Investigation into Local Management Arrangements for SunWater's Channel Irrigation Schemes

Stage 2 Public Report from the LMA Independent Chair, Leith Boully

Map showing the location of SunWater's eight channel irrigation schemes

September 2014

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Summary

The Local Management Arrangements (LMA) project has been an investigation into whether SunWater's eight channel irrigation schemes should be transferred from government ownership to new entities that would be owned and controlled by irrigators and other customers within the schemes.

In December 2012, the Queensland Government appointed Ms Leith Boully as the LMA Independent Chair. The Independent Chair has been responsible for leading investigations into the feasibility, costs, and benefits of moving to local management and with advising government whether or not local ownership and management of the channel irrigation schemes is supported by customers and provides an overall net benefit to Queensland.

In September 2014, the Independent Chair provided the Queensland Government with the final report for stage 2 of investigations into local management arrangements. This public report is drawn from the final report and provides a high level summary of the findings and recommendations of stage 2 of the LMA project. The Queensland government will consider the recommendations and announce their decisions separately to this report.

The eight SunWater schemes considered for local management were the channel distribution systems in Bundaberg, Burdekin, Eton, Emerald, Lower Mary, Mareeba, St George and Theodore.

Following a public call for expressions of interest, interim boards were established for each of the eight schemes. The contribution of the eight interim boards, appointed to investigate the option of local management on behalf of scheme customers, has been exceptional and a clear demonstration of the capability of people in Queensland's regional communities. They have carefully considered the opportunities and risks of local management and engaged openly with scheme customers. Based on the business proposals submitted to the Independent Chair it is apparent that there is a high level of support for local management.

Taking into account the interests of the state and irrigation customers, the Independent Chair has assessed the eight business proposals, produced by the interim boards, against the status quo of ongoing government ownership and seven principles, provided by government, to establish minimum criteria for a move to local management. The seven principles were:

(i) The long-term benefits (including economic, financial and public interest benefits) to the State of each proposal outweigh the costs incurred in setting up and operating local management.
(ii) A strong majority of irrigators support the move to local management.
(iii) The LMA must be a viable enterprise over the long term with limited risk of financial, operational or other significant failure, without recourse to Government.
(iv) The LMA is capable of delivering efficient water services.
(v) The assets will be maintained and refurbished in line with agreed service levels.
(vi) The LMA demonstrates a capacity to meet the statutory planning, regulatory and environmental obligations.
(vii) Any required debt funding can reasonably be accessed, noting that the new entities would be prohibited from borrowing from the Queensland Treasury Corporation (QTC).

The primary conclusion of the assessment is that it is in the long term interests of Queensland and the irrigation customers to transition ownership and management of SunWater's irrigation channel schemes to irrigator-owned entities. Key reasons include:

- A move to local management provides around 3,000 irrigators across Queensland an opportunity to control their own destiny, manage costs, and modernise/expand the schemes.
- Queenslanders will benefit from an increase in scheme productivity and removal of an ongoing subsidy to irrigators.

The transfer of the schemes to local management requires a final investment commitment (separation payment) from government to provide for the schemes' financial viability. Under government ownership it has not been possible to achieve cost reflective pricing or to establish asset annuity reserves with adequate capital to fund renewals. Separation payments can be justified to:

- establish the new businesses – systems setup, final due diligence, asset transfers, staff entitlements, governance etc.
- provide initial working capital
- make up the difference between costs and revenues until cost reflective pricing is achieved
- fund capital needs in the absence of adequate annuity reserves

There are significant differences between the schemes in terms of risk, age, viability, scale, operation, customer culture and local politics which must be taken into account in the design and execution of local management arrangements. On this basis the report recommends that four schemes transition to local management in mid-2016 (Emerald, Eton, St George and Theodore) and the remaining four conduct further work and resubmit proposals to transition to local management in late 2016 (Burdekin) and in 2017 (Bundaberg, Lower Mary and Mareeba). The establishment of transition entities that have legal standing and are able to formally engage with and represent customers is critical to ensure that the final negotiations are conducted commercially and the new businesses are set up to succeed.

The detailed business proposals and much of the financial analysis must remain 'commercial in confidence' to ensure future discussions between scheme customers and the government are not prejudiced. The findings and recommendations contained in this report are extracts from the final report provided to government with commercial in confidence material removed.

