- - Public Submission by Nick Legge - -

Errors in ESC February 2016 Report "Goulburn-Murray Water Price Review 2016 Draft Decision"

This submission details a range of factual, process and logic errors made by the Essential Services Commission in relation to the proposed tariff increases for stock and domestic diverters.

These errors require the Commission to revise its Draft Decision. Failure to do so would be in breach of:

a) the Commission's obligation under the ESC Act, S. 33(3)(a), "*to have regard to - the particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made*;"
b) the Commission's obligation under the ESC Act, S. 5(2), to have overriding regard to the objectives of relevant legislation, in this case the Water Act which has as one of its objectives "*to foster the provision of responsible and efficient water services suited to various needs and various consumers*", and
c) the Commission's undertakings in its consultation charter to be "*independent, balanced and fair*" in its decisions and processes.

The specific errors are enumerated below:

1. Failure by the Report to recognise and account for the special nature of domestic and stock (D&S) water licences,
2. Failure by the Report to recognise that diverters with a single service point, such as most D&S diverters have no capacity to rationalise service points, and therefore the applicable tariff structure cannot encourage "greater efficiency" as stated in the Report, even if efficiency was an issue for D&S users,
3. Failure by the Report to address the range of issues regarding proposed tariffs for D&S diverters raised in the consultation process,
4. Failure by the Report to take note of, and respond to, evidence of potential bias in the advisory structure that G-MW relied upon to frame its proposed tariff structure for D&S diverters,
5. Failure by INDEC and by the Commission's Report to detect anomalies in G-MW's proposals,
6. Failure to detect contradictory claims by G-MW about the 'cost-reflectivity' of its diverters tariff structure whereby the 2015-16 access fee was defended on the basis that it already was reflective of costs,
7. Failure to detect and reject a spurious rationale underpinning the new tariff strategy ("to encourage agricultural production") despite this being pointed out in my previous submission,
8. Misconstruing arguments about the usurious nature of proposed price increases for stock and domestic water (ie for a specific and well-defined diversion customer sub-group) by stating that "we confirm that fees do not exceed the service costs" in relation to aggregate fees and costs across all diverter groups
9. Misreporting the conclusions drawn by the consultant, INDEC, regarding the proposed tariff structure
10. Failure to critically evaluate the various findings by the consultant, INDEC,

11. Erroneously asserting that the consultant, INDEC, "confirmed" that access costs were driven by the number of service points
12. Failure to challenge, much less respond to, the comment by INDEC that "*G-MW indicated that its cost data and analysis are limited in identifying the key cost drivers and which costs are fixed or variable for the delivery of diversions services*", and then failing to even remark upon the wholly qualitative approach adopted by G-MW to attribute costs,
13. Application of an illogical solution to the only problem the Commission identified with the derivation of the tariff structure for diverters, namely inadequate consultation with those most adversely affected.

A detailed explanation for each of these failings is set out in the attachment on the following pages.

Proposed Solution

The Commission doubtless has several options available to rectify the manifold errors and oversights identified here, however from a customer viewpoint the preferred option is clear:

Issue a revised Draft Decision that preserves the 2015-16 domestic and stock diverters tariffs for 2 years while a detailed, independent, properly informed and fully consultative analysis is carried out of an appropriate tariff structure and rates.

Given the Commission's Draft Decision to require G-MW to spread the proposed price increases over four instead of two years, the revenue cost to G-MW of a 2 year deferral would be modest – around $75 per customer[1].

[1] It is not clear from G-MW's published material how many D&S-only diverters there are, but assuming that the figure of 1,269 D&S customers quoted in G-MW's Annual report comprises D&S surface and groundwater diverters only, then the cost of holding prices at 2015-16 levels for two years would amount to less than $100k.

1. Failure to recognise the special nature of domestic and stock water use

The legislation governing the ESC requires it to have overriding regard to the objectives of relevant legislation, in this case the Water Act which has as one of its objectives "*to foster the provision of responsible and efficient water services suited to various needs and various consumers*".

Usage of water for domestic and stock purposes is qualitatively and quantitatively distinct from use of water for irrigation. For starters, the Water Act entrenches a longstanding privilege granted to landowners whose land abuts or includes a waterway to extract water from that waterway for domestic and stock purposes without charge (Water Act S.8).

