



SDP Submission - IPART Draft Report, Water Regulatory Framework Review

SDP's response to IPART's Draft Report on the Water Regulatory Framework Review

An appropriate citation for this paper is:

SDP Submission - IPART Draft Report, Water Regulatory Framework Review

Sydney Desalination Plant Pty Limited

ACN 125 935 177

Suite 19, Level 17

Australia Square

264 George Street

Sydney NSW 2000

Phone: [REDACTED]

Website: www.sydneydesal.com.au

Enquiries about this report should be directed to:

Iffekhar Omar

General Manager Regulation

[REDACTED]

[REDACTED]

Table of contents

1.	Introduction	1
2.	Assessing proposals against the 3Cs	3
2.1	We support clear guidance on IPART’s expectations and Board sign-off.....	3
2.2	We request clarity on IPART’s expectations of SDP’s customer engagement	3
2.3	We recommend narrowing the range of ex-ante incentives for the first round	4
3.	Encouraging continual improvement through financial incentives	5
3.1	We support the principles of balanced and symmetric incentives with caps	5
3.2	Efficiency and performance incentive schemes should not be tied to business gradings	5
3.3	We support explicit innovation funding, where justified	5
3.4	Incentive mechanisms should be accompanied by appropriate risk management measures, as occurs in the AER’s regime	6
4.	Updating common elements of price reviews	8
4.1	We generally support 5-year determination periods, but flexibility is sometimes required	8
4.2	We generally support IPART’s proposed approach to its expenditure reviews, but seek greater clarity, caution and consultation in benchmarking	8
5.	Addressing the changing revenue needs of water businesses	9
5.1	We propose refinements to IPART’s framework for managing changing revenue needs	9
5.2	We support IPART’s openness to accelerated depreciation and changes to asset lives	11
6.	Monitoring the performance of water businesses	12
6.1	Performance monitoring and reporting should consider the different roles, characteristics and circumstance of water businesses	12
6.2	We support a Regulators Advisory Panel, with regular participation by DPE.....	12
6.3	IPART should consult with stakeholders and provide sufficient notice of any proposed material changes to its methodology	12
7.	Modelling simplifications.....	13
7.1	SDP should be allowed to maintain its asset classes for depreciation	13
7.2	SDP does not support reverting to the pre-2018 approach for working capital	13
7.3	SDP supports IPART maintaining flexibility to deduct 50% of asset sales or the regulatory value of an asset when it is sold	13
7.4	SDP does not support IPART ‘locking-in’ a 50/50 sharing of non-regulated income	14

1. Introduction

Sydney Desalination Plant Pty Limited (SDP) welcomes the opportunity to respond to IPART's Draft Report and Draft Technical Paper on its Regulatory Framework Review (*Delivering Customer Value – Draft Water Regulatory Framework*).

IPART has followed an extensive process to develop its draft positions, including several stages of consultation with the sector and drawing on the approaches of other economic regulators – including the Australian Energy Regulator (AER), the Victorian Essential Services Commission (ESC) and Ofwat in the UK.

SDP supports many elements of IPART's proposed package of reforms, including:

- Board sign-off (approval) of pricing proposals
- Greater pricing flexibility when in the interests of customers, including negotiated pricing agreements
- Symmetric, balanced efficiency and service incentive schemes, with caps
- Streamlined/targeted expenditure reviews for high quality proposals, the base-step-trend approach to assessing operating expenditure allowances, and ex-post reviews of capital expenditure by exception
- In-period reviews/adjustments (i.e., partial reopeners) or true-ups to cost allowances where warranted
- Accelerated depreciation and/or changes to asset lives if there is a risk of asset stranding
- IPART working with industry to develop further guidance ('water regulation handbook') on applying the 3Cs framework.

There are some elements of IPART's proposed package of reforms, however, where we request greater clarity or a change to IPART's position and proposed approach. We request that IPART:

- Provides clarity on its expectations of SDP's customer engagement in developing its pricing proposal, given SDP's unique circumstances (including the role of the Government in determining its operating regime and Sydney Water in engaging with its own end-use customers)
- Not tie the application of the Efficiency Benefits Sharing Scheme (EBSS), Capital Expenditure Sharing Scheme (CESS) and Outcome Delivery Incentive Scheme (ODI) to the grading of pricing proposals
- Confirm its approach to adjusting the EBSS and CESS to account for the impact of any cost pass throughs, partial reopeners or cost true-ups, in consultation with the water businesses
- Provides explicit innovation funding where it can be justified by a water business – which can be particularly important for a single asset utility such as SDP
- Be open to deviations from the default 5-year determination period, where a utility makes a case that a shorter or longer determination period is warranted
- Provide greater clarity about when and how more targeted/streamlined expenditure reviews would occur (including, for example, distinctions between a "targeted" and "detailed" review process); and use the size and scope of each business and its expenditure plans to determine the level of scrutiny applied through the expenditure review process