Key findings and recommendations

The key findings and recommendations that follow support the LMA Independent Chair's conclusion that local ownership and management of the channel irrigation schemes will provide long term benefits to scheme customers and the State of Queensland.

Findings

Experience from other jurisdictions

- Experience in other Australian states demonstrates that local management can work. After almost two decades, the privatisation of irrigation schemes in New South Wales, Western Australia, and South Australia, continues to deliver benefits to irrigation customers and governments. Privatised schemes have remained financially viable and there have been no requests for bail outs from government.

Outcomes of due diligence process

- The due diligence has not identified any material barriers to local management. Local management entities will be able to secure affordable insurance and self-fund deductibles and uninsurable assets and events. Key legal and tax issues can be managed. Special purpose legislation is recommended to facilitate any transition to local management.

- The potential risks to government and scheme customers that could arise through moving to local management are likely to be successfully mitigated through implementing a well-planned Stage 3 with a focus on achieving long term sustainability of the new entities and sound governance arrangements.

- Each of the interim boards have selected corporate forms and provided guidance on governance arrangements that should protect the interests of all scheme customers.

- The distribution scheme assets required to be transferred have been identified for each scheme. The engineering due diligence suggests that the schemes will require significant capital investment in asset refurbishment and renewal over the next 30 years. Much of this relates to long-life assets which will approach the end of their standard life in 25-30 years.

- The LMA due diligence process generally did not consider scheme modernisation or restructuring. The experience in irrigation districts elsewhere is that as technology and farming practices change the supporting infrastructure requires new investment. Local management allows for this planning to be undertaken at the scheme level as customers identify the need and are prepared to provide the capital for investment.

Cost to government of retaining the schemes in SunWater

- Since 2000, price paths have been set with the intention of closing the gap between costs and revenues and achieving cost reflective pricing. In practice the gap has in fact commonly grown. The consistent underestimation of costs and/or inadequate price increases is illustrated by the fact that predicted break-even years have seldom been achieved in practice, and where break-even has been achieved it has been only momentary.

- Government has not yet determined a policy position in relation to pricing beyond June 2017. In the absence of guidance, it has been assumed that the current policy settings will continue for the purpose of assessing the long term cost to government of continuing to own the schemes and as a comparator for the interim board business proposals.

- Retaining the schemes within SunWater under the current pricing policy and operational arrangements is likely to result in significant costs to government over the 30 years of analysis.

- The cost to government of retaining the schemes could be reduced by changing irrigation pricing policy, such as by allowing prices to increase faster than the existing \$2/ML+CPI[1] cap on annual fixed price increases.

Benefits of local management

- The major benefit of local management for customers has been described by many members of the interim boards as the capacity to determine the schemes' future at the local level by those who have most to gain. Specifically benefits flow from:
    - ability to modify scheme service standards (up or down)
    - greater focus on delivering value to customers' businesses
    - choice with regard to pricing arrangements
    - greater incentives and ability to reduce costs
    - better engagement with customers on critical decisions
    - greater transparency
    - choice in relation to realising modernisation and restructuring opportunities
    - local employment opportunities.

- For government the benefits that would arise from local management include:
    - capping the cost of the schemes to the taxpayer
    - transferring the risk of future cost increases to customers
    - reducing the opportunity for scheme customers to engage politically over distribution scheme pricing
    - providing a commercial environment through which the water market can achieve maturity and customers can realise the value of their entitlements
    - removing government as a provider of last resort and enabling customers to determine whether or not the schemes are sustainable
    - supporting the efficient delivery of water services and as a result supporting agricultural productivity.

- Based on the proposals presented by the interim boards, local management can deliver cost savings. Significant operational benefits have also been identified.

- A move to local management will support the Queensland Government's Agriculture Strategy and objective to double agricultural production by 2040 through enabling customers to determine how best to operate the schemes to reduce costs and support productive and profitable farm businesses and supply chains.

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[1] References to \$2/ML price increases in line with existing government policy refer to \$2 as in 2012/13.

Customer support for local management

- Six of the eight schemes have satisfied the government principle of strong customer support for moving to local management. In general, the larger commercial irrigators have demonstrated strongest support with smaller irrigators and hobby farmers being more ambivalent. In two schemes, Lower Mary and Mareeba, customers support further investigation into local management. Across all schemes, out of a total of more than 3000 customers, only 40 have voted in opposition to local management. There is a high level of expectation amongst customers within the schemes that government will support a move to local management.

