



20 February 2023
Carmel Donnelly, PSM, Chair
Water Regulation Review
Independent Pricing and Regulatory Tribunal

Re: Submission to Water Regulation Draft Handbook

Dear Ms Donnelly,

Sydney Desalination Plant (SDP) welcomes the opportunity to respond to IPART's Draft Water Regulation Handbook (Draft Handbook), and this letter presents our submission to the Draft Handbook.

As discussed below, SDP's practices are consistent with IPART's key expectations for water businesses, and we support many of the principles in IPART's Final Report on its regulation review and in the Draft Handbook.

The new framework understandably focuses on large water businesses that serve a broad cross-section of customers, and which have scope to adjust the way in which they deliver services. SDP supports the role of customer engagement in the regulatory process, it drives better outcomes for customers and the community. However, as we've noted through the review process, SDP's circumstances are unique in many respects and we request that IPART consider this when developing further guidance in its final handbook.

For example, SDP responds to very specific service levels principally determined by the NSW Government, SDP is not in a position to undertake broad-based customer engagement to co-create optimal service targets. As discussed below, SDP *does* undertake detailed engagement with both Sydney Water and the Department of Planning and Environment (DPE) when developing its regulatory proposals, and these parties act as agents for water customers. It is unclear from the Draft Handbook whether this type of engagement would meet IPART's expectations for customer engagement under the new regulatory framework or whether it would expect a different approach.

SDP's practices are consistent with the principles within IPART's new framework

Consistent with the Draft Handbook, SDP seeks to understand customers' needs and develop robust long-term plans to deliver safe and reliable services now and into the future. For example, as part of our ongoing operations and in developing our September 2022 Pricing Proposal, we:

- engaged, and continue to engage, extensively with our customer, Sydney Water, and DPE to understand customers' needs and the NSW Government policy expectations of our role in enhancing Sydney's water security;
- have a well-evidenced expenditure plan to deliver services efficiently and resiliently, consistent with customer long-term interests and the Government's strategic water plan for Sydney (the Greater Sydney Water Strategy); and
- have robust expenditure governance arrangements and productivity strategies.

There is a need to tailor IPART’s methodologies to the circumstances of water businesses

IPART has stated its intention to take a “tailored approach to price regulation”¹ guided by a “flexible approach driven by the business’s proposal”². We agree that these elements are key to meeting IPART’s objective that the regulatory framework “remains fit for purpose into the future”.³

Consistent with this, IPART appears open to adopting a tailored approach to price regulation for some elements of its framework by considering a business’s pricing proposal and its specific characteristics when making decisions on the regulatory framework to be applied in individual determinations. For example, for the cap on financial incentive schemes for service and cost performance, the Draft Handbook (p. 67) notes that:

The specific cap will be determined by IPART at each regulatory review, based on a proposal by each water business. In determining the cap, we will take into account the specific circumstances of the business, and the anticipated risks involved with implementation of the financial incentive scheme.

However, there are other instances where the Draft Handbook appears to standardise approaches that may in fact need to be tailored to the circumstances of the business to promote the long-term interests of customers. The circumstances facing a water business at a particular point in time, may necessitate some flexibility in IPART’s applications of its methodologies – which should be recognised and explained in the Handbook.

For example, in explaining the base-trend-step approach to forecasting the efficient operating expenditure (opex) allowance, the Draft Handbook (p 41) notes that:

“Baseline opex reflects the business’s efficient recurrent controllable opex in the second last year of the current determination period. This would be the most recent year with a full 12 months of data available.”

A standardised approach may work in a ‘steady-state’ world, where the second last year of the current determination period is a reasonable base from which to forecast efficient opex over the upcoming period. However, this is not case for businesses undergoing a significant change in their operating environment as is currently the case for SDP, where it is transitioning to a new operating role with significant uncertainty around how the plant will actually be utilised.

The second last year of SDP’s current determination period is 2021-22 (FY22), which is not reflective of the efficient costs for SDP to meet its customer’s needs and comply with its amended operating licence over the upcoming determination period. For much of the current determination period, including FY22, SDP was operating under its old drought and emergency response regime. However, for the upcoming determination period (to apply from FY24), it will be operating under its new regime – which commenced with the amendment to its licence in FY23 and requires it to be continuously available to supply water as requested by Sydney Water consistent with the Decision Framework endorsed by the Minister for Lands and Water.

¹ IPART, Delivering customer value: Our water regulatory framework, November 2022, p 6.

² Ibid, p 28.

³ Ibid, p 28.

This change to SDP's required operating regime and service levels was recognised by IPART in its recent Issues Paper for its review of SDP's prices and by Sydney Water and DPE in their responses to this Issues Paper. It means that in some circumstances, an alternative base year, that is better tailored to the circumstances of the business, may be appropriate. In the case of SDP, FY23 is a more appropriate starting point than FY22 for estimating SDP's opex allowances for the upcoming determination period as it more accurately reflects the current level service that SDP is providing, and is closer to SDP's new operating regime than either FY21 or FY22.