- Consult extensively with SDP if developing any benchmarking and predictive models that may apply to SDP – given our unique circumstances means there are no like-for-like comparators
- Make refinements to its framework for managing changing revenue needs, as outlined in this submission
- Allows SDP to maintain its current asset classes for the purpose of calculating regulatory depreciation, given SDP's relatively small number of asset classes
- Retains the methodology IPART established in 2018 for determining the working capital allowance and not revert to the pre-2018 approach
- Not 'lock-in' a 50:50 sharing ratio for non-regulated income and be open to water businesses making a case for alternative sharing ratios given the specific circumstances and nature of the non-regulated income. A 50:50 sharing ratio should only be applied as a default in the absence of reasonable justification by a utility for an alternative ratio.

We would also like to request to be involved in IPART's flagged development of guidance material – including the better water regulation handbook and the detailed assessment tool. In developing this material, it is important for IPART to allow sufficient flexibility to tailor its approach to the role and circumstances of each water business.

SDP is a single asset utility, currently only serving one customer (Sydney Water), which itself is a regulated monopoly. SDP's operating regime is governed by its Water Industry Competition Act (WICA) Network Operator's Licence, which is approved by the NSW Government and reflects the NSW Government's policy intent. Over recent years, SDP's operational role has evolved from primarily a drought response asset, to being more readily available to support Sydney's water supply in a range of circumstances – including drought, floods and 'business as usual' water supply. This more readily available and responsive role is increasingly important given the effects of climate change. This operating environment and role present unique risks and challenges to SDP – which need to be considered in regulating its prices.

In the sections that follow we explain SDP's positions, following the general sequence of IPART's Draft Technical Paper.

2. Assessing proposals against the 3Cs

Below we list our responses to key elements of IPART's draft positions on assessing pricing proposals against the 12 principles under its '3Cs' framework.

We support many elements of IPART's proposed framework. However, we ask for consideration of SDP's unique role and circumstances, and clarity on IPART's expectations of SDP in relation to customer engagement.

2.1 We support clear guidance on IPART's expectations and Board sign-off

In general, the 12 principles outlined by IPART provide a good framework to guide development of pricing proposals. We support IPART's principles that focus on achieving the best outcomes for customers and the community over the long-term. This includes, for example, customer choice pricing – which recognises that, in the right circumstances, a flexible approach to pricing can deliver the best outcomes for customers, rather than an overly prescriptive or rigid approach.

For example, the ability for SDP to enter negotiated pricing agreements with its customer (i.e., customer choice pricing) would have been particularly valuable to SDP and Sydney Water over the last couple of years in dealing with Sydney Water's Emergency Response Notices (ERNs). The prices in IPART's determination did not reflect the ERN supply circumstances, which meant they were lower than SDP's efficient costs of supply (as they did not reflect SDP's loss of economies of scale at low flow, nor the additional staff costs it incurred to remain constantly operational). Such a situation is not sustainable, nor consistent with being able to readily respond to customers' needs in a range of circumstances over time.

We also support IPART's proposed requirement for Board sign-off (approval) of pricing proposals. Our Board is involved throughout the development of our pricing proposal, including through a dedicated Regulatory Committee comprising regulatory experts of the Board. SDP's Board ultimately approves and stands behind our proposal.

Further, we support IPART's development of further guidance material – including the flagged Better Regulation Handbook and the detailed assessment tool – and we would like to be consulted and involved in the development of this guidance material. Clear upfront guidance from IPART about its expectations of pricing proposals and how it will assess those proposals is important for providing required levels of investment certainty, promoting innovation and efficiency gains, lifting the performance of the sector and enhancing customers' interests over the long-term.

2.2 We request clarity on IPART's expectations of SDP's customer engagement

The grading framework needs to recognise SDP's circumstances and we would value clarification of IPART's expectations of SDP accordingly – particularly in relation to customer engagement.

It is not within SDP's purview to determine the level and scope of services it provides in consultation with end-use customers. The NSW Government determines SDP's level of service through its own process – including its development and consultation on the Greater Sydney Water Strategy – and this level of service is set out in SDP's Network Operator's Licence.

Further, SDP only has one direct customer (Sydney Water), which has considerable influence over the level of service SDP provides and is well equipped to engage on complex matters as part of the regulatory process. SDP does not need further incentives to engage with Sydney Water. Sydney Water itself is also a

regulated monopoly, responsible for understanding its own customers' needs. We believe it would be most efficient for SDP to seek to understand end-customers' needs through the lens of Sydney Water's customer engagement.

