3 June 2025

IPART Tribunal
Ms Carmel Donnelly PSM
Chair, IPART

WaterNSW Response to IPART's Information Paper – Prices for WaterNSW Bulk Water Services

Dear Ms Donnelly

On behalf of the WaterNSW Board, we attach our response to IPART's Information Paper.

Our response reflects the extraordinary circumstances placed upon WaterNSW, created by the proposition outlined in the Information Paper, which threaten WaterNSW's financial sustainability and ability to remain solvent.

The prices proposed in IPART's Information Paper will not provide WaterNSW with enough revenue to run its operations for the next three years. This fact is supported by the Frontier Economics analysis attached to our submission.

We are deeply concerned at the impending financial and governance issues IPART's proposal creates. In its proposal to only 'roll-forward' WaterNSW's existing allowances (set in 2021) with only minor variations, we believe the Tribunal has made obvious oversights, notably:

- The failure to consider significant changes in the macroeconomic landscape that has materially changed WaterNSW's cost base between 2021 and 2025 – this accounts for 55% of our proposed cost increases,
- The decision to also adopt historically low rates of return from the 2021 determination for rural valleys, which provides funding significantly below our current actual cost of debt in 2025, and
- The failure to include current market conditions in the financeability test for WaterNSW, which would lead us to fail at least one element of the target financial ratios.

If formalised, WaterNSW will be left with a revenue allowance that is insufficient to maintain our current cost obligations. It should be noted that the small increases proposed by IPART are also disproportionately low compared to recently determined prices for other regulated utilities and local government areas in the state and in Australia.

IPART's proposed allowance will have disastrous consequences for WaterNSW's financial viability. In the absence of extended borrowing limits or 'top up' financial support, WaterNSW expects to exhaust its borrowing limit in the second half of 2026. This will lead to:

- year-on-year net profit after tax losses;
- failure to pay dividends or income tax payable to the shareholder; and
- insolvency.

IPART' proposal as its stands places our Board in the untenable position of needing to assess and approve future investments without the certainty over the future price path, or how WaterNSW should refinance existing and new debt. This presents a significant challenge for how the Board can meet its fiduciary obligations.

We do recognise the cost-of-living pressures in the current environment; however, the proposal outlined in the Information Paper places WaterNSW in a position where it will be unable to fulfil its obligations under the proposed prices, contrary to IPART's obligations under section 15 of its own Act. WaterNSW will see a degradation of essential customer services in the delivery of bulk water, and will not be able to meet all of its new regulatory and statutory obligations, including under its new Operating Licence.

WaterNSW undertook substantial work engaging across the state with our customers and stakeholders to inform our pricing submission to IPART. We are concerned that IPART has presented contested errors and omissions which have been published to our customers and amplified in the media, which will weaken our reputation and legitimacy, perhaps for years to come.

We are unable to see any compelling evidence from IPART as to why the bulk water supplier in the state should not recover its cost reflective revenue requirement, as other related price regulated authorities have been afforded, and why it has been unable to complete its review on this occasion.

Given the seriousness of the implications of IPART's proposal, we urge the Tribunal to give our submission the utmost consideration. We remain committed to working with IPART to assist it in fulfilling its objectives.

Yours sincerely

[redacted]

[redacted]

WaterNSW submission in response to the IPART Information Paper for new bulk water charges from 1 July 2025 for Rural Valleys and 1 October 2025 for Greater Sydney

3 June 2025

Table of contents

Introduction 2

Summary 2

1 WaterNSW has invested heavily in delivering against IPART's regulatory framework 6

1.1 Our proposal was prepared to meet IPART regulatory framework 6

1.2 Our extensive engagement reflects customer priorities 7

1.3. Early IPART engagement review did not appear to be incorporated 9

1.4. Our performance in the current period 9

1.5. IPART's Information Paper and inaccuracies 11

2. IPART has not followed established regulatory practice 11

2.3. IPART has not met its legislative requirements 11

2.4. Our earlier correspondence with IPART recognised the complexity of the challenge 12

3. Consequences of IPART's approach 13

3.3. WaterNSW will not be financially viable under the proposed price paths 16

3.4. Building in future price increases 22

3.5. Managing revenue risk associated with volume variations not addressed 22

3.6. Price paths well below most recent regulatory decisions 22

3.7. Why IPART's proposed price path will not support current staffing levels 23

3.8. Why IPART's proposed price path may not reflect the specific issues for the MDBA and BRC proposals 24

4. Our plan to keep WaterNSW solvent 25

4.3. Minimum Essential Revenue Requirement 25

4.4. Volumes (Rural Valleys) 29

4.5. Weighted Average Cost of Capital 30

4.6. Operating expenditure 33

4.7. Capital Expenditure 38

5. We are committed to working with IPART and Government 41

Annexure 1 – Errors and inaccuracies in the Information Paper and supporting material 43

Annexure 2 – WaterNSW responses to IPART's questions in the Information Paper 45

Appendix 1 – Frontier Economics Report - Analysis of IPART's proposed approach for WaterNSW June 2025 (separately attached)

Appendix 2 – Greater Sydney and Rural Valleys minimum essential building block model.

Introduction

This document is WaterNSW's written response to the IPART *Prices for WaterNSW bulk water services – Information Paper* (Information Paper) issued by IPART on 14 May 2025 for new charges for Rural Valley customers from 1 July 2025 and for Greater Sydney customers from 1 October 2025.

Summary

In its 14 May 2025 Information Paper, IPART proposes bulk water price increases of:

- For **Greater Sydney customers**: 6.9% plus inflation from 1 October 2025, and then by inflation only on 1 July 2026 and 1 July 2027
- For **Rural Valleys customers**: 1.9% plus inflation from 1 July 2025, and then by inflation only on 1 July 2026 and 1 July 2027.

WaterNSW's solvency would be under serious threat if IPART's proposed price paths are implemented

IPART's proposed price paths **do not provide sufficient funding to keep WaterNSW solvent** over the next three years to allow us to meet our statutory and legal obligations. IPART has proposed prices that are designed to keep customer prices low in the short-term while not providing sufficient revenue to maintain our financial sustainability.

The proposed price paths are **out of step with regulatory determinations** in other jurisdictions where regulators have undertaken detailed assessments of the entity's costs, including the impact of current market conditions, interest rates and the regulatory obligations and service levels of those businesses. The price path is also out of step with IPART's own guidelines and regulatory obligations.

IPART has erred in its application of the legislative framework. We believe IPART has not had regard to the relevant matters in the IPART Act for a determination on prices, including the impact on public sector assets and the impact on debt and equity holders. This is a requirement for all bulk water pricing decisions, including IPART's shorter-term or interim determinations. WaterNSW considers that IPART has not deliberated, as required, on the relevant matters in Section 15 of the IPART Act and the matters in the *Water Charge Rules 2010* in considering the proposed allowed revenues and WaterNSW's ability to operate as a going concern financially.

There is **no guidance from IPART on how WaterNSW would recover unfunded revenues when final determinations are made**. There is also no guidance as to how WaterNSW should finance new and existing debt, as IPART has not followed their own guidelines in determining the WACC allowance. This guidance is critical for WaterNSW, its shareholders and customers.

WaterNSW maintains that its pricing proposal, submitted on 30 September 2024, outlines the efficient and prudent costs to meet customer service requirements, legal and regulatory obligations and maintain our assets over the five-year determination period.

In this response, WaterNSW provides the **minimum essential revenue requirements and expenditures**, with the priority being to remain financially sustainable and solvent, whilst also meeting our legislated and regulatory obligations. These minimum expenditure requirements are, however, likely to see a material deterioration in service levels and WaterNSW needing to take more financial, operational and regulatory risks. This response can therefore only be considered a short-term plan for the first year of IPART's three-year determination period, and is not a long term plan outlining our long-term sustainable costs (as these are contained in our original proposal).

The decision as it stands places our Board in the untenable position of needing to assess and approve future investments, but with the uncertainty over the price path and the form and content of the subsequent determinations (i.e. will they return to prices set on a cost reflective basis?). The Board's ability to manage these investment and financing decisions is also not possible as there is no guidance as to how WaterNSW should finance new and existing debt, given IPART has moved away from its WACC guidelines.

This will test how the Board can meet its fiduciary obligations moving forward. IPART has usurped the role of the Board in allocating revenue to manage risks, but without the direct accountability. It should also be of a concern to customers as there is little clarity as to the price path beyond this interim determination period and IPART's proposed mechanism to address unfunded revenues in the final determination. The proposal by IPART places WaterNSW, its shareholders and its customers in a position of regulatory uncertainty.

IPART has not achieved the appropriate balance between ensuring WaterNSW remains financially viable and setting prices that are affordable for customers. This inappropriately places a higher cost burden in the hands of future generations, which is not in the long-term interests of customers. It also means that in the short-term the NSW Government and NSW taxpayers are subsiding bulk water customers. It is not obvious that IPART has considered this in their Information Paper, as the majority of the commentary is focussed on what customers can afford in the short-term, rather than establishing the lowest sustainable cost reflective bulk water charges.

Structure of this response

This response is structured in the following sections:

- **WaterNSW has invested heavily in delivering against IPART's regulatory framework** (Section 1) – Our original proposal was submitted on 30 September 2024 following a two-year period of engagement with IPART, customers and stakeholders, undertaking our most in-depth customer engagement and consultation program ever. WaterNSW has continued to extensively engage with IPART and its consultants since our comprehensive original proposal was lodged.

  The underlying evidence and analysis in our original proposal far exceeded what WaterNSW provided to IPART in previous determinations, and we contend this was sufficient to make a full determination. We reject any assertion that the ability for IPART to issue its determinations on time was impacted by the material provided or our extensive customer engagement program.

  We highlight that in late 2023, IPART engaged FTI Consulting to undertake a review of our investment and governance systems and processes, which confirmed that WaterNSW's processes are at a level and maturity of what they would expect for similar firms.

- **IPART has not applied its established regulatory framework** (Section 2) – IPART has neither followed the requirements of the IPART Act or the Water Charge Rules 2010 (Cth) with respect to what IPART must have regard to in making a determination and has not applied its own established framework. For instance, as outlined in Annexure 1, IPART has not:

  - Applied its own WACC method
  - Applied an overarching building block approach
  - Applied a Base-Trend-Step methodology for operating expenditures
  - Applied a roll forward of the 20-year rolling average of water volumes for pricing purposes.

- Undertaken a detailed expenditure review of our capital and operating programs and has only maintained the status quo with respect to form of control and tariff structures.

Instead of applying its established frameworks, IPART has adopted a new top-down 'CPI-X' methodology. Good regulatory practice (in addition to compliance with IPART's legislative requirements) suggests that IPART's established framework should be followed.

- **Consequences of IPART's approach** (Section 3) – In summary, we see the main consequence of IPART's approach being:

  Insolvency - WaterNSW will be under significant financial stress, before reaching insolvency, should IPART's proposed price paths be adopted. IPART's proposal is not in the long-term interests of customers, the community or the successful operation of WaterNSW.

  Assessing the consequences from an IPART 3C's perspective leads to the following:

  Customers - keeping prices low in the short-term leads to even higher prices in future should the established regulatory framework not be followed, which raises intergenerational equity concerns. It also means maintaining current service levels for customers over the next three years and beyond is not possible, as funding is severely constrained.

  There is also no clarity for customers as to the pricing implications on future determinations when the final determinations are made e.g. the pricing mechanism for recovering lower than required WACC revenue allowances.

  Costs - prices have not been set based on the results of IPART's expenditure reviews and regulatory guidelines (e.g. WACC) which runs the risk of being materially below IPART's final findings at the subsequent review, leading to a "true-up" in three years' time.

  Credibility – our ability to deliver services is compromised by the lack of certainty of the pricing arrangements. This is due to WaterNSW not being able to enter into long-term contracts for capital works and service delivery due to revenue being below what is required to service our current and forecast debt obligations, and the additional uncertainty introduced by having an extended three year interim price determination period with prices that are not set in accordance with the regulatory frameworks.

  In addition, given IPART has moved away from their WACC guidelines and written advice as to the approach to transitioning Murray-Darling Basin (MDB) valleys to a trailing average, WaterNSW is unsure as to what maturity duration it should renew existing debt and new debt. This is not in customers' interests.

  Of significant concern is IPART has not appropriately considered WaterNSW's financial sustainability and the need to provide equity and debt holders an appropriate commercial return as set out in Section 15 of the IPART Act. WaterNSW has obtained an expert report from Frontier Economics that assesses the financing and regulatory implications of IPART's proposed approach and price paths, provided as Appendix 1.

- **Our plan to keep WaterNSW solvent** (Section 4) – WaterNSW maintains that our original pricing proposal contained the prudent and efficient costs over the next five years, including the costs to remain financially sustainable. Our customers recognised that WaterNSW needs to be financially sustainable for customers to succeed.

  Our response supports WaterNSW remaining solvent whilst focussing on critical and urgent works only. This is a short-term plan for the first year of IPART's three-year determination period, and is not a long term plan outlining our long-term sustainable costs (as these are contained in our original proposal). We have removed some customer supported initiatives to focus on critical expenditure only, and have also removed policy and regulatory-driven projects, such as fish passages and cold water pollution investments, that government had required WaterNSW to deliver.

Whilst we will strive to achieve our service standards with the lower than required revenues, it is inevitable that service standards will deteriorate and that business risks will increase.

- **We are committed to collaborating with IPART and Government** (Section 5) - IPART has flagged the need for several reviews over the next three years, including; a more detailed expenditure review, a cost share review, long-term impact of the regulatory and economic impact of the Greater Sydney Water Strategy, a review of the future regulatory model for WaterNSW (in particular for the rural NSW business segment) and potentially a WACC review over the same timeframe.

  WaterNSW is committed to ongoing active involvement in these reviews. We note, however, that additional costs and resources beyond our current proposal to respond to these reviews have not been allowed for by IPART in its proposed price path.

  We can see benefits from a more effective regulatory approach for bulk water services in NSW and particularly for regional NSW.

WaterNSW proposes prices to recover the minimum essential revenue requirement to remain solvent

WaterNSW proposes smoothed annual price changes (e.g. X factors) for **Rural Valleys** for each of the three years starting in 2025-26 of **25%** (excluding inflation) based on our minimum essential revenue requirement costs, or a one-time increase in 2025-26 of 48% (excluding inflation) followed by no real increases in 2026-27 and 2027-28.