The logic behind this provision is that a small amount of water for domestic and stock purposes is special – akin to a basic human right. Indeed, a case could well be made that people relying on water from streams for their household use are a vulnerable class of consumers and that failure to recognise this breaches clause 11(d)(iii) of the WIRO which states that prices should "*take into account the interests of customers of the regulated entity, including low income and vulnerable customers*".

Nowhere in its analysis does the Commission contemplate this issue, notwithstanding that water for household use is an utterly different purpose to water for irrigation.

Other differences exist as well. For example domestic and stock licences cannot be traded as can irrigation licences but are permanently attached to the land.

Furthermore, most water used for domestic and stock purposes will quickly return to the waterway from which it is extracted, whereas water used for irrigation will mostly be lost to evapotranspiration.

In addition, my submission and that of Russell Roberts pointed to major anomalies in G-MW's proposed D&S prices in comparison with the pricing of reticulated, pressurised and potable town supplies. These comparisons clearly demonstrate the unreasonableness of what G-MW proposes for this essential household service.

2. Failure to recognise that D&S diverters with a single service point cannot achieve efficiency gains

The Commission agrees with G-MW that hiking charges for D&S users will contribute to greater efficiency (para 1, p.61). But what underpinning reasoning does it use? Water use 'efficiency' is not an issue for D&S uses, given the legal constraints on how such water may be used and access point efficiency is also not an issue given that the vast majority of D&S users will only have a single access point.

Moreover since the tariff structure for D&S users is essentially fixed – and has been for a long time – there are no savings available to users who do not use their full entitlement. The only option is for them to reduce costs is to surrender their licence. Is this what the Commission wishes to encourage?

3. Failure by the Report to address the entire range of issues raised

The written submissions on G-MW's proposals raised a wide range of objections. As someone who has managed public consultation processes for the State Government in the past, I always regarded it as my duty to carefully examine and catalogue all points raised in written submissions and ensure that the review process took them seriously. This included referencing them or at least covering them appropriately in draft and final reports.

My expectation was that the Commission would do likewise. However the Commission chose to adopt a minimalist approach ("*We reviewed several issues raised in written submissions*" p.61)

And the second sentence of the first paragraph of Mr Calleja's reply to the Commission on 10 February demonstrates how little regard G-MW has for its customers' views, saying "*We have identified the main issues raised in the submissions which we consider it important to respond, . .*"

Given the extent of my previous submissions to G-MW criticising its processes and analysis it is perhaps unsurprising that they chose to be selective about what matters it responded to. Perhaps the Commission should have asked G-MW to respond to all the issues raised, but there may have been an expectation that G-MW would in fact do so. But if that were the case one would expect the Commission's Report to comment on G-MW's selective approach, but I could find no comment on the adequacy or otherwise of G-MW's response.

One is led to the conclusion that the Commission is satisfied with the disregard by G-MW of many of the issues raised in the submissions, since the Commission has apparently also disregarded them. In doing so, the Commission has failed to uphold at least one tenet of its *Charter of Consultation and Regulatory Practice*, namely that it should be:

> Representative and fair in the way in which we explain the key issues, facts and information and reflect the comments that stakeholders make to our processes.

The issues that I raised which the Commission appears to have disregarded in its Report and Draft Decision, in contravention of its *Charter of Consultation and Regulatory Practice,* are:

Legge submission, page 1, para #6:

> The fact that G-MW's short-run costs are largely fixed is no reason to have such a high proportion of its income from diverters set through fixed charges. Significantly, if D&S users were the only class of users permitted to extract water from G-MW waterways - - in particular from unregulated streams - - G-MW would barely need to incur any diverter-related costs since the amount of water extracted compared to the available streamflows would be insignificant. G-MW's organisational infrastructure only exists because of the huge water volumes needed to irrigate crops and pasture and it is irrigators - - not D&S diverters - - who should be paying a higher proportion of G-MW's costs.

Legge submission, page 1, para #8:

> After the proposed price increases, D&S users - - who pay for their own extraction infrastructure and running costs - - will be paying annual fees of almost one quarter the amount paid by urban domestic Goulburn Valley Water consumers for pressurised drinking water delivered to their home. And on a per ML basis D&S users on unregulated streams will be paying 50 times more per ML than large diverters. The inequity of this new structure is appalling.