IPART's Draft Report now states that "each business will propose focus principles from the customers and costs principles according to its customer base."¹ However, we request further clarity from IPART about its customer engagement expectations of SDP. For example, whether SDP should:

- focus its engagement on Sydney Water as its customer and the extent to which it should deliver to Sydney Water's expectations (noting its monopoly and monopsony positions), or
- try to understand end-use customers preferences – even though its ultimate level of service is determined by the NSW Government and Sydney Water is responsible for understanding its own customers' needs.

We expect that Sydney Water is responsible for understanding its own customers' views and preferences, and that our customer consultation should therefore be focussed on Sydney Water and understanding end-customer needs through the lens of Sydney Water's customer engagement, but subject to the constraints set out in our Network Operator's Licence.

Nevertheless, given the focus on customer engagement in IPART's Draft Report and the potentially adverse consequences for SDP of a negative assessment of its pricing proposal under IPART's proposed new framework, we seek clarity from IPART on its expectations.

2.3 We recommend narrowing the range of ex-ante incentives for the first round

IPART's Draft Report has provided some guidance on what would constitute standard, leading or advanced business. However, what exactly will be graded as standard, advanced or leading is still a subjective judgement by IPART. There is no IPART precedent to demonstrate how this judgment will be exercised in practice. This information will only be clear after IPART undertakes its first round of reviews under the new framework.

The current broad range of potential financial outcomes (as shown in the grading table in IPART's Draft Report) are likely to provide a disincentive to businesses to be ambitious because if IPART disagrees with a leading or advanced self-assessment there are material financial penalties at stake. The Draft Report provides between 0.5% and 1% per annum revenue penalties. Thus, businesses are likely to be cautious in their approach.

Narrowing the range of potential financial outcomes for the first round of reviews may be prudent and could drive more ambitious proposals. IPART could then increase the range of incentives in the second round of 3Cs pricing reviews, if appropriate.

¹ IPART, *Draft Water Regulatory Framework: Technical Paper*, May 2022, p 8.

3. Encouraging continual improvement through financial incentives

In this section we outline our response to IPART's proposed financial incentives for efficiency gains and enhanced service outcomes for customers. This includes its proposed EBSS, CESS and ODI schemes.

3.1 We support the principles of balanced and symmetric incentives with caps

We support IPART's principles of balanced and symmetric incentive mechanisms (including the EBSS, CESS and ODI schemes), with caps on rewards and penalties. This is important for providing appropriate incentives to regulated businesses, while not imposing undue risk on them or their customers.

We note that this is in contrast to SDP's current abatement mechanism (a form of IPART's proposed outcome delivery incentive schemes), which is not balanced nor symmetric, and is a disproportionately harsh penalty-only scheme with no cap.

As SDP's role and required levels of service have changed, a new ODI scheme will need to be developed and applied to SDP. We request that IPART applies the principles of balance and symmetry outlined in its Draft Report in developing such a scheme. In our upcoming 2023-27 Pricing Submission we will outline what we believe is a fit-for-purpose Service Level Incentive Scheme (SLIS), aligned to our future role.

3.2 Efficiency and performance incentive schemes should not be tied to business gradings

IPART's Draft Report notes that efficiency and performance incentive schemes will only apply to 'Advanced' and 'Leading' proposals. However, we consider the application of these schemes should not be tied to proposal gradings. Regardless of a proposal's grading, it is in customers' long-term interests that utilities' face incentives to pursue efficiency gains (relative to IPART's assessment of their efficient costs) and improved service outcomes to customers.

3.3 We support explicit innovation funding, where justified

IPART states that proposals for explicit innovation funding should demonstrate:

- a well-defined problem linked to customer outcomes, which explains the limitations of existing funding mechanisms that require an innovation fund; and
- that the business has clear incentives to 'innovate efficiently' to achieve outcomes.

We urge IPART to remain open to explicit innovation funding, where it can be justified by a water business. Research and Development (R&D) can deliver significant benefits to customers over time, through reduced costs, lower risks and/or enhanced services, but such R&D cannot always be directly linked to short-term cost savings or 'payback' within a regulatory period. Therefore, appropriate expenditure allowances are important for facilitating such activities.

This is recognised in other regulatory regimes. For example, in a report for IPART, CEPA concluded that one of the emerging practices in regulation is for regulators to support innovation by providing funding and/or resourcing for companies to trial innovative approaches they would not otherwise undertake. CEPA outlined the examples of Water Services Regulation Authority (Ofwat), Office of Gas and Electricity Markets

(Ofgem) and the Australian Electricity Regulator (AER) providing explicit allowances for R&D and innovation, and of the AER and Ontario Energy Board (OEB) establishing innovation ‘sandboxes’.