WaterNSW proposes smoothed annual price changes (e.g. X factors) for Greater Sydney for each of the three years starting in 2025-26 of **14%** (excluding inflation) based on our minimum essential revenue requirement, or a one-time increase in 2025-26 of 30% (excluding inflation) followed by no real increases in 2026-27 and 2027-28 as illustrated below. Our proposed minimum essential revenue requirement is discussed in Section 4.

To be clear, this is the **minimum revenue requirement** we require to remain solvent and meet basic statutory and regulatory obligations. This minimum revenue requirement however, is insufficient to maintain agreed customer service levels and will increase WaterNSW's operational risks. It is also what customers would pay under the existing cost share arrangements last determined by IPART in 2019. Customers have expressed their strong desire that the sharing of costs between customers and Government under the current 'impactor pays' framework needs urgent review. This is a separate, but related decision that IPART has indicated should occur over the next three years.

How to navigate this response

Our comments on the financial and regulatory impacts of IPART's proposed price paths have been informed by expert advice obtained from Frontier Economics. The Frontier Economics expert report provided as Appendix 1 focusses on IPART's approach to the rate of return, IPART's financeability test and IPART's adherence or otherwise to legislative requirements and established regulatory practice, and the implications this may have on our financeability and incentives for efficient investment.

WaterNSW's responses to IPART's questions from the Information Paper are provided in Appendix 1.

WaterNSW has used its best endeavours to ensure the accuracy of the information contained in this response to the Information Paper and the associated financial model in light of the compressed timeframe to develop our response.

WaterNSW's detailed comments

1 WaterNSW has invested heavily in delivering against IPART's regulatory framework

1.1 Our proposal was prepared to meet IPART regulatory framework

WaterNSW has made significant investments to align with the IPART regulatory framework, submitting a comprehensive pricing proposal on 30 September 2024, following extensive customer engagement. The proposal emphasised efficient costs to meet service and regulatory requirements while addressing customer concerns about affordability. Our original pricing proposal highlighted our:

- **Investment in Engagement**: WaterNSW engaged extensively with stakeholders over two years, reflecting enhanced transparency, outcomes customers wanted, and with customer feedback reflected in its pricing proposal.
- **Comprehensive Documentation**: WaterNSW provided all information required for IPART to assess our proposal. This included 30 attachments and seven appendices extensively detailing the **information required**, and totalling nearly **9,000 pages** of supporting documentation and an electronic data room with 19,000 pages of working documents, facilitating thorough reviews by IPART and its consultants.
- **Customer Feedback Impact:** WaterNSW deferred over **$860 million** in capital projects based on customer feedback, demonstrating responsiveness to affordability concerns.
- **Early Communication of Price Increases**: WaterNSW communicated potential price increases early in the process (up to 12 months prior to the proposal being submitted), many of these attributed to external economic factors, which helped customers understand the financial landscape.
- **Focus on Transparency:** The organisation prioritised transparency throughout its engagement efforts, led by the Executive team, allowing customers to shape their priorities and understand the implications of proposed expenditures.
- **Efficiency Savings Incorporated:** Combined with almost $18 million in base year savings, we proposed a cumulative efficiency target of 1% per annum, leading to combined savings of **$133 million** over the upcoming five-year determination period, or around 10% of our total operating costs.
- **Customer-Centric Approach:** WaterNSW's proposal reflects customer insights, with changes made based on feedback regarding operational investments and cost efficiencies.

When IPART's consultants were appointed in late October 2024, WaterNSW worked with the consultants to arrange initial interviews across the full range of issues raised in the proposals. WaterNSW understood the challenge ahead of the expenditure review, and so sought to provide as much targeted information as possible against the topics nominated by the expenditure review consultants, to set the consultants up for success in their reviews.

In total, WaterNSW participated in 64 interviews held over two weeks covering Greater Sydney and Rural Valleys bulk water and WAMC determinations with up to four interviews being held concurrently. To specifically support the bulk water discussions, WaterNSW produced and spoke to almost 900 presentation slides.

To support the final Question & Answer (or Request For Information) phase that ran until February 2025, WaterNSW established a core coordination team and contact points to work directly with IPART and its consultants to ensure that WaterNSW was responsive to the various data requests with clear responsibilities for meeting our proposed service levels.

WaterNSW was committed to making the process useful and transparent. To facilitate this, WaterNSW used the data room to provide easy access to IPART and the various consultants to all of the data requests received. WaterNSW provided the IPART teams with weekly reporting, including against all data requests received, outstanding items and aged requests. To provide guidance on the commitment made by WaterNSW to this phase of the process, WaterNSW responded to 245 data requests with over 15,000 pages of data.

1.2 Our extensive engagement reflects customer priorities

Following IPART's move to the 3Cs framework, WaterNSW focused on improving stakeholder engagement and consultation, particularly with customers, key stakeholders and other water users, on complex pricing issues. This engagement was not just a compliance exercise; WaterNSW aimed to be transparent and seek genuine feedback on regulatory settings and customer preferences.

WaterNSW consulted with its Customer Advisory Groups (CAG) over many months, discussing topics like volume risks, financial performance, pricing volatility and tariff reform. These discussions allowed CAG members to provide informed preferences that shaped WaterNSW's proposal. We also created water user focus groups across four regions, which allowed for further in-depth education and consultation with a broader range of users over many months including on affordability issues, investments in services, determining customer preferences and outcomes, and an outcome scorecard.

Early visibility on challenging price trajectories due to external economic factors, such as inflation and interest rates, was provided, indicating potential price increases of 20% to 25%. Transparency was a key principle for WaterNSW, enabling customers to understand and prioritise affordability. In November 2023, almost 12 months before WaterNSW lodged its proposal to IPART, WaterNSW provided CAG members early advice on the emerging macroeconomic pressures and water volume issues that were going to have a significant impact on customers, even in the absence of any forward capital or operating programs proposed by WaterNSW.

In March 2024, WaterNSW offered a detailed view of its financial performance by valley, which customers found valuable and requested annually. Two months before lodging the proposal, WaterNSW presented forward revenue and pricing outcomes that reflected customer feedback, including significant reductions in capital and operating expenditures.

WaterNSW's engagement activities were recognised by IPART as significantly improved. The organisation drew on previous engagement insights to identify and test key customer priorities, transforming them into customer outcomes.

Despite IPART's assertion that WaterNSW's customer consultation lacked information, WaterNSW provided extensive evidence of detailed education and information through engagement reports and a data room. Detail was provided in our final engagement reports, with our data room showing every slide and recording of every comment collated during more than 1,180 hours of online discussions across 21 Water Working Group meetings, five rounds of 10 CAG consultations, and numerous other customer meetings. IPART staff also attended some working group meetings as observers to the level of detail provided. Customers were regularly informed about potential bill impacts, and early advice on macroeconomic pressures was tailored to each valley.

WaterNSW's commitment to transparency was acknowledged by customers, even when the conversations were uncomfortable. WaterNSW rejects IPART's claim that uncontrollable costs were out of scope for customer engagement, having provided advice on bill impacts and reflecting customer priorities, by excluding certain capital projects.

The organisation also proposed material operating cost efficiencies, leading to significant savings over the upcoming determination period. Customer feedback shaped many aspects of the proposal, which could only occur because of the extensive customer engagement that was undertaken.

Reflecting the impacts the uncontrollable and external cost drivers were having on customers, WaterNSW sought to reduce or defer expenditure where it could reasonably do so. This meant that WaterNSW reflected back customers' priority around pricing by taking on additional asset risk, and explicitly **excluding a range of capital projects worth more than $860 million**, that would have otherwise been included in our original proposal. In making these reductions, WaterNSW sought to ensure that only those investments that customers valued, or were otherwise required to meet statutory, regulatory or policy drivers, were included in our proposal.

The fact that WaterNSW deferred more than $860 million of capital projects as a direct result of customer feedback seems to have been ignored or overlooked by IPART.

WaterNSW also took customer's priority regarding pricing and efficiency into account when it proposed material operating cost efficiencies across the business, and committed to finding ways to achieve those savings or bear the burden of the costs if it could not. Combined with almost $18 million in base year savings, we proposed combined savings of **$133 million** over the upcoming five-year determination period, or around 10% of our total operating costs.

There were many instances where the proposal lodged by WaterNSW was changed and shaped by customer feedback and these were clearly set out in our proposal and supporting attachments (for example Attachment 3 Customer and Community Engagement - How we have responded to what customers value).

In contrast, we note that IPART's proposed price paths do not specifically include those capital expenditures and other investments (see WaterNSW Water Working Groups Report, p 72, p 61-63, p 52) that our customers explicitly told us was a high priority to them. Notably:

- Operational levels of investment to maintain infrastructure in each valley which were tested along with risk appetite (See WaterNSW Water Working Groups Report, p 74)
- Waterinsights and technology investments
- Upgrades to the CARM system (software system to run the rivers)
- Bushfire, and pest and weed management
- Local customer engagement

Conversely, when customers no longer supported a proposal to increase call centre hours in view of the cost, we removed this from our forward plans.

WaterNSW also notes that, consistent with the requirements of the 3Cs framework, considerable time and effort was devoted in our engagement by all parties to identify the **outcomes** and **output measures** that are of highest importance to our customers. The price paths proposed by IPART contain insufficient expenditures to achieve a significant number of these outcomes and output measures over the next three years, resulting in their deferral until the subsequent determination period.

1.3. Early IPART engagement review did not appear to be incorporated

WaterNSW notes significant inconsistencies between the comments in IPART's Information Paper and the findings of IPART's 2023 system and process review conducted by FTI Consulting.

The objective of the system and process review was to review the appropriateness and maturity of WaterNSW's key business systems and processes. IPART indicated it would use this information as part of its assessment of WaterNSW's pricing proposal, and to make decisions on the prices that should apply from 1 July 2025.

The scope of the review was a targeted, strategic review of WaterNSW's key business systems and practices, which contribute to the development of our capital and operational planning. The review included an assessment of the robustness of systems for linking asset management decisions with current and future levels of service and performance requirements, including customer preferences, service standards and environmental outcomes.

It was understood that completing a review of the governance processes and decision making ahead of receiving the capital and operating programs would provide IPART and the expenditure review team adequate time after receiving the proposals to reach a draft decision, as this work would not be required within the review period.

Although there were a few recommendations in the final report prepared by FTI that WaterNSW already actioned, WaterNSW notes the summary findings of the FTI review:

> *Based on our review, **WaterNSW's systems and processes appear to be appropriate and fit for purpose, and consistent with expectations for a utility organisation such as WaterNSW. The frameworks and processes are also generally supported by well-developed, and relevant and comprehensive guidelines and templates to ensure consistent application and usage**.* (emphasis added)

We are concerned that in suggesting the need for short-term determinations, IPART has not adequately taken into account the FTI findings regarding our asset management and governance processes, which guide our proposed expenditures. As noted above, the FTI report found that our systems and processes were of a standard and maturity expected for similarly sized organisations.

The FTI findings lend support to our contention that IPART should have been able to conduct a full determination in the time available, particularly given the "fit for purpose" state of our systems and processes.

WaterNSW participated in good faith in IPART's systems and process review and committed senior resources to the exercise. We can see no evidence that IPART has considered those prior findings.

1.4. Our performance in the current period

WaterNSW has been responsive to its operating environment and the regulatory framework over the current determination period, despite costs outside of our control being higher than IPART's allowances.

In particular, WaterNSW has:

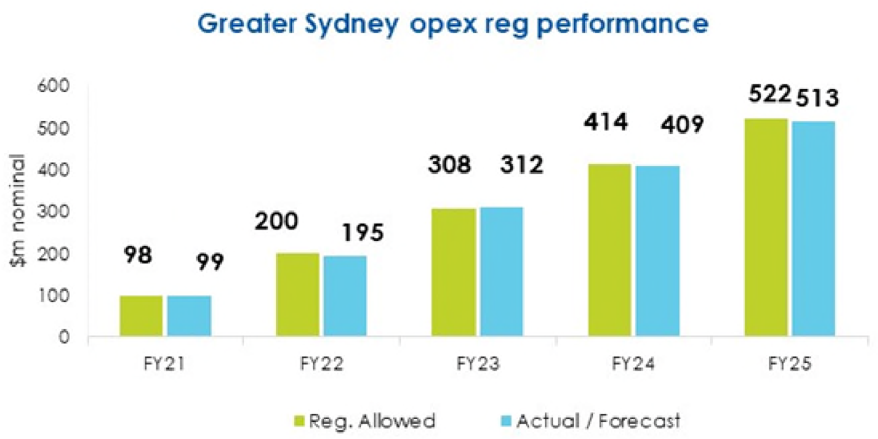
- Been performing well over the current regulatory period responding to all of its constraints and challenges
- Worked hard to deliver efficiency savings so as to keep within the current determination allowances and improve price outcomes for customers, while maintaining (or improving) service levels

- Managed these financial challenges despite being confronted with the direct and consequential impacts of natural disasters such as COVID, floods and bushfire
- Absorbed a range of new and expanded regulatory obligations set by external bodies during the current determination.

The figures below illustrates our regulatory operating costs for Sydney and Rural Valleys against our regulatory allowances.

Greater Sydney: Over the five-year extended determination period our total actual /forecast operating expenditure of $513 million was $9 million below our allowances.

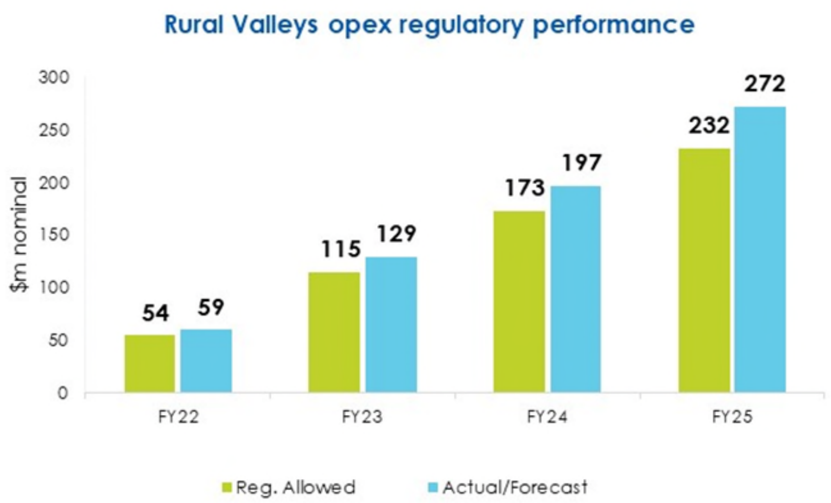
Figure 1 – Regulatory operating expenditure performance over the current regulatory period – Greater Sydney



Note: Given the Greater Sydney Determination was delayed one year we have aligned the FY25 allowance to the FY24 allowance.

