

Submission to the Independent Pricing and Regulatory Tribunal

**Response to the 21 September 2021 IPART Issues Paper on the
Review of Broken Hill Pipeline Prices from 1 July 2022**

22 October 2021



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1. Introduction

WaterNSW is pleased to submit this response (“**Response**”) to the Independent Pricing and Regulatory Tribunal’s (“**IPART**”) *2021 Review of Water NSW’s Murray River to Broken Hill Pipeline Prices Issues Paper* (“**Issues Paper**”). The Issues Paper outlines key issues identified by IPART for stakeholder consideration in its ongoing review of WaterNSW’s prices for water transportation services (“**transportation services**”) via the Wentworth to Broken Hill Pipeline (“**the Pipeline**”) which will apply to Essential Water and a small number of offtake customers for the regulatory period from 1 July 2022.

WaterNSW is Australia’s biggest water supplier and is the major supplier of raw water in NSW, delivering raw water from 42 large dams, pipelines and the State’s rivers.

WaterNSW Infrastructure Pty Ltd owns and operates the *Murray River to Broken Hill Pipeline*. WaterNSW Infrastructure Pty Ltd is 100% owned by Water NSW.

The Murray River to Broken Hill pipeline system consists of a 270 kilometer subterranean pipeline, pumping stations and bulk water storage facility for transporting, storing and delivering bulk water from the River Murray at Wentworth to Broken Hill and surrounding communities.

IPART first determined the maximum prices that WaterNSW could charge for the water transportation services provided by the pipeline in 2019 for the three-year period from 1 July 2019 to 30 June 2022 in its May 2019 *Prices for water transportation services provided by the Murray River to Broken Hill Pipeline from 1 July 2019 Final Determination* (the “**2019 Determination**”).

1.1 Background and process

In June 2021 WaterNSW submitted its *WaterNSW Pricing Proposal for the Wentworth to Broken Hill Pipeline* (“**Pricing Proposal**”) to IPART for transportation services along the Pipeline from 1 July 2022 (“**2022 Determination period**”).

In response to the Pricing Proposal, IPART published its Issues Paper on 21 September 2021. This document forms WaterNSW’s response to IPART’s Issues Paper.

Submissions on the Issues Paper are to be provided to IPART on 22 October 2021. A public hearing will then be held in March 2022 following the release of the draft decision. A final decision is expected in June 2022. New prices will apply from 1 July 2022.

WaterNSW’s Response is designed to be read in conjunction with the Pricing Proposal and seeks to provide further clarity around the key issues raised in the Issues Paper and specific answers to the questions posed, where they were not answered in the Pricing Proposal. This Response does not replace the Pricing Proposal.

Our Response to the Issues Paper focusses on:

- An increase in operating expenditure as a result of applying a reasonable allocation of our corporate support costs as reviewed by IPART in the 2021 Rural Valleys and Water Administration Ministerial Corporation (“**WAMC**”) reviews;
- Transportation volume forecasts and the allowance for Essential Water to sell water; and
- Risk profiles and allocation arising from determination period and cost pass-through allowances.

2. Operating expenditure forecasts

Operating expenditure for the pipeline comprises fixed operation and maintenance costs incurred by the pipeline operating and maintenance contractor (38%), the cost of electricity for the pumps to propel the water up the pipeline (34%), corporate support and contract management costs (18%) and audit, insurance, land tax and other minor charges (9%).

Actual operating expenditure over the three years of the 2019 Determination period is 35% above the average operating expenditure in the 2019 Determination period. The variance is caused primarily by the overhead allowance not adequately providing for the support costs for the pipeline.

In its Pricing Proposal WaterNSW applied its cost allocation methodology to allocate overheads to the pipeline consistent with the methodology used in its 2021 Rural Valleys and WAMC Determinations. This approach facilitates a consistent and transparent allocation of overhead costs, which is key to ensuring that WaterNSW does not over or under recover the support costs of these services. Customers of the pipeline also benefit significantly from the lower relative overhead costs as a result of paying a share of WaterNSW's overheads rather than the much higher overhead costs of a standalone company.