The Australian Productivity Commission (PC) has also found that economic regulation should allow for R&D investment by water utilities. It considered that statements of obligations on businesses, or similar governing documents, should include an expectation that regulated utilities will invest in research and development activities relevant to their business. This would empower utilities and ensure that economic regulators include associated expenditure when making price determinations.²

Innovation fundings can be particularly important for single-asset utilities like SDP. Other urban water businesses, which are larger than SDP and have a broader range of assets and services, have been able to embed R&D activities in their proposed expenditure allowances. For example, appropriate research and innovation is one of the objectives included in Sydney Water’s Strategic Asset Management Plan and Hunter Water’s 2019 pricing submission noted that it had increased resources to undertake research and strategic planning during the 2016-2020 period.³ Such activity is necessary to enhance customer outcomes and provide innovative new services.

Over time, we have identified short-term cost minimisation strategies, or ‘low hanging fruit’, to achieve efficiency savings in operating the Sydney Desalination Plant and pipeline, and these have and will continue to be reflected in our (lower than otherwise) proposed expenditure allowances at price reviews. As we move to a new operating regime, we are now also focused on identifying activities that reduce risks, enhance services and/or provide future benefits to customers over the longer-term. However, identifying these activities can impose a cost on SDP in the short-term, with benefits ultimately flowing to customers through reduced risk and/or enhanced services levels in the future.

3.4 Incentive mechanisms should be accompanied by appropriate risk management measures, as occurs in the AER’s regime

The EBSS and CESS allow the regulated businesses to hold onto a greater share of efficiency gains or losses relative to the allowances set at price determinations. They therefore rely on these allowances reflecting efficient costs throughout the determination period. If they do not, for example because of an event and cost beyond the control of the regulated business, the application of the EBSS and CESS can unduly amplify gains or losses to the regulated business.

The AER’s EBSS and CESS are supported by robust contingent project and cost pass through mechanisms, to ensure that exogenous factors do not lead to revenue rewards or penalties for regulated businesses. If IPART were to implement these schemes, it would be an additional reason why IPART should enhance its approach to addressing unforeseen or uncertain efficient costs – discussed in the next section.

We also request IPART confirm its approach to adjusting the EBSS and CESS to account for the impact of any cost pass throughs, partial reopeners or cost true-ups (at the next price reset). These would effectively result in additions to IPART’s assessment of efficient costs, as well as the water business’s actual costs, but would not be reflected in the original cost allowances. If they are included as actual costs but not included in the expenditure allowances when determining the EBSS and CESS balances (or pay outs), the water business may be unduly penalised. Therefore, one approach would be to adjust both the allowance and actual expenditure by the value of the pass-through or true-up so that a business is not unduly

² Productivity Commission, National Water Reform 2020 Final Report, 2021, p 214.
<https://www.pc.gov.au/inquiries/completed/water-reform-2020/report/water-reform-2020.pdf>

³ For example see: Atkins, Sydney Water Corporation Expenditure and Demand Forecast Review Final Report, 2020, p 56; and Hunter Water, Pricing Proposal to IPART, 1 July 2019, p 29.

penalised under the EBSS or CESS for an 'additional' cost that is ultimately deemed by IPART to be efficient.

SDP considers that it is critical that incentive mechanisms provide SDP with greater accountability for those things within our control, and less exposure to windfall gains and losses for those events outside our control. This is particularly important for SDP as it is a single asset business supplying requested volumes of water, which means that it does not have the benefit of being able to manage risks and the impacts of events outside its control across a broad portfolio of assets and services.

As noted by several businesses at IPART's public forum on the Draft Report, more data and analysis may be needed before a CESS can be successfully introduced. A CESS focussed on improved efficiency of routine repeatable tasks and unit rate efficiencies in delivery of capex is valuable in theory but difficult to design in practice. A CESS applying across all capex could incentivise deferral of necessary and efficient capex, which could be detrimental to asset reliability and long-term water security.

In SDP's case, its future scope of operations is highly uncertain (as SDP will respond to Sydney Water production requests) and as a consequence so will the required scope and scale of capital expenditure. At this stage, SDP's incremental capital expenditure is relatively small both by reference to its entire asset base and other regulated water businesses. Thus, efficiency of capex outcomes are likely to be best achieved through robust competitive tendering, focussed on the best cost, delivery and risk management options offered in the market, rather than through a CESS that may simply incentivise the lowest cost options.