Rural Valleys: Over the four-year determination period our total actual /forecast operating expenditure of $272 million was $40 million higher than allowances, mainly due to uncontrollable items such as land tax, insurance, fuel and energy and flood-related costs (some of which were partly offset by insurance claims) as well as ICT costs and some determination preparation costs.

Figure 23 – Regulatory operating expenditure performance over the current regulatory period – Rural Valleys



1.5. IPART's Information Paper and inaccuracies

WaterNSW is concerned that IPART's Information Paper and supporting published materials, contain a range of errors, inaccuracies and misunderstandings.

These concerns cover a range of matters such as:

- IPART's decision making framework
- Interpretations of WaterNSW's engagement activities
- Representations of the body of evidence provided by WaterNSW
- Statements on the performance of WaterNSW over the current regulatory period
- WaterNSW responsiveness to the regulatory framework and our operating environment.

A non-exhaustive detailing of these concerns is included in Annexure 1.

If these errors and omissions had been presented in a confidential document they might have been corrected without any significant damage to the reputation of WaterNSW. They have however been published to our customers and amplified in the rural media, gratuitously weakening our authority and legitimacy, perhaps for years to come.

2. IPART has not followed established regulatory practice

We understand that IPART has released its Information Paper on the basis that it needs more time to assess WaterNSW's expenditure proposals. In light of the comprehensive nature of the proposal and the extensive material that WaterNSW has provided to IPART and its consultants, we are not clear as to what additional information we need to provide, noting that the information provided for this review is far in excess of what has been provided to IPART in past reviews where building block determinations have been made on time.

WaterNSW contends that IPART has had sufficient time to make full building block determinations and if it had followed its established processes, the need for the proposed price paths could have been averted.

2.3. IPART has not met its legislative requirements

While IPART has stated that it has met the requirements of its legislation, it is evident that this has not in fact occurred. Specifically, where the Tribunal uses a methodology to fix prices, section 14A of the IPART Act requires IPART to report on what regard IPART has had to the nine matters listed in section 14A(2), including:

(b) *past, current or future expenditures in relation to the government monopoly service* – IPART has not provided its forecast of future capital or operating expenditures and has instead provided a top-down price path with no consideration of actual expenditure requirements.

(e) *a rate of return on the assets of the government agency* – unlike previous determinations, IPART has not provided its calculation of the rates of return used and, in the case of Rural Valleys, has not specified its approach to transitioning the WACC to the IPART standard method (for MDBA regulated valleys). This is despite the fact that IPART wrote (twice) to WaterNSW outlining its proposed approach, that does not seem to have been adopted.

(f) *a valuation of the assets of the government agency* – given the significant reductions to the proposed prices required to deliver bulk water services, this would likely lead to a revaluation of the assets of WaterNSW. IPART has not contemplated this in its Information Paper.

IPART is also required under section 15(1) of the IPART Act to have regard to 12 matters in making determinations and recommendations, including the following:

(c) *the appropriate rate of return on public sector assets, including appropriate payment of dividends to the government for the benefit of the people of New South Wales* – as outlined above, it is apparent that IPART has not updated the rate of return on assets, including a transition to IPART's standard method for MDB Rural Valleys, which not only is inconsistent with IPART's previous written communication on this matter, but also leads to no dividends being able to be paid to the government over the next three years (at least) and WaterNSW having to borrow to fund unfunded costs e.g. lower than required WACC allowances. This is not in the interests of the people of New South Wales.

(g) *the impact on pricing policies of borrowing, capital and dividend requirements of the government agency concerned and, in particular, the impact of any need to renew or increase relevant assets* – IPART has not articulated how it has addressed these issues and instead suggests that these are addressed at the subsequent determination for consideration. WaterNSW suggests that issues of borrowing, capital and dividend requirements are core elements of financeability that have not been adequately (or even notionally) addressed in the Information Paper.

IPART has not demonstrated that it has addressed the five elements listed above required in the making of determinations, recommendations and the methodology to fix prices in its Information Paper. On this basis, we consider that IPART has not met the requirements of the IPART Act when setting the proposed price path and request that IPART reconsider and incorporate the fundamental factors of the legislation relating to our financial sustainability and the impact on government and the people of New South Wales.

As outlined in the Frontier Economics report provided as Appendix 1, IPART recognises that it must compute the level of allowed revenues and prices that would permit the recovery of efficient costs:

> *Cost recovery is an important part of the regulatory framework.* ***We consider prices should be set so that forecast revenue is likely to meet the prudent and efficient costs of WaterNSW. This is consistent with our standing reference to consider section 29(2)(b) of the Water Charge Rules 2010.***[1] (emphasis added)

and that:

> *We remain committed to considering prices that ensure WaterNSW's forecast revenue recovers prudent and efficient costs.*[2]

By setting prices that are unlikely to result in revenues sufficient to meet WaterNSW's efficient costs, most notably by not providing a return on assets reflecting current market conditions, IPART has not met the requirements in section 29(2)(b) of *Water Charge Rules 2010* as set out in the standing order.

2.4. Our earlier correspondence with IPART recognised the complexity of the challenge

In our letter to IPART referred to in their Information Paper, we recognised the complexity of the challenge being faced by IPART and recommended a CPI+ uplift in revenue for a **deferral of one year**.

[1] IPART, May 2025, Prices for WaterNSW bulk water services: Information Paper, p. 35.
[2] IPART, May 2025, Prices for WaterNSW bulk water services: Information Paper, p. 35.

That recommendation was made on the reasonable assumption that IPART would still apply the requirements of its Act and the regulatory framework when determining what the "CPI+" would need to be, including critically ensuring the revenue uplift would be sufficient to meet real-world financeability tests, including IPART continuing to apply WACC allowance guidelines.

However, by recommending an up to three-year interim price period, IPART has misrepresented WaterNSW's recommendation and in doing so created a financial crisis and significant uncertainty on what can be achieved within the first year of the Interim period.

3. Consequences of IPART's approach

WaterNSW acknowledges IPART's intent in setting determinations that seek to balance affordability with customers' longer-term interests. However, there are several aspects of IPART's proposed "top-down" approach to the upcoming determinations outlined in the Information Paper that are concerning. In particular:

For customers

Higher prices at the subsequent review – this is not in customers' long-term interests as it requires even higher price adjustments in future to account for lower costs today (assuming WaterNSW comes under the same regulatory framework in the future). It also places strong disincentives to invest in efficient water infrastructure.

It is not evident from the Information Paper how, or if, IPART intends to "true-up" the prices set for the next three years at the subsequent determinations when price increases potentially revert to cost reflective levels. We are concerned that the pricing increases customers would face in subsequent periods due to artificially low prices for up to the next three years is problematic and not in customers' long-term interests.

Deteriorating service levels - under the proposed price paths, WaterNSW cannot provide services at the current level. This is not sustainable. We are concerned about our ability to maintain the condition and serviceability of our assets at the expenditure levels inherent in the proposed price paths, including keeping our regulatory asset base flat in real terms over the period.

Customer investments at risk - setting short-term prices at below cost reflective levels runs the risk that customers make short-term investment decisions that may not be viable, or unwound, if and when prices move to cost reflective levels in the medium term.

High volume risk leads to pricing instability– IPART has not proposed any change to the current form of control (e.g. price cap) or tariff structures for the next three years. This exposes customers to high pricing volatility at each review and WaterNSW to significant revenue risk, at a time when it can least afford it. We maintain our support for a revenue cap with side constraints and reform of tariff structures to manage revenue and volume risk and look forward to discussing these important matters in the leadup to the final determination.

For WaterNSW

WaterNSW's financial viability is under serious threat over the proposed three-year term of each determination under IPART's proposed price paths. This has serious implications for all stakeholders, including customers, communities, WaterNSW, other water sector participants, and the NSW Government.

The implications on WaterNSW's debt management strategy, aimed at managing financing risk by aligning its borrowing with IPART's WACC guidelines is a significant concern. An extract from the WaterNSW policy is provided below:

WaterNSW is to target a Risk Neutral Position ("Benchmark") in structuring its debt portfolio and undertaking new borrowings, aligned to the Regulators' cost-of-debt methodologies.

To the extent that the WaterNSW debt portfolio ("Portfolio") can be structured to replicate the Benchmark, this will result in WaterNSW's debt costs closely mirroring the Regulators' cost of debt allowances, and financial risks being naturally hedged.

For example, the WaterNSW debt portfolio Benchmark may be comprised of:

A share weighted in alignment to the Greater Sydney RAB share of total WaterNSW RAB, with the following characteristics:

- *having a real rate cost which adjusts in line with actual inflation over time*
- *having a tenor horizon of up to ten years*
- *credit margin (GGF) tenor aligned to the real rate term to maturity*
- *50% of the portfolio should be repriced in line with the 10 year average of the 10 year Commonwealth bond rate (i.e. 5% re-pricing or maturing per annum) – i.e. in line with IPART's 10-year historic trailing average approach.*
- *50% of the portfolio should be repriced in line with the 40 business day average of the 10 year Commonwealth bond rate at IPART's advised observation period, with a trailing average profile aligned to the length of the regulatory period (e.g. a five year determination would result in a five-year trailing average with 10.0% re-pricing or maturing per annum) – i.e. IPART's current cost of debt approach.*

A share weighted in alignment to the Rural Valleys RAB share of total WaterNSW RAB, with the following characteristics:

- *having a real rate cost which adjusts in line with actual inflation over time.*
- *having a tenor horizon of up to 10 years.*
- *credit margin (GGF) tenor aligned to the real rate term to maturity*
- *For Regulatory Determinations commencing after 30 June 2025 (subject to transitional arrangements):*
- *50% of the portfolio should be repriced in line with the 10 year average of the 10 year Commonwealth bond rate (i.e. 5% re-pricing or maturing per annum) – i.e. in line with IPART's ten-year historic trailing average approach.*
- *50% of the portfolio should be repriced in line with the 40 business day average of the 10 year Commonwealth bond rate at IPART's advised observation period, with a trailing average profile aligned to the length of the regulatory period (e.g. a five year determination would result in a five-year trailing average with 10.0% re-pricing or maturing per annum) – i.e. IPART's current cost of debt approach.*

The Benchmark will change over time depending on the relative weightings of the Greater Sydney and Rural Valley RABs in relation to the total WaterNSW RAB.

In the absence of IPART applying its WACC guidelines and its written confirmation that WaterNSW transition to a trailing average for MDB valleys, WaterNSW is unable to manage its debt portfolio so as to achieve a risk neutral position with respect to the IPART allowed cost of debt.

By preventing WaterNSW from structuring its debt portfolio maturity to replicate the regulatory "allowed" cost of debt, IPART's position has introduced additional financial risk into WaterNSW management of its debt portfolio. The Information Paper provides no guidance as to how IPART will calculate the WACC going forward nor as to the mechanism for compensating WaterNSW for under recovered funding costs (i.e. regulatory true-up of the cost of debt).

It is critical that IPART provide this guidance in its final interim determination. WaterNSW cannot manage interest rate and debt duration risk without clear guidance from IPART as to how it plans to address the financial risk this creates for WaterNSW and the unfunded WACC costs.

As discussed further below we strongly recommend that IPART revert to following its WACC guidelines, including their previous written support for WaterNSW to transition MDB valleys to a trailing average for the cost of debt.

IPART's financeability test, as discussed below, understates the extent of the financial stress on WaterNSW financial position.

Not enough funding to pay our interest costs – By IPART not following its own guidelines for determining the WACC and has, for Rural Valleys, locked in historically low interest rates (implicitly based on 2021 rates for MDB valleys) for up to the next three years. This results in WaterNSW being unable to fund our interest charges and ultimately becoming insolvent within the period (without significant financial support from our shareholder).

Equally concerning is that IPART has not followed its own written advice to WaterNSW supporting the transition to a trailing average cost of debt for the MDB assets. Earlier this calendar year WaterNSW refinanced its debt portfolio based on IPART's written support of transition to a trailing average from the previous ACCC methodology in determining the cost of debt applied to MDB valleys in the 2021 determination. Regulatory certainty is a key foundation for debt and equity investors and IPART moving away from their guidelines sets a dangerous regulatory precedent**.**

Insufficient funding to meet our regulatory obligations - WaterNSW would be unable to meet existing and new regulatory and legislative requirements due to the insufficient funding under the proposed price paths, such as new obligations recently included in the WaterNSW Operating Licence and SOCI Act requirements, to name two examples.

Foregone revenues - the short-term price path proposed by IPART does not consider under-recovered revenues foregone during the current regulatory period, nor does it reforecast volumes for the upcoming period. Whilst WaterNSW is not proposing to 'claw back' foregone revenues during the current regulatory period arising from IPART not updating prices for a lower 20-year rolling average, not updating the 20-year rolling average on a 'go-forward' basis is not sustainable.

A new operating model takes time - While some reductions might be relatively straightforward to accommodate (for instance, WaterNSW may decide to not comply with an individual regulatory obligation should regulatory funding not be provided), structural changes to our systems and processes would be required that will take time to redesign and implement in a sustainable manner. For instance, our workforce plans, digital systems, customer outcomes and the extent of our regional presence for new programs would all need to be reviewed if insufficient funding is provided.

Time is required for a structured and orderly transition to a new operating model. There is also a need to consider the longer-term implications on service delivery, asset maintenance and the need to maintain skilled and capable employees to deliver a critical service to customers.

Whilst WaterNSW has looked for, and will continue to look for efficiencies, it is not sustainable to address real price increases and new regulatory obligations by increasing business risk and reducing customer service outcomes.

3.3. WaterNSW will not be financially viable under the proposed price paths

Fundamentally, WaterNSW cannot support draft pricing outcomes that jeopardise our financial sustainability or solvency. The proposed price paths do not recognise the costs of meeting regulatory obligations and or (in the case of Rural Valleys) lock in historically low rates of return that are well below rates that reflect current market conditions (noting that IPART's 2018 WACC methodology adopts a BBB credit rating as the most appropriate measure of the debt margin for a benchmark firm operating in a competitive market). This is not in the long term interests of our customers and communities and compromises the incentive to efficiently invest in water infrastructure.