Legge submission, page 3, Issue #2, last para:

> By not disclosing information about the representativeness of the group that worked with G-MW on developing the DTS, it is not possible for me, or the ESC, to know whether decisions that led to its development were clouded by potential conflicts of interest.

Legge submission, page 4, Issue #4, last sentence:

> Examining counterfactual positions is often a good way of assessing the reasonableness of many policies. If there was no irrigation in Victoria, G-MW would not need to exist, however if D&S users did not exist there would be almost no change to G-MW's operations.

Legge submission, page 4, Issue #5, first sentence:

> The DTS states that *tariffs should encourage productive agriculture as that underpins the regional economy and community*. However this position should be rejected by the ESC.

Legge submission, page 5, Issue #6, first sentence, second para:

> The underlying problem is that Water Plan 4 takes a rudimentary activity-based costing approach by using easily measurable apparent cost drivers as the basis for tariffs (e.g. number of service points, number of customers) rather than considering whether these are indeed the real drivers of G-MW's costs.

Legge submission, Appendix Page 4, second and third paras under 'Service Point Fee' heading:

> The G-MW information sheet 'Diversion fees and services' dated July 2015 indicates that the non-meter related costs underpinning the $100 service point fee comprise
>
> *"Performing both routine and random checks of your water source to ensure you're able to access water as efficiently as possible and your supply is not compromised by illegal removal of water."*
>
> In relation to the access efficiency element this should be of concern only to the customer, not to G-MW. In relation to the 'policing' element, it is hardly fair that honest users should be obliged to bear these costs, especially since much water theft presumably occurs via unlicensed extraction points. More significantly, the application of a service point approach to apportioning these costs is particularly unfair given that the need to guard against water theft is most critical for large users since it is their entitlements that could be most jeopardised by over-extraction. A volumetric based tariff would be a far fairer way of funding the costs of policing.

Legge submission, Appendix Page 5, last para:

> A billing system if designed just for D&S would be very simple and certainly would not cost $800,000 pa to run, as set out in the Diverters' Tariff Strategy. In particular, it would not need to include a delivery volume itemisation, simply an invariant annual charge. Also the billing system costs entailed in amalgamating separate licenses and service points into a single customer charge is not a cost that should be shared amongst sole D&S users. Water registry costs should also not be borne by D&S customers who are not involved in trading. For, these reasons requiring sole D&S customers to bear a pro-rata share of overall billing costs based on total G-MW customer numbers is grossly unfair.

Legge submission, Appendix Page 6, last para:

> And the bigger the irrigation volume, the more critical is the role of G-MW. A risk-management approach to assessing operational priorities for diverters would presumably entail most effort being directed to areas of highest risk, whether in terms of delivery efficiency, water security or revenue loss.

4. Failure by the Report to mention or respond to evidence of potential bias

It was clearly pointed out in my previous submission to the Commission that there was reason to believe that the advisory group that assisted G-MW develop its *Diverters' Tariff Strategy* (DTS) was biased towards favouring large irrigators.

This was evidenced by:

a) the failure of most members of the Regional Water Services Committees to disclose their water entitlements as G-MW policy – and good corporate governance – requires (as demonstrated by G-MW's response to my Freedom of Information request),
b) the failure of G-MW to respond properly to repeated requests by me find out what the entitlements of the advisory group members actually were, and
c) the explicit – and wholly improper (see point 6 below) – basis for one of the key foundations of the new tariff structure, namely that "*tariffs should encourage productive agriculture as that underpins the regional economy and community"* (as set out in the DTS and on page 2 of G-MW's two page brochure dated 1 July 2015 titled '*Your guide to our diversion services and how diversion fees are calculated*'.

The failure of the Commission to address this issue of potential bias underpinning the development of the tariff structure, or to query G-MW about the matter, could well be construed as the Commission being similarly biased towards a tariff structure favouring large irrigators.

5. Failure by INDEC and by the Report to detect anomalies in G-MW's proposals

Examples of the anomalies that the Commission failed to detect include:

a) the tariff structure between D&S users in gravity districts and D&S diverters whereby D&S diverters on unregulated streams – which entail negligible costs for G-MW – will be paying 13% more than D&S users in gravity systems – which entail significant costs for G-MW, and
b) the small but irksome discrepancy b/w the service point fee for surface water and groundwater diverters, when harmonising/simplifying the tariff structure was a key aim of the new tariff structure for diverters, and
c) the fact that G-MW saw fit to present a detailed response to customer concerns about its proposals for gravity customers in Water Plan 4 (Table 56), but not for diverters.