SDP's position is that further consultation and analysis is required before a CESS can be successfully introduced. This could be achieved through 'paper trials' where the scope and design of a CESS is developed and data captured over the first round of regulatory reviews under the new framework, after which IPART could determine whether to apply a CESS and, if so, its optimal design.

4. Updating common elements of price reviews

In this section we provide our responses to IPART's proposed length of determination periods, and its proposed approach to expenditure reviews.

4.1 We generally support 5-year determination periods, but flexibility is sometimes required

IPART has flagged that it will set 5-year determination periods.

We support 5-year determination periods as a default, but IPART should be open to changes to this when a utility makes a case that a shorter or longer determination period is warranted.

This degree of flexibility is important for ensuring that determination periods optimally balance the pros and cons of a shorter versus longer determination period – given prevailing circumstances.

4.2 We generally support IPART's proposed approach to its expenditure reviews, but seek greater clarity, caution and consultation in benchmarking

We generally support IPART's proposed:

- use of the base-step-trend approach for determining operating expenditure allowances
- use of predictive capital expenditure models where appropriate and where the data is available (e.g., drawing on information on best practice membrane replacement cycles)
- ex-post review of actual capital expenditure 'by exception'
- streamlining information returns to IPART
- allowing businesses to nominate their own continuing efficiency factor under the "3Cs" framework.

We also support a more targeted/streamlined expenditure review. However, we request greater clarity from IPART about when and how this would occur (including, for example, distinctions between a "targeted" and "detailed" review process).

SDP considers that the size and scope of each business and its expenditure plans should determine the level of scrutiny applied through the expenditure review process.

We also urge caution and consultation in developing and applying benchmarking and predictive models across heterogeneous businesses where like-for-like comparators are not available. This is particularly pertinent to SDP, given its unique circumstances (including its operating regime).

Not all businesses may be suitable for benchmarking and, at a minimum, some businesses will be less suitable than others. Before applying benchmarking, we consider that IPART should assess whether a business is suitable for benchmarking relative to other potential methods of assessing expenditure allowances, given factors such as the operating environment of the business, its role and operating regime, and the availability of like-for-like comparators.

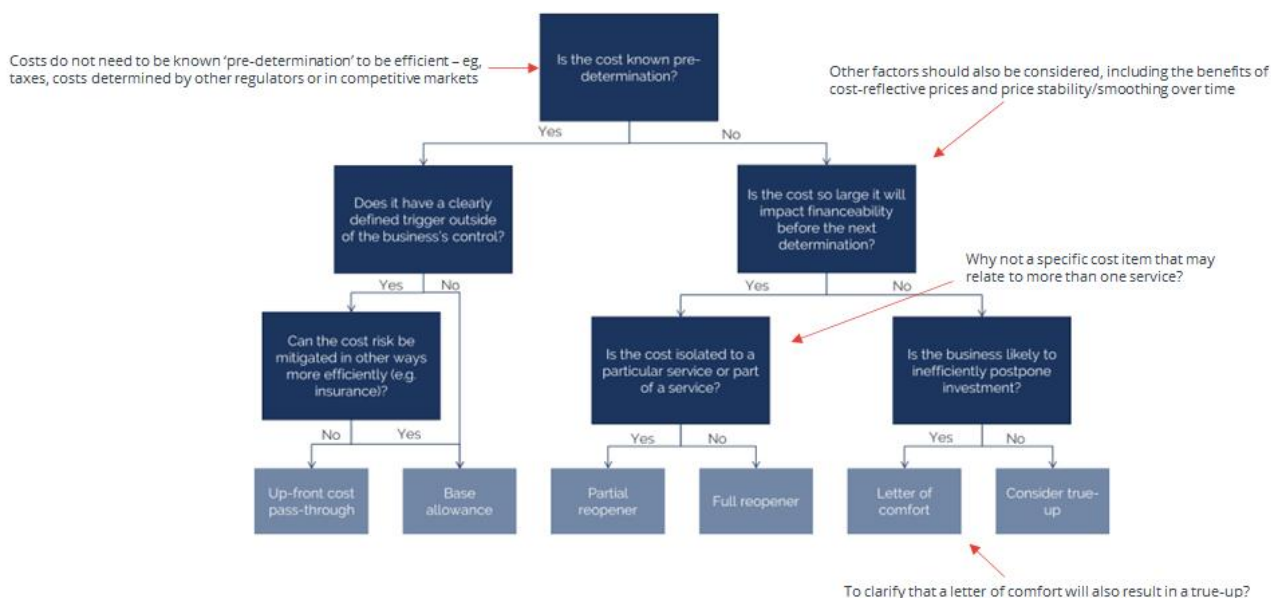
5. Addressing the changing revenue needs of water businesses

Below we present our responses to key elements of IPART's proposals for addressing the changing revenue needs of water businesses.

