QCA review of irrigation prices

Supplementary information
Review and adjustment triggers

February 2011

1 Introduction

The Queensland Competition Authority (QCA) is currently investigating irrigation prices to apply in 22 bulk water schemes and 8 distribution systems owned by SunWater.

The QCA released a paper from NERA discussing issues surrounding the form of regulation. In its submission to this paper, SunWater proposed that a review mechanism was required as part of the regulatory regime in relation to potential or unforseen cost imposts arising that were outside SunWater’s control. SunWater also proposed that a materiality threshold should not apply, but if the if the QCA chose to apply one it should be set at an individual bulk water scheme or distribution system.

SunWater did not specifically address whether any adjustments should occur within-period adjustments or between-periods.

The QCA has sought more information about SunWater’s proposal.

This supplementary submission provides additional information to the Authority.

SunWater has separately provided information to the Authority about its proposals for dealing with electricity costs, and is not considered in any detail in this supplementary submission.

2 Materiality threshold

The Referral Notice requires the Authority to recommend prices to provide a revenue stream that allows SunWater to recover its efficient operational, maintenance and administrative costs, and prudent and efficient expenditure on renewing and rehabilitating existing assets, through a renewals annuity (lower bound costs).

The Referral Notice requires the Authority to “recommend appropriate regulatory arrangements, including price review triggers and other mechanisms, to manage the risks associated with the allowable costs identified ... (above) outside the control of SunWater.”[1]

The QCA and other regulators have previously considered setting materiality thresholds for triggering price reviews.

The Referral Notice requires that prices recover lower bound costs. The Referral Notice does not contemplate nor provide for a failure to recover any part of lower bound costs, including new cost imposts outside of SunWater’s control. This would occur if changes in costs arose that were outside SunWater’s control, yet fell below any materiality threshold set by the QCA. Accordingly, SunWater submitted that no materiality threshold should apply.

This remains SunWater’s position.

[1] Refer clause 1.3.

3 Timing of price adjustments

There are two options for the timing of pricing adjustments to recover additional costs arising from an event outside of SunWater’s control (apart from electricity price changes):

- A within-period adjustment, where prices would be adjusted once the change event occurred; or
- A between-period or ex-post adjustment, where prices in the following regulatory period would be adjusted to recovery the additional costs incurred.

The Referral Notice effectively sets a floor price for the review, applicable where irrigation prices already recover lower bound costs (refer clause 1.1(iii)). In these bulk water schemes and distribution systems, a within-period review would only be applicable where costs increased to the extent that existing prices no longer recovered the higher lower bound costs.

The Referral Notice also sets a price ceiling for certain bulk water schemes and distribution systems (refer clause 1.2). In this instance, prices are to increase at a nominated rate (in real terms) until such time as lower bound costs are recovered. An increase in lower bound costs would simply extent the timeframe for prices to reach the required level of cost recovery.

In the remainder of bulk water schemes and distribution systems, real price increases may be needed. In this instance, the Referral Notice requires the QCA to consider implementing a price path to moderate the price impacts, while having regard to SunWater’s legitimate commercial interests (refer clause 1.8). This price path may be longer than one price path period however the QCA must provide its reason for the longer timeframe. The QCA must also give reasons if it recommends to not implement a price path.

Where the QCA recommends that price paths apply, it presumably would have done so having regard to the impacts of those price increases on irrigators. In this case, SunWater would not expect that a within-period adjustment would be considered as the QCA would have already determined an acceptable rate of price increase over that price path period.

At the same time, the QCA must have regard to SunWater’s legitimate commercial interests. Clearly, SunWater has a legitimate commercial expectation that it will be able to recover the lower bound costs specified in the Referral Notice. Accordingly, SunWater has a legitimate expectation that any price path would be NPV neutral, allowing SunWater to recover lower bound costs in NPV terms, over the price path period.

Similarly, SunWater has a legitimate commercial expectation that any price review trigger implemented via a between-period adjustment would also be NPV neutral. For example, if an event occurred in the final year of the regulatory period that increased operating costs $100,000, then that $100,000 would be recoverable in the following price path, adjusted at WACC.

SunWater accepts that there may be little scope for within-period adjustments. Nonetheless, SunWater submits that within-period adjustments occur where the QCA is not constrained under the Referral Notice, or where price paths do not apply. Such within-period adjustments are only necessary in relation to operating cost changes, on the basis that changes to renewals costs (eg new compliance expenditure) would be accounted for in the Asset Restoration Reserve and recovered at the next regulatory period.

Where it is possible to do so, a within-period review is of critical importance as bulk water schemes/distribution systems will effectively be operating on a cash flow negative basis where operating costs increase beyond that allowed for in prices.[2] Clearly this is not a commercially sustainable situation.

4 Summary

In closing, SunWater submits that:

- the Referral Notice requires the QCA to establish price review triggers and other mechanisms to manage the risks of lower bound costs increasing due to matters outside SunWater's control. These events may be foreseeable, but uncertain (eg resource management and planning charges applying to distribution losses), or were not foreseen at the time of the current price review;
- there should be no materiality threshold for price reviews, on the basis that lower bound costs need to be recovered in full;
- there would appear to be no scope for within-period price reviews to apply where floor and ceiling price limitations apply or where the QCA has recommended price paths;
- where such constraints do not exist, the QCA should provide for within-period adjustments for events leading to increased operating costs, in order to ensure SunWater can at least recover its cash costs of operations during the forthcoming regulatory period;
- where a between-period adjustment applies, the adjustment in the next pricing period should be set to enable SunWater to recover the operating cost imposts incurred in the previous regulatory period, on an NPV neutral basis;
- where an event occurs that requires a change to the renewals program, no price review is proposed. Rather, the costs of this event will be incorporated into the Asset Restoration Reserve used to calculated the renewals annuity in the following period; and
- SunWater's proposed arrangements for adjusting consumption tariffs to reflect actual changes in Franchise Tariffs should be dealt with separately, resulting in annual adjustments to the consumption charge.

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2 After setting aside renewals annuity income into the Asset Restoration Reserve.