The failure to detect or mention this contradiction suggests that the Commission lacks the diligence Victorians expect from their official regulator of essential services.

6. Failure to detect contradictory claims by G-MW about 'cost-reflectivity'

On page 1 of its two page explanatory brochure dated April 2015 titled '*Changes to our pricing for diverters*' G-MW stated that its 2015-16 pricing changes "*reflected the rue costs of providing services to small diverters*". Yet in its Water Plan 4 pricing submission to the Commission only a few months later, G-MW declared that the further increases it proposed also reflected the true cost of service provision.

Which is true?

In its role as regulator most Victorians would expect that the Commission would keep a record of pricing announcements by its regulated entities, and therefore have been aware of G-MW's previous claims.

As with point 5 above, the failure to detect or mention this contradiction suggests that the Commission lacks the diligence Victorians expect from their official regulator of essential services.

7. Failure to detect and reject a spurious rationale for the changes

G-MW openly admits that one of the key foundations of the new tariff structure is that "tariffs should encourage productive agriculture as that underpins the regional economy and community" (as set out in the DTS and on page 2 of G-MW's two page brochure dated 1 July 2015 titled '*Your guide to our diversion services and how diversion fees are calculated*'.

Neither the Water Act nor the ESC Act contemplate the encouragement of a particular form of economic activity, such as agricultural production, over another, such as allowing households access to an affordable water supply via their D&S licence.

The unreasonableness of this underpinning foundation was fully argued in my first submission and it is incumbent upon the Commission to reject it in its final report and to ensure that the approved tariffs are revised to exclude its effect.

8. Misconstruing submitted arguments about the usurious nature of proposed price increases for D&S water

The Commission states on page 61 of its report that "*regarding a concern that diversion fees exceeded the costs of the service, we confirm fees do not exceed the service costs*". This would appear to be a deliberate misconstrual of the arguments put by me, by Peter Zlabek and by Russell Roberts in which we argued that it was the tariffs for D&S users that exceeded costs, not the diverters' tariffs in the aggregate.

The failure of the Commission to properly acknowledge the arguments put to it and respond appropriately is lamentable.

9. Misreporting the conclusions drawn by the consultant

The Commission states on page 60 of its report that "*regarding G-MW's proposal to reduce the number of customer groups from ten to four, Indec reported that G-MW could not provide cost data and analysis to support the key cost drivers*". This is simply wrong since the finding that G-MW could not provide cost data and analysis to support the key cost drivers was in relation to the tariff structure itself, not to the reduction in diversion customer groups from ten to four.

The Commission's failure to properly report – and presumably understand - the findings of its own consultant is reprehensible.

10. Failure to critically evaluate the various "findings" by the consultant

There is an abundance of errors and analytical deficiencies in INDEC's report. For example:

In relation to account management costs for diverters – which underpin the service fee - INDEC states that "*These costs would be common to all customers as every customer receives accounts in the same way and frequency, have identical payment options, are serviced by a single billing and accounting system, have similar options of contacting the same call centre and operate under the identical customer charter*" (last para p.27). This is simply wrong. As pointed out in my previous submissions both to G-MW and the Commission, unmetered users such as D&S diverters will have an invariant bill and they should not be required to bear the costs of a billing system that requires the input of meter readings.

Also in relation to account management costs INDEC states that "*The greater the number of customers is likely to result in higher costs*" (first para p.28). While this is obviously true, the key issue is not aggregate costs but unit costs and it is certain that the marginal cost of one more or one less customer is trivial compared to the average per customer cost.

In relation to access compliance costs which underpin the access fee, INDEC notes that these costs include "*the cost of ensuring water is accessed in line with management rules and plans . .* [and] *. . includes managing allocations, rosters, restrictions and water ordering*" (third para p.29). Apart from the fact that most of the specified costs do not apply to diverters, none of them apply to D&S diverters since their modest 2ML entitlement – at least on unregulated streams – applies under all conditions. At least on unregulated streams, D&S licences do not form part of the calculation of 'restrictable demand'.