5.1 We propose refinements to IPART's framework for managing changing revenue needs

IPART's Technical Paper presents a framework outlining when it would provide for a cost pass-through allowance, incorporate costs into the base allowance, reopen all or part of a determination, provide a 'letter of comfort' or consider a true-up for cost recovery at the next price determination (see **Figure 1**, which includes SDP comments on aspects of the framework).

Figure 1: IPART's Framework for managing changing revenue needs, with SDP comments



Source: IPART, Draft Water Regulatory Framework: Technical Paper, May 2022, p 51; with SDP comments

Costs should not need to be known pre-determination to qualify for an upfront cost pass through mechanism

Within this framework, IPART suggests that the threshold question for determination of whether a cost pass through may occur is if the cost to be passed through is known pre-determination. The rationale for this is presumably so that IPART can assess the cost to be passed through and be confident that it is efficient.

However, even if a cost is unknown pre-determination, there can still be assurances that the value passed through represents efficient costs – for example, if this value is ultimately determined in a competitive market, by another regulator (e.g., the AER), market body (e.g., AEMO) or via government taxation (e.g., land tax or council rates). Even though changes to these costs may not be known at the time of a determination, passing them through within a determination period (in response to a specified trigger event) is consistent with cost-reflective pricing, which is in the long-term interests of customers.

This approach, for example, was adopted in IPART's 2016 determination of Water NSW's bulk water prices to Sydney Water.⁴ This determination included a cost pass through mechanism that allowed Water NSW to pass through into its prices to Sydney Water an amount equal to its actual volumes of water pumped from the Shoalhaven multiplied by a benchmark energy price published by the Australian Energy Market Operator (AEMO).⁵

The threshold question for whether there should be a partial or full reopener should not be limited to whether it impacts financeability

SDP supports IPART conducting in-period reviews/adjustments to cost allowances where warranted (i.e., a partial reopener of the determination) or true-ups at the next determination to account for differences between allowances and actual efficient expenditure (e.g., due to unforeseen or uncertain costs).

IPART's framework indicates the determining factor (or threshold test) as to whether to apply an in-period adjustment (via a partial re-opening of the determination) versus an end of period true-up is limited to considering the financeability impacts on the business. However, IPART's financeability test, as applied to date, does not always accurately reflect financeability impacts on the business.

If IPART is to apply a threshold test to determine whether an in-period adjustment should occur, it should be equal to +/-1% of the business's notional annual revenue requirement, consistent with the materiality test used by the AER to determine whether a cost pass through should be triggered.

We also consider that while financeability is an important consideration, other considerations could also support a re-opening of the determination – e.g., if a re-opener would ensure more cost-reflective pricing or enhanced price stability/smoothness over time (rather than a steeper adjustment, for example, at the next price reset).

For a partial or full reopener, why must the cost be isolated to a particular service or part of a service?

We welcome IPART's provision for a partial reopening of the determination, as a way of conducting an in-period adjustment to incorporate unforeseen efficient costs that are outside a business's control into prices. However, we query why a partial reopener would only apply to "a particular service or part of a service", as opposed to also potentially applying to a particular cost that may impact more than one service. For example, if a full price review is deferred, there may be a case to partially reopen the determination to simply adjust prices by consumer price index (CPI) – which would maintain prices in real terms and may help to smooth prices between the current determination and the next full determination.

We request that IPART clarify the relationship between its proposed letter of comfort and the true-up

IPART's framework seems to present a 'Letter of Comfort' (issued within a determination period but relating to the next price determination) and 'Consider true-up' (at the next determination) as alternatives to each other. However, a letter of comfort should result in a true-up at the next price re-set. We seek confirmation from IPART that a letter of comfort would result in a true-up at the next price reset.

We request that IPART clarify its treatment of cost pass throughs, partial re-openers and true-ups in the EBSS and CESS

As outlined in 3.4, we also request that IPART confirm its approach to adjusting the EBSS and CESS to account for the impact of any cost pass throughs, partial re-openers or cost true-ups (at the next price reset). We suggest that one way to do this would be to adjust both the 'allowance' and actual expenditure by the

⁴ See: IPART, Review of prices for WaterNSW, From 1 July 2016 to 30 June 2020, Final Report, p 73.

⁵ The NSW regional reference price for the 18 half-hourly periods starting at 10:00pm and ending at 07:00am, averaged for the month, in \$/MWh, as reported by the Australian Energy Market Operator.

value of the pass-through or true-up so that a business is not unduly penalised under the EBSS or CESS for an 'additional' cost that is ultimately deemed by IPART to be efficient.