Allocating corporate support costs based on our Cost Allocation Methodology (“**CAM**”) has been accepted by IPART for WaterNSW's other Determinations and has been applied consistently in this Pricing Proposal.

WaterNSW's forecast operating expenditure is outlined in section 6 of the Pricing Proposal.

3. Sales forecasts

The forecast water sales adopted by IPART for the 2019 Determination were based on a detailed 'bottom-up' analysis provided by Essential Water, adjusted to account for water losses and a proportion of Essential Water's forecast sales that IPART forecast would be supplied from Essential Water's own sources. More specifically, IPART assumed that 30% of Essential Water's customers' demand for water could be supplied from Essential Water's storage reservoirs, on average. IPART noted that although the volume of water supplied by these storages can be volatile because it's affected by rainfall, IPART considered it appropriate to subtract the median amount of water supplied from these storages (1,910ML per year) from the overall amount of water that Essential Water will require.

Over the 2019 Determination period, this prediction did not materialise and the actual water sales largely matched the forecast water sales adjusted for real water losses. On this basis, WaterNSW proposes to calculate operating expenditure and variable charges on the forecast sales figures prepared by Essential Water adjusted for real water losses for the 2022 Determination.

WaterNSW's sales forecasts are discussed in section 13 of the Pricing Proposal and in the responses to IPART's questions (sections 5.5 and 5.6) below.

4. Risk profiles and allocation

WaterNSW has prepared a risk management framework for the delivery of transportation services over the 2022 Determination period. This framework draws on WaterNSW's broader risk management framework and involves:

1. Identifying and describing risks to our costs and revenue.
2. Identifying the cause of each risk, including whether it is systematic or non-systematic in nature, and its likely impact on our business and customers.
3. Determining whether a cost allowance, rate of return or other regulatory mechanism that shared risks would most efficiently address each risk.
4. Ensuring there is no double-counting.

In determining the most appropriate approach, we have drawn on principles including allocating risks to the party best placed to manage them, which impacts on regulatory certainty, creating appropriate incentives for WaterNSW and considering administrative costs. This is consistent with approaches IPART has previously taken in determining risk allocation.¹

Allocating risks appropriately, with additional controls to balance the information asymmetry between customers and regulated businesses, reduces overall cost (and therefore prices) and allows for a longer determination period, which facilitates greater certainty and planning for customers.

WaterNSW's detailed analysis is discussed in Appendix F of the Pricing Proposal and in the responses to IPART's questions (sections 5.7 and 5.8) below.

5. Responses to IPART's Questions

5.1 What are your views on the proposed prices for Essential Water?

WaterNSW's proposed prices reflect the recovery of our forecast efficient costs to meet the service levels expected by our customers over the 2022 determination period. We have proposed arrangements which promote efficient investment in, and efficient operation and use of, the pipeline for the long-term interests of customers.

We have calculated the prices we need to charge Essential Water to recover these costs, and have structured these prices so that Essential Water is provided with appropriate price signals about the cost of our water transportation services.

The fixed charges have been calculated by dividing the annual fixed costs of the pipeline by the number of days in the year. The variable charge has been calculated by dividing the annual variable costs of electricity by annual forecast demand.

WaterNSW's proposed prices are outlined in section 15.3 of our Pricing Proposal.

5.2 What are your views on the proposed prices for offtake customers?

WaterNSW's proposed prices reflect the recovery of our forecast efficient costs to meet the service levels expected by our customers over the 2022 determination period. We have proposed arrangements which promote efficient investment in, and efficient operation and use of, the pipeline for the long-term interests of customers.

Our approach to offtake charging maintains IPART's methodology from the 2019 Determination. The two-part tariff for offtake customers reflects the incremental fixed and variable costs to WaterNSW of serving them.

Our proposed prices are outlined in section 15.4 of our Pricing Proposal.