Consequently, WaterNSW is likely to significantly under-recover its efficient costs over the proposed three-year price path period. Indeed, analysis undertaken by Frontier Economics as provided in Appendix 1 demonstrates that under IPART's proposed price path:

- The return to equity investors would be materially lower than the cost of equity capital that would obtain under IPART's 2018 WACC method, for both Rural Valleys and Greater Sydney; and
- **The real return to equity investors for Rural Valleys would actually be negative, meaning that equity holders would be required to pay (in real terms) to supply the equity capital needed to deliver the regulated services.**

These outcomes are untenable. Furthermore, they violate the requirement under section 15(1)(c) of the IPART Act, which requires IPART to have regard to the appropriate rate of return on public sector assets, including appropriate payment of dividends to the Government for the benefit of the people of New South Wales.

IPART has proposed no mechanism that would allow WaterNSW to recoup efficient costs that would be under-recovered during the proposed three-year price path period. This represents a material departure from IPART's long-established approach that regulated businesses should have an opportunity to recover their efficient costs. This undermines confidence in IPART's regulatory framework, which in turn will make it difficult to forecast our future revenues and our ability to fund longer term contractual liabilities.

The price path would also not allow a benchmark efficient business in our circumstances to support the benchmark BBB credit rating at the benchmark gearing level of 60%. This is not in the long term interests of our customers and communities and undermines the incentive and ability of WaterNSW to efficiently invest in water infrastructure. As IPART itself explained, a failure of its 'benchmark' financeability test would indicate a regulatory error, which must be corrected through a reassessment of the pricing decision.

WaterNSW has undertaken a review of our financeability and credit worthiness if the draft price paths are introduced. In summary, WaterNSW would not be able to meet its interest coverage requirements and would likely have a standalone credit rating below investment grade (thereby increasing funding costs) which, without significant financial support from the shareholder, would result in WaterNSW not being able to operate as a going concern.

The shareholder support is not sustainable, it would be funding a financially unviable business to maintain the business's solvency.

3.3.1. IPART's benchmark financeability tests

In its Information Paper, IPART indicated that it has taken into consideration the financial sustainability of the business resulting from the pricing decisions through undertaking a financeability test. IPART has conducted separate benchmark financeability tests for Rural Valleys and Greater Sydney, with the respective results and implications summarised in the following sections.

With respect to WaterNSW's overall financeability for regulated bulk water operations, IPART states in the Information Paper that:

> *Overall, our assessment is that our draft decisions are likely to provide adequate revenue to support WaterNSW's financial sustainability in the short-term. However, some of the ratios for Rural Valleys are lower than for Greater Sydney, and are lower than in the last Rural Valley determination. The root issue is identified in WaterNSW's proposal, which recognised that* ***prices would need to increase significantly higher than what customers report they can afford if the business is to remain in a strong financial position****.*[3] (emphasis added)

As explained in the Frontier Economics expert report provided as Appendix 1, WaterNSW contends that the extent of the financeability problem is underestimated by the results of IPART's financeability test and that, even in the short-term (three years) there is inadequate revenue that will lead to WaterNSW's insolvency.

WaterNSW highlights that IPART's assessment does not fully capture our financeability concerns. For instance, "gearing" in IPART's assessment will, by construction, always remain at 60% under the benchmark test. Therefore including gearing remaining at 60% as a 'pass' using IPART's approach to assessing financeability overstates the financial sustainability of the decision.

WaterNSW notes that in conducting the financeability test, IPART multiplies the debt balance by the real cost of debt rate. As interest is calculated on nominal rates, we believe the financeability test should be undertaken on this basis.

As discussed in Appendix 1, these results occur even without the significant impact on credit metrics associated with higher capital and operating expenditure that WaterNSW expects to incur to meet our regulatory obligations, maintain asset health and deliver customer service standards.

The IPART benchmark financial sustainability calculations are flawed. The modelling contains errors as identified in Appendix 1. In addition, the calculations do not align to WaterNSW's forecast efficient costs, which IPART has not refuted. For example, the financeability test applies debt costs as per a 2025-26 estimated WACC, noting this is a trailing average rather than a prevailing rate, but current prices contain interest rate assumptions based on an . IPART's price path has not been adjusted to recognise that WaterNSW has had to refinance debt at substantially higher current market interest rates.

WaterNSW notes that the Information Paper as it stands will not support a credit rating of Baa2 (or BBB as per the Fitch rating agency metrics) under the Base Case. Year-on-year net losses after tax, unfunded interest costs and credit metrics that quickly decline, together with uncertainty as to the price path beyond the next three years would result a non-investment grade credit rating.

Of concern, beyond the interim decision, is that there is unlikely to be any balance sheet strength to support a required increase in capital investment, which WaterNSW has had to defer due to a material reduction in its capex allowance.

3.3.2. IPART's Rural Valleys financeability tests

The following figure reproduces IPART's benchmark financeability test for Rural Valleys from the Information Paper.

[3] IPART Information Paper re Prices for WaterNSW bulk water services, May 2025. Page 54.

Figure 4 – IPART's benchmark financeability test for Rural Valleys

Table 6.6 WaterNSW – Rural Valleys benchmark financeability ratios

	Target ratio	2025-26	2026-27	2027-28
Real Interest Coverage Ratio	Higher is better >2.2x	2.7x	2.8x	2.8x
Real FFO/Net Debt	Higher is better >7.0%	4.6%	4.7%	4.8%
Net Debt/RAB	Lower is better <70%	60%	60%	60%

Source: IPART analysis.

IPART states that its financeability test for Rural Valleys suggests the following:

- *The real interest coverage ratio is above target, meaning WaterNSW is expected to receive enough free cash flow to pay its real interest more than twice over. However, this is a decline from the 2021 price review (where the ratio was 8-9 times).*
- *The real FFO/net debt ratio is below target. Rural Valleys was below the threshold in the 2021 determination as well, but it has dropped further in this review (from 5.4% in 2024-25 to 4.6% in 2025-26).*
- *The net debt / RAB ratio (also known as the gearing ratio) is less than the 70% target.*

WaterNSW contends that, if the limitations of IPART's financeability are recognised, and the inputs reflect current market conditions, a vastly different outcome is achieved. For instance:

- Given that the 60% net debt / RAB (i.e. gearing) limb is an input assumption to the benchmark financeability test, it is of limited use as IPART's model operates to back-solve to the input assumption. Therefore, meeting the gearing assumption in the model should not be considered "passing the test".
- Applying IPART's assumptions, WaterNSW marginally 'passes' the Real Interest Coverage Ratio but 'fails' the Real FFO / Net Debt limb. In our experience, rating agencies such as Moody's give primary weight to the FFO/Net Debt ratio (rather than the Real Interest Coverage Ratio) when rating regulated water businesses in Australia. Hence, a failure against the FFO/Net Debt ratio is a very serious matter. Yet, IPART concludes that a failure against this metric still constitutes a pass of the overall financeability test. This does not comport with commercial reality.
- The benchmark test fails to recognise that the interest expense for the Rural Valleys benchmark business should align with a cost of debt determined using a gradual transition from the 'on the day' ACCC cost of debt allowance to the IPART trailing average cost of debt allowance (consistent with guidance provided by IPART in May 2024 and again in March 2025). The failure of the benchmark test on the FFO/Net Debt ratio is even more severe if the interest expense for the benchmark business is calculated correctly.

For Rural Valleys, WaterNSW failed in each year of the regulatory period on the FFO/Net Debt ratio, but passed in each year on the Interest Coverage Ratio (ICR). This indicates that a benchmark efficient business would have sufficient cash flow to make interest payments, but insufficient cash flow to service its full debt obligation. This is true in every year of the three-year pricing period. This is objectively a "**failure"** not a pass of the financeability test.

IPART's interpretation of '2 out of 3' constitutes a 'pass' of the financeability test is inconsistent with the view IPART expressed in the 2018 financeability review, whereby IPART applied a number of ratios since each ratio contributes some different information about financeability. The ICR provides information on one aspect of financeability, while the FFO/Net Debt ratio offers information about a different dimension. As noted above, rating agencies such as Moody's give primary importance to the FFO/Net Debt ratio when conducting rating assessments of regulated water businesses in Australia.

If the business fails on one metric but passes on another, IPART should use this result to diagnose the source of the problem. A failure on the FFO/debt could only be because the business:

- Has an insufficient depreciation allowance, and/or
- Receives too low a real return on equity. The real return on equity might be too low because:
    - The nominal return on equity is too low; and/or
    - The inflation forecast is too high.

WaterNSW has undertaken a detailed assessment of the cash flows used in IPART's financeability calculation as outlined in Appendix 1.

To derive the WACC implicit in the net present value (NPV) of the target revenue, we adjusted the post-tax real WACC applied in order to obtain a notional revenue requirement (NRR) with the same NPV as the revenue allowance. We obtained NPV equivalence between the revenue allowance and the revenue requirement at a post-tax real **WACC of less than 1%.**

That is, the implied WACC is **2.5% below** the IPART's post-tax real WACC estimate of 3.4%.

WaterNSW considers that failing the financeability test as outlined above is likely to cause a steep decline in credit metrics, leading to higher debt margin (GGF) costs and loss of investment-grade credit rating, without Government intervention.

3.3.3. IPART's Greater Sydney financeability tests

The following figure reproduces IPART's benchmark financeability test for Greater Sydney from the Information Paper.

Figure 5 – IPART's benchmark financeability test for Greater Sydney

Table 6.4 WaterNSW – Greater Sydney financeability ratios

	Target ratio	2025-26	2026-27	2027-28
Real Interest Coverage Ratio	Higher is better >2.2x	3.4x	3.4x	3.4x
Real FFO/Net Debt	Higher is better >7.0%	6.4%	6.4%	6.3%
Net Debt/RAB	Lower is better <70%	60%	60%	60%

Source: IPART analysis.

IPART states that its financeability test for Greater Sydney suggests the following:

- *The real interest coverage ratio is above target, meaning that WaterNSW is expected to receive enough free cash flow to pay its real interest expense 3.4 times. This indicates WaterNSW would have sufficient revenue to service its interest expenses (based on benchmark parameters).*

- *The real funds from operations (FFO)/net debt ratio is below target. This result is driven by WaterNSW having relatively long-lived assets (which the fixed target ratio of >7% does not accommodate).*

WaterNSW agrees that the financeability concerns are more serious for the Rural Valleys determination, but we do not agree that there is not a financeability issue for Greater Sydney. Greater Sydney also fails the benchmark test in each year of the regulatory period on the FFO/Net Debt ratio.

This should be interpreted as a serious financeability concern that indicates an error in the pricing decision that must be addressed.

3.3.4. Summary of our review of IPART's financeability assessments

WaterNSW's conclusions on IPART's financeability assessment are summarise below and discussed in detail in Appendix 1.

In the Information Paper, IPART proposes an approach for setting prices for WaterNSW over a forthcoming 3-year regulatory period. The proposed approach:

- Is a very significant departure from IPART's usual regulatory approach. In fact, it **bears no resemblance to IPART's standard approach to determining allowed revenues**.
- Significantly, the proposed approach contains **no updating of the allowed return on capital** – it simply involves maintaining real prices after a one-off adjustment to the current figure from the previous determination.
- Produces an allowed return on equity that is materially lower than IPART's own calculation of the efficient allowance for the return on equity for a NSW water business. Indeed, **for Rural Valleys, IPART's proposed approach provides equity holders with a negative real return – equity holders are required to pay (in real terms) to supply equity capital to WaterNSW** – as illustrated in Table 1 below.

Table 1: Post-tax real rates of return for WaterNSW – after updates and corrections

Financial ratio	Greater Sydney	Rural Valleys – Inland Valleys
Updated WACC using standard IPART approach	3.6%	4.1%
Implied WACC under proposed approach for next 3 years[4]	2.9%	1.0%
Updated allowed return on equity using standard IPART approach (computed by IPART)	4.8%	5.9%
Implied allowed return on equity under proposed approach for next 3 years	3.1%	-1.7%

- Any difference between the allowed return on equity under this new approach and IPART's best estimate of the efficient financing costs (i.e. using IPART's usual approach for estimating WACC) would seem to remain a permanent difference, there being no proposed true-up or loss capitalisation mechanism.

[4] Computed to reconcile with NPV of allowed revenues under IPART's proposed new approach.

- The proposed new approach also objectively fails IPART's financeability test in every year of the proposed regulatory period and for both Greater Sydney and Rural Valleys.
- This new approach for a proposed forthcoming 3-year regulatory period is inconsistent with the important regulatory principles of:
  - **Accuracy** – setting an allowed return that best reflects the efficient cost of finance;
  - **Regulatory stability and predictability**;
  - **Regulatory transparency**.

  These core principles were identified by IPART as being central to its approach to setting allowed returns in its 2018 WACC Review.

We note that:

- There is a significant margin between the proposed return on capital and IPART's own estimate of the efficient return on capital;
- The shortfall is proposed to persist for a 3-year period; and
- It appears that the under-recovery is intended to remain permanent.

Thus, the proposed arrangements result in a significant and permanent differential between the regulatory allowance and the efficient cost.

Consequently, we submit that IPART must set a revenue allowance for Greater Sydney and Rural Valleys that is commensurate with a WACC allowance determined using the method that IPART confirmed, in guidance provided to WaterNSW in May 2024 and March 2025, it intended to apply for the forthcoming regulatory period. That method would involve:

- Updating the WACC allowance for Greater Sydney using the 2018 WACC method; and
- Updating the WACC allowance for Rural Valleys using the WACC method and applying a debt transition for both the current and long-term cost of debt components.

If IPART decides to set an interim 3-year pricing determination, IPART should apply a loss capitalisation mechanism to allow WaterNSW to recover in future periods (in an NPV-neutral fashion) any shortfall between WaterNSW's efficient revenue requirement over that 3-year period and the allowed revenues under the interim 3-year pricing determination.

The table below shows that the proposed revenue allowance is materially lower than the revenues that would ordinarily be allowed via the routine application of IPART's standard regulatory approach – for both Rural Valleys and Greater Sydney.

Table 2 - NPV of revenue requirement under IPART's standard and proposed approaches over next 3 years ($m)

Regulatory approach	Greater Sydney	Rural Valleys
Standard IPART approach	719.6	269.0
Proposed new approach	679.9	223.0
Shortfall relative to efficient allowance	**39.7**	**46.0**

Source: IPART regulatory models; Frontier Economics calculations.

3.4. Building in future price increases

WaterNSW is concerned that the price paths proposed by IPART in the Information Paper unreasonably place the burden of funding efficient water infrastructure on future customers and generations.

The potential three-year determinations based on top-down analysis are not cost reflective. While that may provide short-term relief for customers, it is not sustainable, are not supported and not consistent with IPART's legislation and good regulatory practice.