Similarly, IPART notes that it will consider options to manage cost risks (such as cost pass through mechanisms and true-ups) but the Draft Handbook (p 54) notes that these tools "are to be used in exceptional circumstances." There is little discussion as to what these circumstances are, and how IPART would assess a proposal that seeks to demonstrate that well targeted risk management mechanisms are in customers' long-term interests.

In developing our September 2022 Pricing Proposal to IPART, we closely considered the unique set of risks and challenges in providing our services over the 2023-27 regulatory period and proposed a framework for managing and allocating risks that is consistent with 'best practice' principles. In our view, this framework is in the long-term interests of customers as it would focus the business accountability on those things within the business' control, while reducing the business' exposure to windfall gains or losses for these things outside the business' control. Our proposed changes are intended to provide long-term benefits to water customers by enabling us to focus our efforts on those areas where we can deliver value and to minimise the total costs to water customers.

It is critical that the Draft Handbook acknowledges that applying a "flexible approach driven by the business's proposal" involves transparently considering where and when it is appropriate to standardise or tailor elements of the Regulatory Framework to the circumstances of the business, in the long-term interests of customers.

IPART's application of its new approach should reflect SDP's unique circumstances

SDP has a unique set of risks and challenges in providing its services, including specific:

- **asset characteristics**, such as being a single asset business that is not able to diversify performance risk across a portfolio of assets like other water businesses;
- **service characteristics**, with the nature of the services required from the asset constantly changing, with SDP currently in a unique situation of transitioning to a new operating regime, requiring a higher, more readily available level of service. IPART has highlighted that "the next few years will be a learning phase for SDP".⁴

Relative to other water businesses regulated by IPART, SDP is also unique in that it currently only has **one customer**, Sydney Water (which itself is a regulated monopoly).

We therefore request that IPART's application of its new framework and approach considers the unique circumstances of SDP. For example:

- The design of the Efficiency Benefit Sharing Scheme (EBSS) outlined in the Draft Handbook needs to be amended if it is to be applied to SDP. This is because SDP's required levels of output and hence its level of efficient opex can vary significantly from one year to the next under its new operating regime, and much more so than other water businesses. This variation is problematic and would need to be accounted for (without undue complexity) if marginal year-to-year efficiency gains are to be carried forward under the EBSS (as per its current design). We consider this issue further in discussing the Efficiency Carryover Mechanism (ECM) in our recent submission to IPART's Issues Paper on its current review of SDP's prices.

⁴ IPART, Review of prices for Sydney Desalination Plant from 1 July 2023: Issues Paper, 2022, p 42.

- The Draft Handbook notes the potential role for benchmarking in justifying the efficiency of proposed expenditure allowances. However, there is likely to be limited opportunity to apply benchmarking to SDP. The efficient costs of desalination can vary with factors such as plant design and size, operating environment, operating regime/rules and environmental and other regulatory requirements. There are no comparable water businesses to SDP within NSW and other desalination plants across Australia and other parts of the world all operate in different environments, at different scales, and to different operating rules – which drives very different levels of efficient costs. This severely limits the potential to benchmark SDP’s costs – which should be recognised by IPART in its approach to assessing SDP’s efficient costs.
- The Draft Framework has a large focus on customer engagement, in terms of outlining IPART’s expectations of water businesses and its assessment of the quality of a business’s pricing proposal. We can see the significant value of this for other water businesses regulated by IPART and we regularly engage with our customer, Sydney Water, to understand its needs. However, SDP does not have a direct interface with end-use customers, has only one customer and the manner and circumstances in which it provides its services is prescribed in its operating licence – which reflects the NSW Government’s intended role for SDP, as outlined in its strategic water plan (the GSWS). Therefore, IPART’s expectations of SDP’s customer engagement and its assessment of SDP’s pricing proposals should be tailored to reflect SDP’s unique circumstances.

We request that IPART clarify its expectations of SDP and its assessment approach

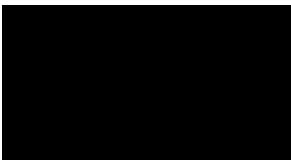
We recognise that there is a limit to what can be included and explained in the Handbook, and that further information on how IPART will apply its new framework and approach will be revealed during the 2024-25 price reviews for Sydney Water, Hunter Water and Water NSW. However, for reasons such as those outlined above, these are very different businesses to SDP. While IPART noted that SDP’s size (alongside Essential Water) was a distinguishing feature⁵, SDP’s broader asset and service characteristics are also key features that should be considered in tailoring the regulatory framework to the circumstances of the businesses.

We therefore request further information from IPART on its expectations of SDP on customer engagement and how it would assess the quality of SDP’s pricing proposal given SDP’s specific role, direct customer base, lack of comparators and the constraints in which it operates.

SDP would be happy to liaise further with IPART to discuss these issues and seek clarification on IPART’s expectations.

If you would like to discuss this submission, please contact myself or Ifty Omar, General Manager Regulation, [REDACTED].

Yours sincerely,



Philip Narezzi
CEO
Sydney Desalination Plant Pty Ltd

⁵ IPART, Delivering customer value: Our water regulatory framework, November 2022, p 13.