5.2 We support IPART's openness to accelerated depreciation and changes to asset lives

IPART flags that it in certain circumstances it will consider:

- accelerated depreciation – where there is an asset stranding risk
- annuities – where they more evenly spread costs for a single asset business
- escrow accounts – in rare circumstances (escrow accounts would be used to start recovering revenue to fund future investments before they are made to ensure that businesses do have sufficient funding ahead of time for large investments)
- asset life changes – including modest changes when in customers' interests.

SDP supports IPART's consideration of accelerated depreciation where there is a risk of asset stranding, and changes to asset lives where warranted.

As noted by IPART, asset stranding can occur where there is no use for an asset while it still works (e.g. where there is no further demand for the services an asset provides, even though it is still capable of providing services) – or, in other words, where the economic life of an asset may be less than its design life. Design life represents the expected physical useful life over which an asset can provide services. IPART also recognises that a firm will only invest where it expects to recover the economic costs of its assets.

To avoid the risk of asset stranding, and hence to ensure there is not a deterrent to efficient investment, it is important that regulators such as IPART set the depreciation allowance based on the expected economic life of assets rather than their design life. There are many examples of regulators in Australia (including IPART) that have set regulatory depreciation allowances using an economic life that is shorter than the design life of the assets, to avoid a situation where the full economic cost of the regulated assets cannot be recovered by investors.⁶

A regulatory framework that allows the stranding of regulated assets is likely to:

- deter efficient investment in the assets used to deliver regulated services – which could result in a deterioration in service quality to consumers; and/or
- increase the return required by investors to compensate for the risk of their investments in regulated assets becoming stranded – which would raise the cost of supplying services, and ultimately result in consumers paying more than they would if stranding were prevented by the regulator.

⁶ For example see: the Economic Regulation Authority of Western Australia (ERA), Final decision on proposed revisions to the Dampier to Bunbury Natural Gas Pipeline access arrangement 2021 to 2025, 1 April 2021; Australian Energy Regulator (AER), Evoenergy access arrangement 2021 to 2026, Final Decision, Attachment 4, pp. 7-8; Queensland Competition Authority (QCA), DBCT 2019 draft access undertaking, March 2021, p. 171; IPART, Rate of return and remaining mine life 2019-24, Final Report, July 2019, p. 24.

6. Monitoring the performance of water businesses

IPART has flagged that it will:

- require businesses to report to customers on their progress against the customer outcomes in their pricing proposal annually
- produce and maintain a dashboard that collates the information provided by each business, to provide stakeholders with comparable information across businesses
- establish a Regulators Advisory Panel
- review its framework every five years, after it has been implemented, and continually refine and improve its regulatory approach.

6.1 Performance monitoring and reporting should consider the different roles, characteristics and circumstance of water businesses

SDP supports enhanced transparency and reporting of performance against customer outcomes.

However, we also note that the regulated water businesses in NSW vary materially in size and scope (relative to each other, as well as relative to water businesses in other jurisdictions). Therefore, extreme caution should be exercised in comparing performance across businesses.

6.2 We support a Regulators Advisory Panel, with regular participation by DPE

SDP supports the establishment of a Regulators Advisory Panel (RAP) and IPART publishing the minutes of meetings of the RAP.

We suggest that, along with the Environmental Protection Agency (EPA), NSW Health and IPART, the NSW Department of Planning and Environment (DPE) is a regular member of the RAP – to ensure consistency between IPART's decisions and government policy such as the Greater Sydney Water Strategy.

6.3 IPART should consult with stakeholders and provide sufficient notice of any proposed material changes to its methodology

SDP supports IPART reviewing and refining its approach to regulation every five years, following a transparent and consultative review process.

We note, however, that this needs to be balanced against the benefits of regulatory certainty and stability. To promote investment certainty and maximise incentives for efficiency gains – both of which are in the long-term interests of customers – it is important that IPART consults with stakeholders and provides sufficient notice of any material changes to its methodology.

7. Modelling simplifications

IPART has proposed some ‘modelling simplifications’ on the basis they “would not compromise the overall integrity of the prices we set (or the incentives we provide to promote better outcomes).”

However, as outlined below, we contend some of these proposed changes would compromise the integrity of prices or the incentives for better outcomes for customers over time.

We also query the value of pursuing modelling simplifications as its own end. We see very little to no cost savings from IPART’s proposed modelling simplifications. Any changes to methodology should be made because they improve accuracy of costs and prices and outcomes to customers over time, rather than to pursue ‘modelling simplifications’ for little to no cost savings.