The current price paths do not signal to customers the current costs of existing water infrastructure, let alone the investment required to continue to provide bulk water services that meet regulatory obligations and customer outcomes. Deferring required investment will only lead to intergenerational inequity whereby future customers fund the costs for existing customers.

3.5. Managing revenue risk associated with volume variations not addressed

While not explicitly rejecting WaterNSW's proposed revenue cap and tariff structure changes, IPART has effectively locked in the current price cap and tariff structures for up to the next three years. This is disappointing as WaterNSW has undertaken thorough analysis and extensive customer engagement on these matters and have addressed issues of the fair sharing of volume risk in our proposal and attachments.

WaterNSW continues to be the only water infrastructure business regulated by IPART without a demand volatility adjustment mechanism (DVAM) or equivalent to address volume risk. This is made more problematic given the potentially larger volumes at risk compared to our industry peers. WaterNSW maintains that a revenue cap is the most effective approach to manage volume risk that shares the risks equitably with customers and we will continue to advocate for this change to the form of control at the subsequent review.

We note that changes to pricing structures, including introducing higher fixed charges, may also be appealing to some segments of our customer base and can be effective in managing volume risk in some segments (e.g. environmental water holders and other large users), but have had mixed support from other segments. We seek IPART's support in progressing potential changes to the form of control and pricing structures as part of a three-year determination for Rural Valleys.

These ongoing risks must be reassessed and addressed as part of future regulatory reform.

3.6. Price paths well below most recent regulatory decisions

During 2024 there were a number of decisions made by economic regulators in water and other sectors that acknowledged the material input cost pressures on regulated entities. The table below sets out a range of regulatory decisions that (whilst include a number of entity specific drivers) by and large recognise that there are material and unavoidable input cost pressures. These provide a direct contrast to IPART's draft decisions (particularly the Rural Valleys draft decision).

The comparison also clearly demonstrates the recognition of the regulators in these other decisions (including IPART) of the structural and unavoidable input cost drivers facing regulated entities across all sectors; and the urgent but uncomfortable need to accommodate these costs in the coming years.

Table 3: Comparison of recent regulatory revenue and pricing decisions

Regulated Entity	Regulator	Average Annual Real Revenue/Price Increase*	Decision Summary
WaterNSW (Rural Valleys) - Proposed	**IPART**	**22%**	
Goulburn Mulwaree Council	IPART	19.5%	22.5% nominal increase in 1 Year
Narrandera Shire Council	IPART	18.8%	48.1% nominal increase over 2 years
WaterNSW (Greater Sydney) - Proposed	**IPART**	**14%**	
Tamworth Regional Council	IPART	13.9%	36.3% nominal increase over 2 years
Willoughby City Council	IPART	12.2%	15% nominal increase in 1 year
Randwick City Council	IPART	8.9%	11.67% nominal increase in 1 year
Kempsey Shire Council	IPART	8.7%	24.09% nominal increase over 2 years
Griffith City Council	IPART	7.8%	22.10% nominal increase over 2 years
SA Water (Sewage Charges)	ESCOSA	7.5%	30% real increase over 4 years
Blayney Shire Council	IPART	7.3%	33.1% nominal increase over 3 years
SA Water (Water Charges)	ESCOSA	5.3%	21% real increase over 4 years
Sydney Water – Draft Decision	IPART	4.6%	4.6% real price increases for typical residential bill over 5 years
Hunter Water – Draft Decision	IPART	3.6%	3.6% real price increases for typical residential bill over 5 years
Endeavour Energy	AER	2.7%	13.3% real revenue increase between regulatory periods
WaterNSW (Greater Sydney) - draft	**IPART**	**2.3%**	**6.9% real revenue increase over 3 years**
Ausgrid	AER	1.9%	9.4% real revenue increase between regulatory periods
Essential Energy	AER	0.7%	3.4% real revenue increase between regulatory periods
WaterNSW (Rural Valleys) - draft	**IPART**	**0.6%**	**1.9% real revenue increase over 3 years**

*Assuming 2.5% CPI where decisions are in nominal terms

3.7. Why IPART's proposed price path will not support current staffing levels

IPART's decision to only increase revenues by CPI for all existing services and activities, through to 2028, is inconsistent with both the macro- and micro-economic contexts in which WaterNSW operates.

Continued adherence to the price path set out in the Information Paper is likely to result in reduced services and or reduced customer outcomes over the length of the determination period and does not support WaterNSW's current staffing levels.

To evidence WaterNSW's concerns we provide the following example:

- We start with the final year of the current IPART determination period (2024-25) as the base, and assume that it represents the efficient staffing levels, operating and capital expenditures and financing costs to meet the financial, regulatory and service requirements of WaterNSW.
- Holding all other variables constant, we increase the interest costs that must necessarily be paid by WaterNSW to meet the loans it has in place to fund the physical infrastructure across NSW.

- If we were to follow IPART's approach from the Information Paper and simply escalate all revenues (and by inference all revenue building blocks) by CPI of 3.1% (as per the Information Paper), we would expect a shortfall in the allowed interest costs.
- However, WaterNSW's forecast benchmark debt costs in 2025-26 (based IPART's standard methodology) are much higher, resulting in a modelled interest allowance '**gap' of around $18 million** per annum. This funding gap must be met by reducing some or all other existing costs and or services.

That is, salaries and wage costs are not quarantined from the need to reduce costs to meet the funding gap in order to remain financially viable, particularly given salaries and wages make up 65-70% of WaterNSW operating costs.

Put another way, WaterNSW holds actual debt and has actual interest expense and legally binding financial instruments with financial market participants. Not paying interest on loans as and when they come due is a serious financial act and can lead to, amongst other things, insolvency or related proceedings.

Consequently, WaterNSW is obliged to prioritise the payment of its debts and financial obligations in order to remain in business and by doing so places serious pressure on all expense lines, including salaries and wages which are not adequately funded by IPART's proposed price paths.

3.8. Why IPART's proposed price path may not reflect the specific issues for the MDBA and BRC proposals

WaterNSW's original proposal includes pass through charges components to allow for the recovery of costs relating to the bulk water activities of the Murray Darling Basin Authority (MDBA) and Dumaresq-Barwon Border Rivers Commission (BRC).

In its Information Paper (page 52), IPART states the following with respect to bulk water charges for the MDBA and BRC:

> *Consistent with the 2021 price review, our draft decision is to continue to use the building block approach for Murray-Darling Basin Authority (MDBA) and Dumaresq-Barwon Border Rivers Commission (BRC) costs. However, under our draft decision to set prices for WaterNSW Rural Valleys from 1 July 2025 to 30 June 2028 based on current prices plus increases for inflation and safety-related priorities, these costs will be based on the previous determination period rather than the costs in WaterNSW's pricing proposal.*

and

> *... MDBA & BRC prices are increasing by only CPI.*

As outlined in Attachment 16 of our original proposal, NSW's contribution to the MDBA is characterised as operating expenditure, therefore there is no forecast MDBA capital expenditure. The MDBA costs are treated by NSW as recurrent operational expenditure.

In the 2021 determination, IPART 'looked through' the actual contributions paid to MDBA and set a building block cost allowance based on a conceptual assessment of the 'capital' and 'operating' costs used to supply MDBA services. IPART's decision at that time was to set a building block capital cost allowance to incorporate MDBA capital costs in Bulk Water prices in the next determination period. WaterNSW supports the NSW DCCEEW proposal to treat all bulk water related MDBA costs as operating expenditure in the next determination period.

If IPART was to maintain its approach for the upcoming determination period by uplifting current charges by CPI only this would:

- Require the NSW Government to fund the difference between NSW's actual contribution to the MDBA for its water management activities and the revenue received from prices – which would be on top of the NSW Government's already significant contribution to water management costs under this pricing proposal (for which no additional NSW government funding has been agreed), or
- Come at the expense of other bulk water activities or services, as there is no guarantee that the NSW Government would fund such a shortfall.

Neither outcome would be efficient or equitable. The combination of these issues will result in cross subsidisation between the broader Bulk Water customer base and MDBA customers. The proposed approach of treating MDBA and BRC costs as operating in nature is consistent with how MDBA costs are treated by other utilities and price regulators in other jurisdictions. South Australia Water and Goulburn-Murray Water (Victoria) treat MDBA costs as operating expenditure (Goulburn-Murray Water MDBA related costs within the Essential Services Commission 2024 determination are treated as operating expenditure).

If IPART maintains is approach to setting MDBA and BRC costs by locking in current prices for three more years, this would lead to:

- Under-recovery of costs due to IPART's building block calculation for pricing purposes when costs are invoiced on an operating cost basis, and
- Under-recovery as expected costs have increased materially in real terms since the 2021 determination while prices would only increase by CPI.

4. Our plan to keep WaterNSW solvent

4.3. Minimum Essential Revenue Requirement

WaterNSW has considered the proposal by IPART and through a number of meetings with IPART staff sought clarification around certain aspects of IPART's proposal. We have based our assessment on the outcome of these discussions and our understanding of the Information Paper. For the reasons outlined in the section above, our understanding is that accepting IPART's proposal will result in the financial viability of WaterNSW being compromised within the three-year review period. It also introduces uncertainty as to the price determination beyond 30 June 2028.

As such, we have prepared an approach that will support the ongoing viability of WaterNSW and provide the opportunity for WaterNSW to work collaboratively with IPART and the NSW Government to undertake the required reviews. The approach would also reduce uncertainty in prices for customers and it would minimise the impact of recovering unfunded costs e.g. WACC.

The WaterNSW approach:

- Protects our financial viability through ensuring we have sufficient funding to meet our financing and operational requirements over the next three years.
- Looks to minimise longer term price impacts for customers.
- Applies IPART's guidance on the WACC previously communicated to WaterNSW and that is consistent with the current regulatory model.
- Provides for a bare minimum level of expenditure that recognises and prioritises our regulatory and statutory obligations and considers the macro-economic changes since the last determination and the significant impact these have on costs.

- Includes some expenditure supported by our customers and the draft consultants' reports through the extensive consultation undertaken over the past two years.
- Mitigates some key operational risks due to asset maintenance deficiencies, yet assumes a higher overall risk level.
- Sees WaterNSW being able to meet material regulatory and legal obligations.

Considerations underpinning our approach

WaterNSW proposes a price path that enables WaterNSW to meet its borrowing cost debt obligations and provides funding to meet critical and urgent expenditures. In consultation and agreement with NSW Government agencies, including NSW Treasury, our overarching approach is to include items in the price path that are mechanistic adjustments to IPART's regulatory framework, are largely outside of our direct control and are **critical and urgent**.

Our considerations include:

- **Length of determination period**

  If IPART cannot commit to making a final determination within 12 months (as requested by WaterNSW), then WaterNSW conditionally supports IPART's three-year price path **provided** the revenue requirement is based on the full recovery of our minimum essential revenue requirement . This is the primary means to address our financial sustainability. If IPART does not adopt prices based on our minimum essential revenue requirement, we suggest that IPART must complete its review of our prudent and efficient expenditure and make a final determination that ensures our ongoing financial viability, within one-year (otherwise WaterNSW will be insolvent in the second year).

- **Update Rural Valleys pricing to transition to IPART's standard WACC method**

  Current prices were set in an environment of historically low interest rates that are insufficient moving forward to maintain our credit worthiness and to fund debt at today's rates. We propose that IPART updates the WACC for Rural Valleys to transition to IPART's standard WACC method consistent with guidance previously provided by IPART on this matter that recognises we have already refinanced debt on this basis with support to do so in writing from IPART.

- **Uniform price changes for each Rural Valley**

  With the exception of North Coast and South Coast valleys, WaterNSW proposes to maintain IPART's approach of charging the same percentage increase to each charge in each valley, reflecting required revenues while not incorporating changes in customer usage. We propose uniform increases for each valley rather than valley-specific increases to reflect the shorter-term nature of IPART's determination over the next three years. Valley specific adjustments and reconciliations would form an element of the subsequent determination.

The main features of our approach are outlined below.

Regulatory framework

WaterNSW's proposed approach to the regulatory framework for the upcoming reviews is summarised below.

- Recommend that IPART **not depart from its established regulatory framework** as a general principle (e.g. maintain established approaches to WACC and volumes) to guard against impacts on future investment, future customer price increases and our financial sustainability. IPART departing from its established framework would also set a dangerous precedent.

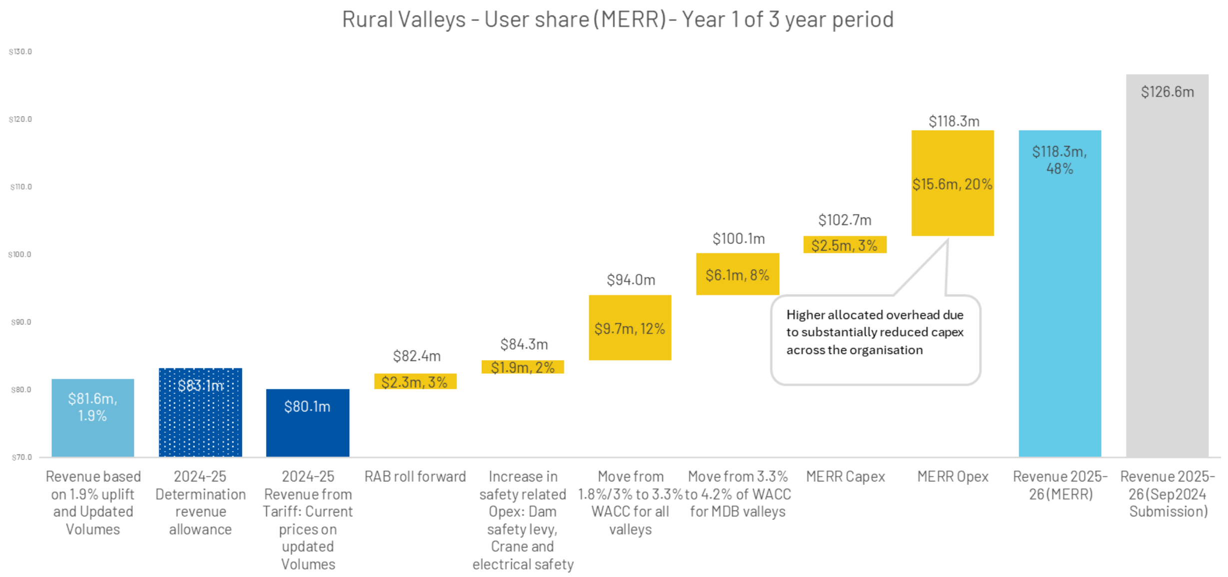
- Seek a **true-up of revenues** in the subsequent determinations for any shortfall from shorter-term price paths, noting that moving away from IPART's WACC methodology is not negotiable. Doing so creates an untenable financial outcome for WaterNSW. Applying the correct WACC will also minimise the price outcomes for customers that would arise from addressing the true up in future years.
- Support the need for several of the **reviews identified by IPART**, including a review of the appropriate future regulatory arrangements for Rural Valleys and Greater Sydney and a review of cost shares. This includes the appropriateness of the 3C's engagement model for RV's, including whether the costs of this model outweigh the benefits.
- Seek a **smoothed price path over three years** rather than a one-off increase in FY26 for our minimum essential revenue requirement proposal to help mitigate pricing increases for customers.
- Over the next one to three years, WaterNSW will work with Government and IPART to assess how to best balance stakeholder requirements of WaterNSW with what our customers can afford, including the pricing mechanism, within the context of regulatory reform.