¹ See IPART, Review of regulated retail tariffs and charges for electricity 2010-2013 – Final Report, March 2010, p52.

5.3 What payment options should be available for new and existing offtake customers?

WaterNSW will offer to install additional offtakes at cost over the 2022 Determination period via either the annual charge or an upfront capital charge.²

Customers who pay the upfront capital charge will only thereafter be required to pay the variable charge for each ML (or kilolitre) of water ordered/delivered. Alternatively, the pricing will be subject to any unregulated pricing arrangement negotiated between the parties.

WaterNSW's proposed prices are outlined in section 15.6 of our Pricing Proposal.

Given the relatively small proportion of income recovered from offtake customers, WaterNSW is prepared to offer the choice of the upfront capital charge (for existing customers this will be calculated with reference to the annual access charges already paid and the residual value of the offtake in the Regulatory Asset Base) or annual access charge to new and existing offtake customers.

5.4 Should shutdown, standby or restart charges remain unregulated?

WaterNSW can request from the pipeline operator a cessation of the operation of the pipeline, at Essential Water's request, under certain conditions to be negotiated under the raw water supply agreement. Additional costs for placing the pipeline in shutdown mode are incurred under the Operations and Maintenance contract.

WaterNSW proposes that these charges remain unregulated and formed based on commercial negotiation between WaterNSW and Essential Water. This position is consistent with the 2019 Determination. At that time IPART noted that:

These costs are driven by Essential Water, and should be internalised by Essential Water. Essential Water should make water source decisions to achieve its water supply requirements at an efficient total cost.

In 2019 IPART's expenditure review consultant Synergies³ indicated that the shutdown and restart fees were reasonable:

We assess the proposed standby payments as being reasonable, as they are of a similar order of magnitude to the fixed operating and maintenance charge proposed under the O&M contract.

The Design and Construct and the Operations and Maintenance contracts were competitively tendered and the successful party determined on the basis of lowest whole of life costs. This procurement process was endorsed by IPART's expenditure consultants in the 2019 Determination. Further, the infrequent nature of these activities means the costs outweighs the benefits of regulating these charges.

On this basis WaterNSW considers that any costs incurred in shutdown, standby and restart modes are equivalent to efficient charges and therefore it is not necessary to regulate the charges to Essential Water.

² Noting that any additional supply will be subject to the availability of capacity in the pipeline.

³ <https://www.ipart.nsw.gov.au/files/sharedassets/website/shared-files/pricing-reviews-water-services-rural-water-prices-for-watarnsw-murray-river-to-broken-hill-pipeline-services-from-1-july-2019/legislative-requirements-prices-for-watarnsw-murray-river-to-broken-hill-pipeline-services-from-1-july-2019/consultant-report-by-synergies-expenditure-review-of-watarnsw-broken-hill-pipeline.pdf>, page 110

5.5 What affects how much water is transported from the Murray River to Broken Hill?

There are a number of socio-economic and weather-related factors that would determine how much water is required by customers and that would be transported on the pipeline. This question is better addressed by Essential Water and its customers.

5.6 What are the barriers or opportunities to transport more water using the pipeline?

The pipeline has capacity over and above the forecast usage by Essential Water over the forecast period. Therefore, there is expected to be sufficient infrastructure capacity to transport more water from the Murray River to meet the water needs of the Broken Hill community for the foreseeable future.

5.7 Should we set Water NSW's prices for 5 years?

WaterNSW's Pricing Proposal proposes a five-year determination period to balance the uncertainty of forecasts and the regulatory burden of determinations. The period of stable operation since the pipeline's commissioning ensures that Water NSW has a good understanding of the pipeline's operating profile and the associated costs. This reduces the uncertainty associated with making forecasts over the 2022 Determination period, meaning a longer determination period is appropriate.

A longer determination period requires appropriate risk management mechanisms to be in place to efficiently manage risks over the determination period, particularly those risks over which utilities have little control, and ensure prices reflect the costs of providing services.