- Support for local management is based on the proposals put forward by the interim boards. Where separation payments offered are less than the quantum requested in the business proposals the implications will need to be assessed by the transition boards and customers consulted prior to the finalisation of the transfer.

- Maintaining customer engagement and support is essential to achieving a successful transition and will be assisted by early advice on an intention to proceed to implementation of local management.

Assessment of the business proposals

- The business proposals generally satisfy the principles set by government that the local management entities be financially viable, and be able to provide efficient water services, maintain assets, meet regulatory requirements, and manage risks without recourse to government.

- All schemes require separation payments to be financially viable.

- The high level of uncertainty with regard to how government will regulate prices into the future has been a major impediment to the ability of the interim boards to consider alternative approaches to and consult with customers with regard to pricing under LMA. In order to be able to provide direct comparisons for customer consideration the interim boards have assumed the existing $2/ML +CPI cap on price increases will be maintained if LMA does not proceed. The boards have generally not proposed price increases above this level, on the pragmatic assumption that customers are unlikely to support LMA if it would result in higher prices than under SunWater.

Cost benefit analysis

- The LMA analysis demonstrates a net benefit to the state of moving to local management.

- Transaction costs would be significantly offset by other cost savings and benefits, for example the self-insurance costs and the cost of future regulatory pricing reviews.

- The impact of local management on SunWater in relation to future bulk water pricing is challenging to model given the uncertainty over SunWater's future business structure and the outcomes of future Queensland Competition Authority assessments. Modelling by SunWater suggests that divestment of four channel schemes (Emerald, Eton, St George and Theodore) will not have a material impact. Further work will be required to determine the impact on SunWater of divestment of the other four channel schemes.

Consistency with 2012 Commission of Audit

- The LMA project findings are consistent with the Commission of Audit findings:
  - That the irrigation schemes are uncommercial for as long as the current policy of not allowing a rate of return continues.
  - The public policy rationale for continued public subsidisation of irrigation channel systems is not well defined.
  - The benefit from the continued provision of these services is largely captured by well-established private operators rather than the public at large.
  - The opportunity cost of the subsidies, to the public, is not transparent. Moreover, there has been no formal assessment of the practicable limits of irrigation prices to determine whether further price increases can be achieved, as is contemplated in the NWI.
  - As the benefits from irrigation channels are captured largely by private businesses, responsibility for provision of maintenance and upgrading of the channels should rest with private irrigators.

- The recommendations which follow are consistent with the Queensland government's response to the Commission of Audit recommendation that: "SunWater's irrigation channels should be transferred to private irrigators under user-management or similar arrangements, and that SunWater should withdraw fully from this activity."

Recommendations

1. Under current pricing and service standard policies the long-term financial risk to government of continued ownership of the schemes is very high. This risk should be capped and transferred to commercial irrigators as the primary beneficiaries of the services provided by the channel infrastructure—through the implementation of local management.

2. All eight schemes should transition to local management, via a staged approach.

3. The schemes' individual circumstances must be taken into account in determining separation payments, transfer arrangements and timing.

4. Government owned transition boards should be established prior to separation payment offers being made to ensure that customers have an entity with legal standing to negotiate on their behalf.

5. Further customer consultation will be required to confirm support for local management particularly where there are material changes to the approach originally proposed by interim boards, and specifically in relation to changes to pricing and separation payment quantum.

6. Final separation payment amounts will need to be adjusted taking account of various factors including:

   - the outcome of negotiations
   - any signals government is able to provide on future pricing
   - an update to the discount rate used by the interim boards, to reflect the long-term cost of government debt as at the time of finalising the arrangements

- any material CAPEX within the scheme assets undertaken (or deferred) during the transition period and which differs from the current planned approach
- in the case of those schemes not transitioning immediately, the outcome of further engineering due diligence during Stage 3.

7. Taking into account the differences between the schemes, implementation should be staged as follows:

    a. St George, Theodore, Eton and Emerald - mid 2016.

    b. Burdekin– late 2016.

    c. Bundaberg, Mareeba and Lower Mary - late 2017.

8. A commitment of funds will be required to implement these recommendations. A detailed implementation plan and budget should be prepared subsequent to a government decision to proceed.

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Disclaimer
This report has been prepared for the Queensland Government. The LMA Independent Chair and project team accept no responsibility for any reliance placed on the report by any other party.