Rural Valleys

WaterNSW's proposed approach to pricing for the Rural Valleys from 1 July 2025 is summarised below:

- Support IPART's **three-year price path** based on the full recovery of our **Minimum Essential Revenue Requirement**. This is the primary means to address our financial sustainability, meet new regulatory and statutory requirements and minimise operational risk.
- **If IPART does not adopt prices based on our minimum essential revenue requirement**, we suggest that IPART must complete its review of our prudent and efficient expenditure and **make a final determination within one year that ensures our ongoing financial viability** (otherwise WaterNSW will be insolvent in the second year of the review period).
- Update prices to take account of the **updated 20-year rolling average**.
- Seek **uniform price increases** (except for North and South Coast) rather than calculating valley-specific increases that would lead to much higher increases in some valleys.
- Proposed **smoothed annual price changes** (e.g. X factors) for **Rural Valleys** for each of the three years starting in 2025-26 of **25**% (excluding inflation) based on our minimum essential revenue requirement costs, or a one-time increase in 2025-26 of 48% (excluding inflation) followed by no real increases in 2026-27 and 2027-28 as illustrated below.

Figure 6 - Uniform revenue requirement and price increase for 1-year of 3-year determination period – Rural Valleys



Note: assumes current operating expenditure allowance in 2024-25 of $58.6m p.a. ($54.2m of user share). Roll forward of actual capex 2021-22 to 2024-25, capex limited in FY26-28 to maintain RAB in real terms. 3.3% WACC is forecast for GS and Coastal Valleys and is not our recommended WACC for the MDB valleys but shown for completeness. 4.2% WACC includes uplift to implement transition to current and long-term cost of debt for MDB valleys.

WaterNSW proposes that the annual increase of **25%** (excluding inflation) is uniformly applied to all valleys **OR** the above adjustments lead to valley-based bill increases ranging from to **18% in Hunter Valley** to **60% in Peel Valley**, noting CPI only adjustments to North Coast and South Coast.

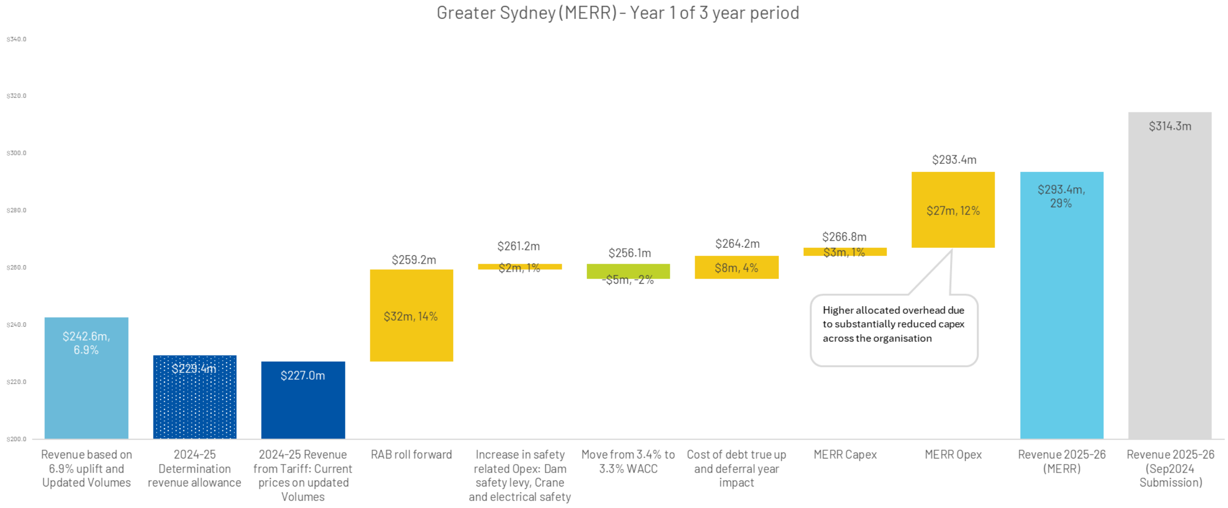
Greater Sydney

WaterNSW's proposed approach to pricing for the Rural Valleys from 1 July 2025 is summarised below:

- Support a **three-year price path** based on Minimum Essential Revenue Requirement.
- Seek a **smoothed price path** over three years rather than a one-off increase in FY26 for our proposal to help mitigate pricing increases for customers
- If IPART does not accept our proposed three-year price path based on our minimum essential revenue requirement (MERR), then request a final determination is made **within one year** for the reasons outlined above for Rural Valleys. Noting especially that Greater Sydney revenues are vital for WaterNSW's financial sustainability.

WaterNSW proposes smoothed annual price changes (e.g. X factors) for **Greater Sydney** for each of the three years starting in 2025-26 of **14%** (excluding inflation) based on our minimum essential revenue requirement (MERR), or a one-time increase in 2025-26 of **30%** (excluding inflation) followed by no real increases in 2026-27 and 2027-28 as illustrated below.

Figure 7 – Uniform revenue requirement and price increase for 1-year of 3-year determination period – Greater Sydney



We note IPART has indicated that expenditure above the funding supported in the price path does not limit WaterNSW's actual expenditures and that it is open for WaterNSW to seek recovery of its actual costs during the transitional year.

WaterNSW seeks confirmation that any expenditure or revenue requirement component is 'trued-up" in the subsequent determination when IPART has undertaken a full building block revenue requirement assessment. This will be important to provide customers and other stakeholders with clarity of the approach so they can consider this in their own business plans and investment decisions.

As noted above, our plan would also minimise the true up requirement.

4.4. Volumes (Rural Valleys)

WaterNSW proposes updating Rural Valley prices for the 20-year rolling average.

In the 2021 Rural Valley Determination, IPART set variable charges based on a calculation of the 20-year rolling average using data from 2000-01 to 2019-20 that produced averaged volumes of 3,964,658 ML. Updating the 20-year rolling average for actual data from 2004-05 to 2023-24 results in a volume calculation of 3,806,128ML, representing a **4% reduction**.

IPART stated the following in its Information Paper (page 50) on this matter:

> *Our draft decision is to accept WaterNSW's approach to use the 20-year rolling average and to hold these forecasts constant over the 3-year determination period. This approach is consistent with the 2021 determination period.* ***We have updated the 20-year rolling average using the latest set of actual water sales data as this data is now available for 2023-24*** *(it was not available at the time WaterNSW was preparing its pricing proposal).* (emphasis added)

Following clarification from IPART, it is apparent that the updated 20-year rolling average was included as the volume assumption in IPART's financeability analysis, but it **was not used to set prices** for the Rural Valleys.

We consider this to be an oversight and that IPART's intention was in fact to update prices for the updated 20-year rolling average. In any case, updating prices for the updated volumes is good regulatory practice and consistent with IPART's normal price setting process. To not update prices for the updated volumes would place more pressure on WaterNSW to recover IPART's revenue requirement.

As illustrated below, the 20-year rolling average can differ significantly by valley, which can lead to material variations in prices across valleys to recover IPART's revenue allowance.

Table 4 – Current and updated 20-year rolling average of water usage using 2023-24 data (ML)

Valley	Current Determination	Draft decision	Change ML / %
Border	139,453	132,090	-7,363 (-5.3%)
Gwydir	220,489	212,956	-7,533 (-3.4%)
Namoi	138,241	132,494	-5,747 (-4.2%)
Peel	12,625	11,597	-1,028 (-8.1%)
Lachlan	182,100	159,390	-22,710 (-12.5%)
Macquarie	232,545	199,081	-33,463 (-14.4%)
Murray	1,379,454	1,347,696	-31,759 (-2.3%)
Murrumbidgee	1,531,279	1,493,305	-37,974 (-2.5%)
North Coast	676	671	-6 (-0.8%)
Hunter	123,631	113,030	-10,601 (-8.6%)
South Coast	4,165	3,817	-347 (-8.3%)
Total (excluding Fish River)	**3,964,658**	**3,806,128**	**-158,530 (-4.0%)**
Fish River	5,753	4,705	-1,048 (-18.2%)

For the purposes of a three-year determination, WaterNSW is proposing a uniform uplift of 4% to prices in each valley. We suggest that a reconciliation with valley-specific volumes should form part of the subsequent determination.

4.5. Weighted Average Cost of Capital

4.5.1. Rural Valley WACC

WaterNSW received correspondence from IPART in May 2024 and March 2025 that confirmed we should be using IPART Standard WACC methodology with a cost of debt transition for calculating the return on capital for Rural Valleys.

This advice has informed our debt refinancing over the last few months.

In the Information Paper proposal, IPART has not updated prices on the basis advised and instead implicitly **maintains the historically low 1.8% post-tax real WACC embedded in current MDB prices for up to three more years**.

With nominal interest costs of around 2.8% in prices, while current interest rates are around 5.5%, our financeability is significantly compromised if prices do not reflect current market conditions. We propose that Rural Valley prices are uplifted to reflect the WACC based on IPART's previous guidance that includes a transition for the current and historic cost of debt.

We engaged Frontier Economics to provide an estimate of the likely WACC. The post-tax real WACC for the MDB Valleys is forecast to increase to 4.2% reflecting a transition for both the 5-year and 10-year trailing averages for the cost of debt consistent with IPART's guidance as illustrated below.

Table 5 – Updated estimate of WACC for Rural Valleys – 5 year length

Parameter	Current	Long term	Midpoint
Risk-free rate	4.50%	4.50%	
Inflation	2.60%	2.60%	
Debt margin	1.20%	1.20%	
Market risk premium	6.20%	6.00%	
Cost of equity (post-tax nominal)	8.84%	8.70%	8.77%
Cost of equity (post-tax real)	6.08%	5.95%	6.01%
Cost of debt (pre-tax nominal)	5.70%	5.70%	5.70%
Cost of debt (pre-tax real)	3.02%	3.02%	3.02%
Post-tax real WACC	4.25%	4.19%	**4.20%**

We propose that Rural Valley prices are uplifted to reflect a post-tax real **WACC of 4.2%** based on IPART's previous guidance that includes a transition for the current and historic cost of debt.

4.5.2. Greater Sydney WACC

For Greater Sydney, a similar transition to the cost of debt as per Rural Valleys is not required as we have already transitioned to IPART's standard WACC method.

Based on IPART's guidance, the forecast WACC for Greater Sydney and Coastal Valleys is a post-tax real WACC of 3.3% for the upcoming three-year period as illustrated below.

Table 6 – Updated estimate of WACC for Greater Sydney – 5 year length

Parameter	Current	Long term	Midpoint
Risk-free rate	3.20%	2.70%	
Inflation	2.60%	2.60%	
Debt margin	2.10%	2.30%	
Market risk premium	6.20%	6.00%	
Cost of equity (post-tax nominal)	7.54%	6.90%	7.22%
Cost of equity (post-tax real)	4.81%	4.19%	4.50%
Cost of debt (pre-tax nominal)	5.30%	5.00%	5.15%
Cost of debt (pre-tax real)	2.63%	2.34%	2.49%
Post-tax real WACC	3.50%	3.08%	**3.30%**

4.5.3. Summary of our views on WACC

As outlined in Appendix 1, there are compelling reasons for IPART to continue to apply their established framework to calculate the rate of return on capital. IPART's last major review of the allowed return on capital resulted in the *Final Report published in February 2018*.[5]

Two key outcomes of that Review are:

- **Estimating a WACC that best reflects efficient financing costs**

  IPART's conclusion that the central objective of its WACC estimation task is to produce an estimate that is as accurate as possible - that its WACC estimate should best reflect the efficient financing costs of the regulated entity.[6]

  In this regard, IPART concluded that setting the allowed return on capital above or below the efficient financing costs would be inconsistent with the matters that IPART is required to consider under section 15 of the IPART Act.

- **The importance of regulatory stability and predictability**

  IPART's recognition of the importance of regulatory certainty and stability - the importance of adopting an approach to WACC estimation that is stable and predictable over time.

  In this regard, IPART drew particular attention to the very material weighting that credit rating agencies place on regulatory stability and predictability within the credit rating process - and the high score that had been applied to the IPART framework.

Contrary to the above, and with respect to the rate of return on capital, IPART has instead proposed a new approach for setting allowed revenues whereby:

- The length of the forthcoming review period is reduced from 5 years to 3 years.
- There would be no updated calculation of the allowed return on capital and no building block calculation of allowed revenues, even though the updated WACC has already been performed as part of IPART's biannual WACC updating process.
- Any difference between the allowed return on capital under this new approach and IPART's best estimate of the efficient financing costs (i.e., using IPART's usual approach for estimating WACC) would seem to remain a permanent difference, there being no proposed true-up mechanism to be borne by equity holders.
- No return on debt transition would be applied for Rural Valleys, in contrast to (a) written assurances provided by IPART in May 2024 and March 2025 that such a transition would be applied and (b) WaterNSW's actual debt refinancing based on those assurances.

WaterNSW contends that IPART should revert to its standard WACC methodology for the upcoming determinations and apply the debt transition as noted above and shown in Section 4.3.1 above in order to estimate a WACC that best reflects efficient financing costs and recognises the importance of regulatory stability and predictability.

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[5] https://www.ipart.nsw.gov.au/Home/Industries/Special-Reviews/Reviews/WACC/WACC-Methodology-2017/20-Feb-2018-Final-Report/Final-Report-Review-of-our-WACC-method-February-2018.

[6] IPART, February 2018, Review of our WACC method, p. 13.