A five-year determination period, when supported by a holistic approach to efficient risk mitigation, appropriately balances the uncertainty of forecasts over the 2022 Determination period and the regulatory burden of determinations.

If appropriate risk mitigation measures are not implemented by IPART, WaterNSW proposes a shorter determination period (i.e. three years to 30 June 2025) to reasonably manage forecasting risk in the outer years and to align to other WaterNSW determination timelines.

WaterNSW's proposed regulatory period is discussed in section 5.2 of our Pricing Proposal and our approach to managing risk is described in section 5.5. The compromise between determination length and risk allocation is addressed in Appendix F of the Pricing Proposal and in the answer to IPART's question 8 below.

5.8 Do Water NSW's cost pass-through events place too much risk on customers?

5.8.1 Cost pass-through events

Applying WaterNSW's risk management framework has identified a number of events, outside of WaterNSW's control, that are appropriately assigned as cost pass-through events. These events can be clearly defined and WaterNSW's proposed cost pass-through mechanism provides sufficient rigour and transparency by requiring WaterNSW to substantiate the change in costs and outlining timeframes that facilitate a full review, by IPART and stakeholders, of the proposed changes in prices.

Cost pass-through mechanisms are a common part of incentive based regulatory frameworks.⁴ They are used to manage the risk associated with external events that occur within a determination period - that are outside the control of the business but have a material impact on costs and hence the financial position of the firm.

These risks are unable to be adequately managed through internal risk management, insurance or self-insurance. Examples can include major changes to regulatory obligations or natural disasters.

Cost pass-throughs provide a mechanism to allow regulators to review the efficient costs associated with events (after they have occurred) that could not be forecast as part of the revenue proposal and allow regulated businesses to recover the determined efficient costs to ensure that prices continue to reflect efficient costs.

The costs associated with pass-through events are those that would have been included in a determination had WaterNSW and IPART known with perfect foresight the scope, timing and efficient costs of the pass-through event in advance. For the majority of pass-through events, at least one element of the scope, timing or efficient costs of the event are unlikely to be known over a determination period.

Therefore, WaterNSW proposes a targeted cost pass-through framework to address the risk of defined exogenous events occurring during a determination period that may change the efficient costs of providing water services (i.e. such that efficient costs differ from those assumed by IPART in setting prices in a determination).

The event definitions and proposed framework is discussed in Appendix F of the Pricing Proposal.

5.8.2 Cost of electricity

The cost of electricity represents a significant portion of the variable cost of providing transportation services.

We have proposed a forecast of the benchmark electricity price and electricity cost to generate the revenue requirement to IPART, our customers and stakeholders over the term of the proposed determination.

This forecast reflects information available today, but the cost of electricity is also highly uncertain given that key components of electricity prices are determined by dynamic market forces, or independent regulators and/or market authorities.

To manage this forecast price risk - which WaterNSW cannot practically manage itself - WaterNSW is proposing changes to the pricing formulae to enable an end of period true-up for movements in the network and wholesale components of the benchmark electricity price over the 2022 Determination period.

This includes introducing a framework for efficiently managing movements in those costs that are beyond WaterNSW's reasonable control - such as a mechanism to provide an end of period true-up for movements in the network and wholesale elements of the electricity benchmark price over the 2022 Determination period.

⁴ For instance, the regulatory framework for energy networks explicitly provides for the AER to approve cost pass-throughs, contingent projects and reopeners. The ESCV also has a well-established "uncertain and unforeseen events" mechanism to account for events that were significant and uncertain or unforeseen at the time of the original determination.

The proposed mechanisms are designed to ensure WaterNSW is incentivised to take accountability for events within our control, while not exposing WaterNSW to risks beyond its control - particularly where it may not be efficient for WaterNSW to manage this risk. Ultimately, we think this proposed approach to risk mitigation is in the long-term interests of customers.

The rationale for this proposal and a proposed methodology (similar to IPART's cost of debt true-up mechanism) is outlined in Section 10.3 and Appendix G of our Pricing Proposal.

END