should be considered together with capacity to pay issues. The first scenario also complies with *CoAG's Water Reform Agenda*.
12. The *QCA* needs to identify the wider community benefits of schemes and in so doing identify an appropriate *CSO* that is then appropriately recognised in water price determinations. Annual reports of *SunWater's* pervious entities (e.g. *DPI*, *WRC*, *IWSC*) reported on visitor numbers to storages. Clearly tourism needs to be reflected in the *CSO*.

9.0 ENQUIRIES

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