4.6. Operating expenditure

4.6.1. Why locking in historic expenditures is problematic

The operating and capital expenditure activities for our current determination were developed in 2020. However, assumptions changed significantly due to broader water sector reforms in NSW, compounded by the effects of floods, bushfires that diverted resources for asset repairs and necessitated increased water monitoring and operations and the global pandemic.

The extreme weather events also had an impact on our capital program due to our ability to access assets. In addition, we also had a material change to our operating model and number of new regulations to meet (i.e. Security of Critical Infrastructure Act, Privacy Act and Modern Slavery Act, Land Management, IPART's 3Cs framework and WHS obligations).

There was also a need to:

- Redirect resources to improve operating licence compliance and in meeting increased customer demands for water data.
- Address the Covid 19 pandemic and significant macroeconomic matters such as inflation and interest rate increases, along with wage growth.

The technology landscape has evolved significantly, with a continued shift from on premise software and storage (capital expenditure) to cloud based subscription services (operational expenditure). This mirrors the global trend towards cloud computing, with over 85% of organisations taking a cloud first strategy to meet increased customer and community expectations for near real time data availability.

The growing cyber risk and threat landscape has necessitated increased investments in cybersecurity for threat monitoring, incident response, and compliance, especially for critical infrastructure organisations under the SOCI Act. Consequently, our operating costs have risen substantially.

The above examples are not exhaustive and we would also highlight that we received no allowance to meet the 3Cs framework and improvement recommendations from IPART with respect to the current determination. These costs were in the vicinity of **$20 million** and we worked hard to find cost efficiencies within our revenue allowances. The cost efficiencies derived to fund meeting the 3Cs framework have not been recognised.

All the above contributed to a major shift to our cost base and the allocation of costs between operating and capital expenditure and the allocation of costs across determinations. These matters are discussed further in Sections 3 and 4.

There is no justification for the IPART approach based on the IPART Handbook and we would still anticipate the need to adjust this base for:

- Increased regulatory and legislative obligations like the new Operating Licence, cyber security, privacy laws, WHS laws, changes to the economic environment including financial markets, real cost increases and consumer behaviour.
- Customer expectations through the engagement process and through the current determination e.g., increase in requirements for the provision of data.
- Changes to climate challenges like emission targets or related policy decisions.

WaterNSW believes that the IPART approach is not practical because there are a significant number of changes leading to baseline adjustments from the 2021-22 determination and the underlying business environment has changed substantially.

4.6.2. Proposed Minimum Essential operating expenditure

WaterNSW's plan is based on operating expenditure that is critical and urgent over the next three years. The proposed expenditures are lower than those contained in our original proposal and reflect the temporary approach to meeting our obligations. They do not reflect long-term sustainable costs.

While the proposed operating costs differ somewhat between Rural Valleys and Greater Sydney, there are many common elements. These include the following:

- The increased costs associated with our obligation to pay land tax. Land values have increased significantly in the last 5 years as has the number of landholdings WaterNSW now legally own.
- Higher safety-related costs relating to the Dam Safety Levy and crane and electrical safety
- Increased regulatory submission costs under the 3Cs framework
- Increased costs of technology including costs for software licensing, telecommunications (including data) and cybersecurity
- Other costs, including the reallocation of overheads due to the lower capital expenditure programs

For the **Rural Valleys**, additional critical and urgent costs are proposed for the following:

- Increased costs associated with implementing the new Operating Licence changes
- Increased costs for catchment protection and biosecurity land management programs noting that modest increased investment was generally supported by customers throughout our engagement.

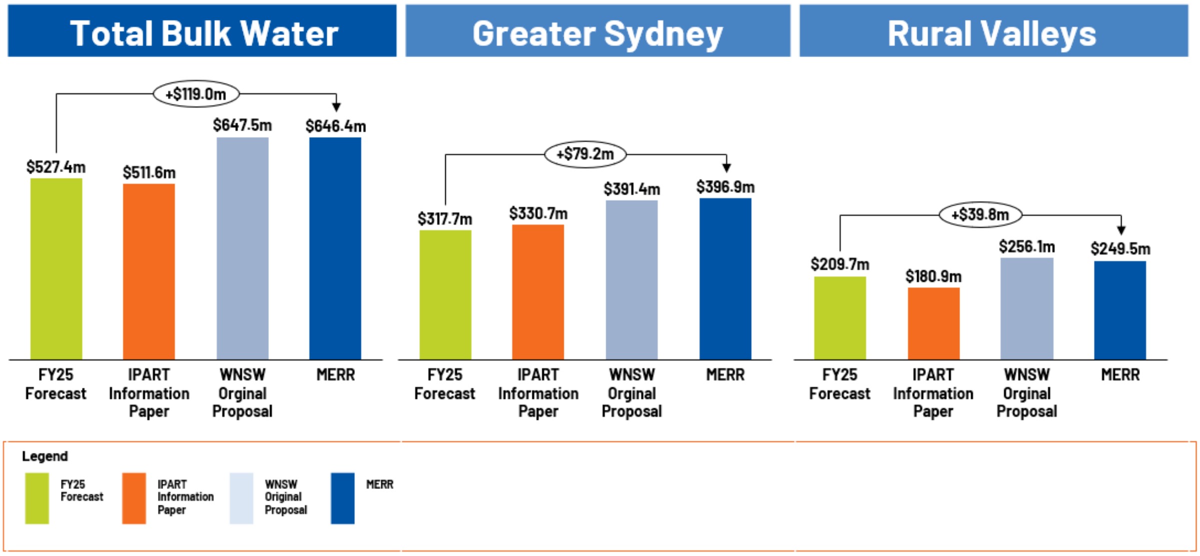
For **Greater Sydney**, additional critical and urgent costs are proposed for the following:

- Cost of energy for routine pumping and facilities
- Security services across our critical infrastructure and Bendeela campground

Both of these services have been recently contested via a procurement process.

The following figure compares WaterNSW's combined operating expenditures for the Rural Valleys and Greater Sydney for 2024-25 actuals/forecast, the implied level in the Information Paper, the level in our original proposal and the level in our minimum essential cost proposal.

Figure 8 – Operating expenditure (FY26-28) included in our minimum essential costs proposal– 3 year total ($m, $2024-25)



* For comparison with the 3-year submission total, IPART information paper assumes 2023-24 or 2024-25 inflated allowance multiplied by three plus safety related costs over 3 years.

As illustrated above, WaterNSW has reduced the combined level of operating expenditure in our minimum essential revenue proposal compared to our September 2024 proposal. The reduction is masked by a large level of capitalised overheads that have necessarily been reallocated to operating expenditure due to the approximately 70% lower implied capital program in the Information Paper. The proposal includes $8 million per annum ($24 million of the three-year period) in additional overhead when compared to our Original Proposal due to a materially lower minimum essential capex program.

The components of the proposed minimum essential operating expenditure program compared to the levels in the respective current costs for Greater Sydney and Rural Valleys determinations are illustrated below for the average per year over the three year determination period.

Table 7 - Total Bulk Water (regulated operating expenditure- annual amounts, ($m, $2024-25)

	Trend (T), Step(S), Base Adj (BA)	FY25 Forecast	FY26-29 Average-MERR	Difference	Comments
Total Bulk Water Regulated Opex		**175,793**	**215,471**	**39,677**	
Made up of:					
Land Tax	T	7,167	13,242	6,074	Driven by Land Value increases and increased land holdings
New Operating Licence	S		3,199	3,199	Additional regulatory operating license obligations
Hire & contract services	S	28,899	43,178	14,279	Safety programs (Electrical and Crane), land management, Determination preparation and ICT
Materials	S	15,869	23,547	7,678	Predominantly ICT
Bulk water purchase	S	3,150	3,315	165	Fish river bulk water purchase (non-controllable)
Licence fees	S	1,160 *full fee not accrued	3,558	2,398	WAMC licence fee (non-controllable)

	Trend (T), Step(S), Base Adj (BA)	FY25 Forecast	FY26-29 Average-MERR	Difference	Comments
		(understated by approx. $1.1m)			
Insurance	T	5,652	5,454	-197	Revised from Icare- now aligned to historical spend
Labour (excl employee provisions)	S,T	100,073	105,317	5,244	Aligned to EBA, vacancy normalisation (higher in H1FY25, current 4.5%, MERR 6%). Includes efficiencies via WaterNSW Business Transformation Program
Other		13,822	14,659	837	Property leases and outgoings
Total Regulated Opex		**175,793**	**215,471**	**39,677**	
Allocated Overheads (included above)		**42,633**	**38,196**	**-4,437**	Change in overhead pool and profile of opex and capex
Digital (included in the costs categories above)		**22,155**	**32,648**	**10,494**	Cyber risk management, software and hardware licences and data storage etc,

Table 8 - Greater Sydney (regulated operating expenditure - annual amounts ($m, $2024-25)

	Trend (T), Step(S), Base Adj (BA)	FY25 Forecast	FY26-29 Average-MERR	Difference	Comments
Greater Sydney Regulated Opex		**105,902**	**132,298**	**26,397**	
Made up of					
Land Tax	T	5,298	7,553	2,254	Driven by Land Value increases
New Operating Licence	S				NIL for Sydney
Hire & contract services	S	20,704	31,832	11,129	Safety programs (Electrical and Crane), land management, Determination preparation and ICT
Materials	S	7,817	13,296	5,479	Predominately ICT
Bulk water purchase	S	3,150	3,315	165	Fish river bulk water purchase (non-controllable)
Licence fees	S, T	1,104 *full fee not accrued (understated by approx. $1.1m)	3,498	2,394	WAMC licence fee (non-controllable)
Insurance	T	3,412	3,254	-158	Revised from Icare- now aligned to historical spend
Labour (excl employee provisions)	S,T	54,136	58,497	4,360	Aligned to EBA, vacancy normalisation (higher in H1FY25, current 4.5%, MERR 6%). Includes efficiencies via WaterNSW Business Transformation Program
Other		10,280	11,053	774	Property leases and outgoings
Total Regulated Opex		**105,902**	**132,298**	**26,397**	

	Trend (T), Step(S), Base Adj (BA)	FY25 Forecast	FY26-29 Average-MERR	Difference	Comments
Allocated Overheads (included above)		**23,997**	**21,983**	**-2,014**	Change in overhead pool and profile of opex and capex
Digital (included in the cost categories above)		**12,657**	**19,346**	**6,689**	Cyber risk management, software and hardware licences and data storage etc,

Table 9 - Rural Valleys (regulated operating expenditure - annual amounts ($m, $2024-25)

	Trend (T), Step(S), Base Adj (BA)	FY25 Forecast	FY26-29 Average-MERR	Difference	Comments
Rural Valley Regulated Opex		**69,892**	**83,172**	**13,281**	
Made up of					
Land Tax	T	1,869	5,689	3,820	Driven by Land Value increases and additional land holdings
New Operating Licence	S		3,199	3,199	Additional operating license regulatory obligations
Hire & contract services	S	8,196	11,346	3,150	Safety programs (Electrical and Crane), land management, Determination preparation and ICT
Materials	S	8,052	10,251	2,199	ICT licences / subscriptions
Licence fees	S	56	60	4	
Insurance	T	2,239	2,201	-39	Revised from Icare- now aligned to historical spend
Labour (excl employee provisions)	S,T	45,937	46,821	884	Aligned to EBA, vacancy normalisation (higher in H1FY25, current 4.5%, MERR 6%). Includes efficiencies via WaterNSW Business Transformation Program
Other		3,543	3,606	63	
Total Regulated Opex		**69,892**	**83,172**	**13,281**	
Allocated Overheads (included above)		**18,636**	**16,213**	**-2,423**	Change in overhead pool and profile of opex and capex
Digital (included in the cost categories above)		**9,498**	**13,303**	**3,805**	Cyber risk management, software and hardware licences and data storage etc,

For the avoidance of doubt, WaterNSW has reduced its proposed operating expenditure for the three-year period based on a Minimum Essential Revenue Requirement.

This is <u>not</u> our lowest sustainable operating expenditure; rather, it is the minimum required expenditure over the next three years to "keep the lights on" and to remain a solvent and financially viable entity.

4.7. Capital Expenditure

IPART's Information Paper does not provide a detailed capital expenditure assessment and associated findings. Rather, for the purposes of a shorter-term price path, IPART assumes that the Regulatory Asset Base (RAB) remains constant in real terms over the three-year price path.

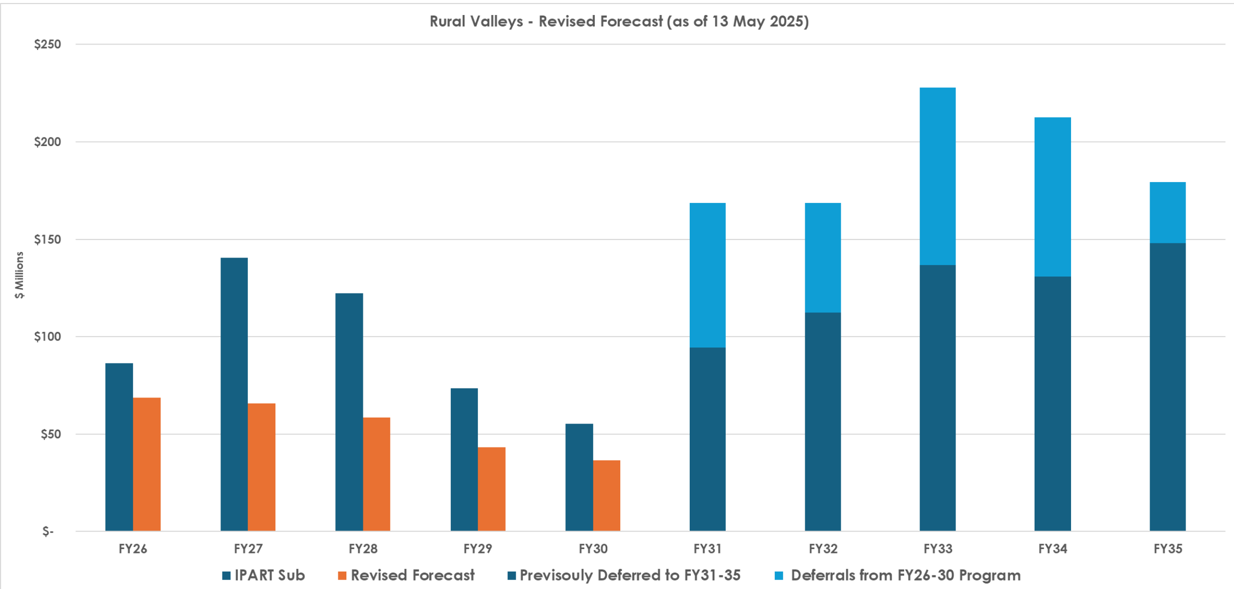
What this implies is that for the RAB to remain constant, any reduction from depreciation is approximately offset by capital additions. We acknowledge that IPART is adopting this approach in its Information Paper as a short-term approach for the three-year price paths until a more substantive review of expenditures is undertaken for the subsequent reviews.