The fact that restrictions need to be imposed on irrigators to ensure that streams do not run dry – and as far as practicable can supply D&S licencees - <u>does not mean</u> that the costs of monitoring flow and imposing restrictions should be borne in any way by D&S licencees. This is because it is irrigators and irrigators alone that necessitate the imposition of restrictions. If the only water users were D&S licencees there would be no need for G-MW to incur any such access costs. Indeed as was stated in my earlier submission, if D&S diverters were the only users of water G-MW would not even need to exist.

Moreover to the extent that some of the access compliance costs are inspectorial in nature – ie to guard against water theft - such costs would be properly borne in proportion to licence volumes, not in relation to service points. Indeed it is questionable whether guarding against water theft should be the responsibility of licencees, as opposed to the State of Victoria. However if it is to be borne by licencees, then why should they bear the entire cost of water theft since at least some theft will be by people who have a private right but who extract more than that right permits?

11. Misleading representation of INDEC findings

Dot point 1 under heading Tariff Structure on p.60 states:

> *Regarding G-MW's proposal to transition to a fixed cost access fee, Indec's analysis* ***confirmed*** *that the cost drivers for access compliance relate to the number of service points (which are a fixed cost) rather than water entitlement volume.* (my emphasis)

In fact INDEC's report stated (p.31):

> *G-MW did not provide cost data and analysis to support the key cost drivers identified for the major activities associated with diversion services.* (my emphasis)

While it did go onto state that it '*did not identify any issues with the qualitative analysis* [of cost drivers] *provided by G-MW',* this is hardly a ringing endorsement. Given these statements by INDEC, the bald statement in the Commission's report that INDEC "*confirmed that the cost drivers for access compliance relate to the number of access points*" is indefensible.

However the entire INDEC analysis of diversion services and tariffs is clouded by deficiencies and inconsistencies. At the start of the analysis – although the term 'analysis' seems barely justified – INDEC's report states (p.30):

> *G-MW provided cost data which demonstrated that the operating cost base related to the diversion services is fixed and does not vary with the volumes of water usage of diversion customers.*

INDEC's conclusion was based on an infantile chart (Fig. 3.6) plotting costs against total volume of water consumed. Obviously for a weather-dependent business like irrigation water supply, and for an organisation whose raw material is free and whose distribution costs are largely fixed the relationship depicted is entirely expected, and not just for diverters.

What should have been shown is an analysis of costs plotted against various configurations of customer groups by water volume consumed. But since G-MW does not have such data such a chart was all G-MW could produce.

The Commission should not need to be reminded of its own WIRO guidance to G-MW:

> G-MW's price submission **must provide sufficient information** for the Commission to assess G-MW's proposals for services, expenditure, revenue and tariffs.

Given the other shortcomings of the Commission's approach set out below, no fair-minded person could accept this criterion as being met. If the proposed tariff changes for diverters were minor this could be overlooked, but the fact that the Commission chose to accept the information provided as sufficient to justify massive tariff increases for a large number of customers is astonishing.

12. Failure to challenge or discuss the absence of costings

INDEC noted that "*G-MW indicated that its cost data and analysis are limited in identifying the key cost drivers and which costs are fixed or variable for the delivery of diversions services*". Surely this is ESC 'core business' and totally ignoring the issue is a major error. Then failing to even remark upon the wholly qualitative approach adopted by G-MW to attribute costs and accepting reliance on such a weak cost accounting approach as the use of three very high level budget buckets (Operations, Maintenance and Management/Admin) as proly dexy costs is woeful.

13. Application of an illogical solution to the only problem identified

The Commission has accepted that G-MW's consultation with those most adversely affected by the proposed tariff increases for diverters was inadequate. However instead of requiring G-MW to rectify this – in line with the heavy emphasis the Commission places on the value of consultation in producing better outcomes – the Commission has proposed simply stretching the implementation period from 2 to 4 years. This is little more than a crumb not just to those of us who have raised this issue, but to the many others on whose behalf we speak.

It is noted that under the Commission's WIRO guidance it may reject parts of a price submission if it considers that consultation was unsatisfactory. Merely extending the implementation period seems hardly consistent with the hard-nosed approach that the ACCC, the Victorian Government and the people of Victoria would expect.

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5 April 2016