7.1 SDP should be allowed to maintain its asset classes for depreciation

IPART proposes fewer Regulatory Asset Base (RAB) categories for the purpose of calculating the depreciation allowance (i.e., two per service: one for all depreciating assets and the other for non-depreciating assets) and allowing businesses to propose asset lives that are weighted by depreciation rather than asset values.

We propose that IPART should allow SDP to maintain its current asset classes for the purpose of calculating regulatory depreciation, given SDP’s relatively small number of asset classes. This would translate to a more accurate and transparent calculation of depreciation – which is in the best long-term interests of customers.

7.2 SDP does not support reverting to the pre-2018 approach for working capital

IPART proposes reverting to the pre-2018 approach to determine the working capital allowance.

SDP does not support reverting to the simplified pre-2018 approach to determining the working capital allowance. SDP provided substantial input to IPART’s 2018 method for calculating working capital requirements, which provides a more accurate and fairer assessment of efficient business needs than the simplified approach proposed in IPART’s Draft Report. The pre-2018 method systematically understates the working capital allowance for SDP owing to SDP’s contractual arrangements with its customer, Sydney Water. We support maintaining IPART’s 2018 working capital methodology.

7.3 SDP supports IPART maintaining flexibility to deduct 50% of asset sales or the regulatory value of an asset when it is sold

SDP supports IPART maintaining flexibility to deduct 50% of asset sales or the regulatory value of an asset when it is sold (net of efficient selling, capital gains tax and rehabilitation costs).

There is value in providing flexibility to allow a business to make a case that IPART’s default 50:50 sharing ratio should not apply given the circumstances (e.g., if instead the business considers the regulatory value of an asset should be deducted from the RAB, where this can be identified).

Not all water businesses have the ‘line-in-the-sand’ (LOS) issue that makes identifying the regulatory value of pre-LOS assets challenging. Further, it is important that IPART maintains flexibility to promote efficient asset sales – which will ultimately benefit customers (e.g., through the sale of assets in the RAB that may

no longer be necessary to efficiently supply services). Therefore, IPART should maintain some flexibility in its treatment of asset sales.

7.4 SDP does not support IPART 'locking-in' a 50/50 sharing of non-regulated income

IPART proposes applying a 50:50 sharing ratio (between a water business and its customers) for all non-regulated income – which is unregulated income, derived from using regulated assets.

SDP does not support IPART 'locking-in' a 50:50 sharing for all non-regulated income. Rather, IPART should allow water businesses to make a case for alternative sharing ratios that reflect the specific circumstances and nature of the non-regulated income. IPART should only apply a 50:50 sharing ratio as a default in the absence of reasonable justification by a utility for an alternative ratio.

By allowing a water business to share of a reasonable proportion of its non-regulated income with its customers, IPART can provide incentives to the business to maximise the value of its assets for the benefit of customers. This is recognised by IPART in its 2020 Final Report on its determination of Sydney Water's prices, which noted that: "We encourage water utilities to seek ways to generate revenue in ways other than from traditional services, for instance, through renting some of its land."

Notably, in its 2020 determination of Sydney Water's prices, IPART allowed flexibility in the proportion of the business's non-regulated revenue to be shared with customers. It agreed with Sydney Water's proposal to give customers 10% of its forecast non-regulated revenue from bio-banking credits. This meant that 10% of forecast bio-banking revenue was deducted from Sydney Water's notional revenue requirement for the purpose of setting water prices.

IPART stated that its decision to allow Sydney Water to keep 90% of the forecast revenue from bio-banking credits recognised that "Sydney Water would bear non-negligible scheme participation costs (such as setup and ongoing costs) and responsibilities of the scheme that create increased revenue risk." Notably, if IPART had not recognised these additional costs and risks to Sydney Water, then Sydney Water may have not pursued the non-regulated income and customers would therefore be worse off as they would receive 0% rather than 10% of this income.

To provide incentives for water business to innovate and maximise the value of their regulated assets for the benefit of the community and customers, we urge IPART to maintain a flexible approach to the sharing of non-regulated revenue. IPART should only apply a 50:50 sharing ratio as a default in the absence of reasonable justification by a utility for an alternative ratio. A business's justification for a specific sharing ratio could relate to, for example, the cost and/ or risk it may face in pursuing non-regulated revenue – which, in turn, may mean it requires a certain share of this revenue for it to be viable for the business.

To move away from this more flexible approach to a rigid 50:50 share of non-regulated revenue for the sake of 'modelling simplification' would be counter to the objectives of IPART's proposed new regulatory framework, which include incentivising water businesses to maximise value to their customers.