Therefore, in responding the Information Paper, WaterNSW has included in our price path recommendation an assumption of limited capital growth that includes only those expenditures that are critical and urgent to maintain the integrity of our assets and the safety of our staff, contractors and the community.

For the avoidance of doubt, the underlying capital expenditures in our proposed price path is not what WaterNSW considers to our lowest sustainable cost. Rather, it is the lowest cost to maintain a bare minimum essential service over a 1-3 year period, without having any regard for the cost burden it places on future generations.

This future cost burden is illustrated for Rural Valleys in the figure below, where IPART is essentially creating a capital delivery bow wave in the future that will be unaffordable, if not challenging to deliver.

Figure 9 - 10 year Capital Investment Plan revised forecast for Rural Valleys

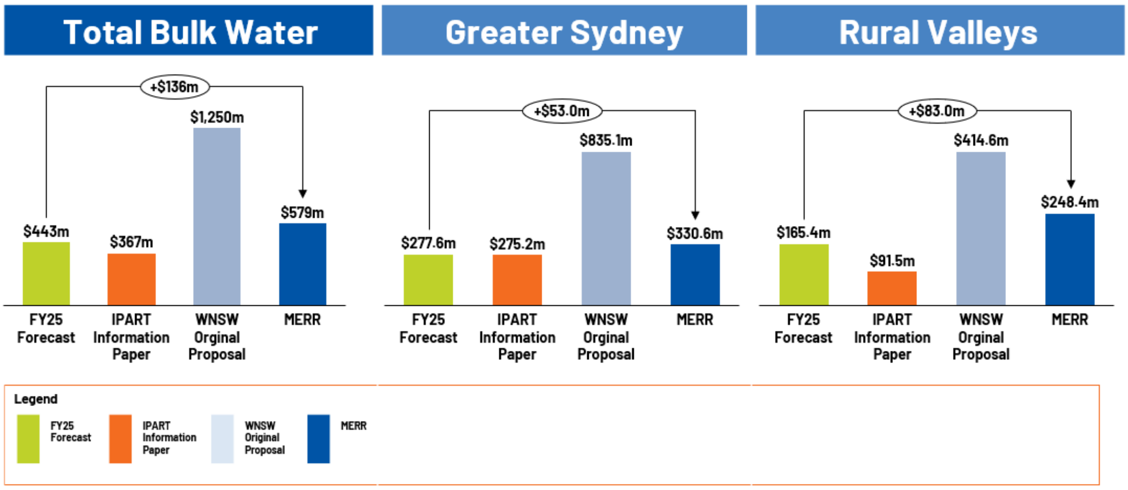


Note: the numbers in this graph relate to infrastructure costs only

The following sections of the WaterNSW response focus on the implications on the Rural Valleys capital program proposed by WaterNSW.

The following figure compares WaterNSW's combined capital expenditures for the Rural Valleys and Greater Sydney for 2024-25 actuals, the implied level in the Information Paper, the level in our original proposal and the level in our MERR proposal.

Figure 10 - Capital expenditure (FY26-28) included in our MERR costs- Greater Sydney and Rural Valleys - 3 year total- Includes overhead allocations. ($m, $2024-25).



As illustrated above, WaterNSW has **reduced the combined level of capital expenditure** in our minimum essential revenue requirement proposal compared to our September 2024 proposal by approximately **54%**. The reduction has contributed to the lower proposed revenue requirement for the proposed three-year regulatory period and a large level of capitalised overheads being reallocated to operating expenditure.

4.7.1. Rural Valleys – Top 5 Infrastructure projects (direct costs)

The following figure presents the critical and urgent "top 5" projects contained in our minimum essential revenue requirement for Rural Valleys.

Table 10 - Top 5 Rural Valleys infrastructure projects (Direct Costs)

Project	FY26-28 ($m)	F26 ($m)	Project description	Project criticality
Lake Cargelligo Embankment Upgrade	21.8	12.4	Project includes long-term structural works to be completed on embankments by addressing the known structural deficiencies.	Lake Cargelligo consists of 5 earthfall embankments with known structural deficiencies. Risk assessments provide assets at high-risk to potential failure and Lake Cargelligo is listed on the WaterNSW 'critical asset' list.
Pamamaroo Inlet Regulator Renewals	18.1	1.3	Works include remediation of structure and installation of new sheet piles to mitigate uplift pressures.	Delay of this project will prolong the period of exposure to this high risk, thereby increasing the likelihood of further damage to the structure or failure.
Copeton Spillway Remediations	8.7	0.7	Detailed design and construction to remediate flood erosion to the spillway training wall (Right side).	There is a significant dam safety risk that uncontrolled erosion would occur and impact the spillway channel if the damaged training wall is not treated.
Ballyrogan Bridge Replacement	5.2	2.8	The existing bridge will be replaced with a two-span bridge.	The bridge is used by the public and has significant structural damage, becoming a risk to public safety and a liability to WaterNSW.

Project	FY26-28 ($m)	F26 ($m)	Project description	Project criticality
Marebone Electrical Renewals Project	5.1	3.2	Renewal of obsolete electrical and controls assets on Marebone Weir.	The project is required to ensure safe, reliable and compliant operations of this critical river regulating structure on the Macquarie River.
Total	**58.9**	**20.4**		**Top 5 projects are 31% of total RV Operations direct capex**

As illustrated above, the top 5 Rural Valleys contribute over **30%** of the proposed total Rural Valleys minimum essential infrastructure capital expenditure.

4.7.2. Greater Sydney – Top 5 Infrastructure projects (direct costs)

The following figure presents the critical and urgent "top 5" projects contained in our minimum essential revenue requirement for Greater Sydney.

Table 1111 – Top 5 Greater Sydney infrastructure projects (Direct Costs)

Project	FY26-28 ($m)	F26 ($m)	Project description	Project criticality
Warragamba Pipeline Works Program	57.9	8.5	Coatings, civil and mechanical works on the Warragamba Pipeline assets	The works address poor drainage conditions on the pipeline, which has also led to worsening corrosion on the pipeline assets. Mechanical works address remediation to pipeline support structures.
Wingecarribee Peat Barrier Renewals	9.8	9.8	Replacement of barriers on Wingecarribee Reservoir	The barriers are required to replace the failing existing barriers; the barriers allow for continued function of the Wingecarribee Reservoir Spillway
Warragamba Dam Safety Instrumentation	9.6	1.4	Replace Dam Safety Instrumentation at Warragamba Dam and Prospect Reservoir	Risk Management plans have been developed for these dams that identify instrumentation enhancements as a short-term risk mitigation measure to record and monitor the critical failure modes for dam safety.
Prospect Resilience	9.1	4.0	Replace motor drives for Prospect Pump Station	Replace end of life Variable Speed Drives (VSDs) at Prospect Raw Water Pump Station.
Shoalhaven Control Gate Renewals	8.4	4.5	Refurbish outlet works assets at six Shoalhaven facilities	Reliability of outlet works at these sites is critical to ongoing water delivery in the Shoalhaven region in Greater Sydney, as well as enable Origin Energy's Shoalhaven hydro scheme.
Total	**94.8**	**28.2**		**Top 5 projects are 36% of total RV Operations direct capex**

As illustrated above, the top 5 Sydney projects contribute over **35%** of the proposed total Rural Valleys minimum essential infrastructure capital expenditure.

4.7.3. Digital- Top 5 bulk water projects (direct costs)

The following are the Top 5 digital projects included in our minimum essential revenue requirement proposal.

Table 1212 – Top 5 Digital projects (Direct Costs)

Project	FY26-28 ($m)	F26 ($m)	Project description	Project criticality
Communications Network Upgrade[3] Other network upgrades[3]	8.6	2.6	Improved latency at remote sites and modernised network to support resilience, cyber developments and protections.	Critical investment given the condition of the communications network and limited investment in current regulatory period.
Cybersecurity Resilience	7.4	4.3	A more secure platform to protect our employees and customer data as well as our infrastructure. Immutable storage capability and processes to recover from a ransomware event.	Cyber uplift is required to protect data and infrastructure and to remain compliant with the Security of Critical Information Act 2018. Lack of investment could yield inability to protect against cyber-attack.
ICT Renewals & Replacements[2]	7.2	4.9	Replacement of end of life or degraded hardware to enable WaterNSW to continue to reliably and securely deliver services.	Further delays in renewals and replacements will impact asset reliability and there is a risk of further replacement costs.
Future Workforce	3.6	2.3	Streamlined processes and increased automation and integration, increased self service capabilities and improved employee experience.	Fragmented processes and systems will persist if funding is not secured for implementation and rollout.
Top 5 Total	**26.8**	**14.1**		

Notes:

1 - Numbers represent the regulatory reporting view of Capex, therefore SaaS costs are included (SaaS costs are ordinarily treated as operating expenditure from an accounting reporting perspective).
2 – FY26 ICT Renewals & Replacements spend includes FY25 carry-over spend of $3.3M.
3 – The project split between communications and other network upgrades is subject to prioritisation and has been presented as consolidated expenditure.

5. We are committed to working with IPART and Government

Despite the concerns raised throughout this response, WaterNSW has sought to constructively engage with IPART and other stakeholders in the review process and in responding to the Information Paper and draft decisions.

In engaging in the process WaterNSW is committed to collaborating in good faith with all stakeholders to deliver evidence-based outcomes that recognise all parties' obligations, needs and priorities, with a focus on the long-term interests of our customers.

Notwithstanding the departure from IPART's usual regulatory practice, this response seeks to provide constructive and realistic options that IPART could implement. WaterNSW has proposed options that are consistent with IPART's approach in this review, whilst ensuring WaterNSW's financial viability and compliance with its obligations until a detailed expenditure review can be completed.

IPART has identified the need for several reviews over the next three years, including:

- A more detailed expenditure review for Greater Sydney and Rural Valleys
- A cost share review, long-term impact of the regulatory and economic impact of the Greater Sydney Water Strategy
- A review of the future regulatory model for WaterNSW (in particular for the rural NSW) and
- Potentially a WACC review over the same timeframe that had been delayed by IPART during the current regulatory period

WaterNSW is committed to ongoing active involvement in these reviews. We note, however, that additional costs and resources beyond our current proposal to respond have not been allowed for by IPART.

We can see benefits from a more effective regulatory approach for bulk water services in NSW and particularly for regional NSW.

Annexure 1 – Errors and inaccuracies in the Information Paper and supporting material

WaterNSW is concerned that IPART's Information Paper and supporting materials and statements, contain a range of errors, inaccuracies and misunderstandings. WaterNSW is concerned that when taken as a whole these matters deliver regulatory outcomes and a perception of WaterNSW that is not appropriately reflective of the circumstances.

Selected concerns are listed below, noting that the list is not exhaustive.

IPART did not adhere to its own framework or its legislative obligations in making this draft

- IPART did not apply its standard approach to setting the rate of return (with transition), despite this issue not being impacted by IPART's stated concerns regarding the forward capital and operating proposals.
- IPART did not appropriately consider the relevant matters in Section 15 of the IPART Act requiring consideration of the impact on public sector assets and the impact on debt and equity holders.
- Consistent with the previous point, IPART did not adequately consider the matters in Section 29(2)(b) of the *Water Charge Rules 2010* (Cth) to ensure that IPART followed its own legislation in its price setting function.

WaterNSW did provide customers and stakeholders with specific pricing expectations

- As early as November 2023, WaterNSW began providing valley-by-valley price movement advice, reflecting on those uncontrollable macroeconomic and regulatory framework matters such as interest rates and water volumes.
- WaterNSW then tested specific activities with price implications through February and May 2024 at the Water Working Groups and subsequently reflected on these projects with CAGs (March), including detailing how the final position on key initiatives was amended based on feedback.
- In July 2024 WaterNSW then provided customers and their representatives at the various CAGs with valley specific pricing outcomes that were to be included in the regulatory proposals to ensure full transparency and no surprises. This couldn't have been done earlier as WaterNSW was awaiting pricing data from other agencies (who were themselves awaiting Government approvals), including DCCEEW and NRAR (WAMC), MDBA and Border Rivers Commission.
- WaterNSW provided customers with a number of potential scenarios that could be used to help shape a considered response to the clear pricing and affordability challenge imposed by the combination of macroeconomic conditions, obligations on WaterNSW and the needs of the assets under management.

WaterNSW did present enough information for IPART to make a full decision

- WaterNSW provided IPART with its most comprehensive regulatory proposal to date, far exceeding historic proposals where IPART was able to make complete regulatory decisions.
- WaterNSW engaged with IPART at all organisational levels leading up to the lodgement of the regulatory proposals, providing clear visibility of our intentions and key challenges.

- WaterNSW embraced the reviews initiated by IPART both prior to and after lodging the regulatory proposal.
- If WaterNSW were to "print" all of the material made directly available or submitted since lodging the regulatory proposal it would total over 45,000 printed pages, highlighting the comprehensive nature of the material we provided throughout the review process.

WaterNSW did propose challenging cost reductions that increase the risk that it will manage in order to limit price changes

- WaterNSW **reduced capital expenditure by $860 million** compared to the capital that would have been required to meet its pre-existing risk position. This means that WaterNSW has volunteered to take on more risk across its assets to help defer costs and keep near term prices materially lower than would have otherwise been the case.
- WaterNSW also proposed **operating efficiency reductions of $133 million** below that which was forecast using the base step trend operating expenditure projections, and WaterNSW has committed to finding ways to achieve those savings over the regulatory period or bear the cost in response to customer pricing concerns.

Annexure 2 – WaterNSW responses to IPART's questions in the Information Paper

Question 1 - Do you agree with the draft decision to set a 3-year determination period?

WaterNSW response

If IPART cannot commit to making a final determination within 12 months (as requested by WaterNSW), then WaterNSW conditionally supports IPART's three-year price path **provided** the revenue requirement is based on the full cost recovery of our Minimum Essential revenue requirement. This is the primary means to address our solvency and financial sustainability.

If IPART does not adopt accept prices based on our minimum essential revenue requirement, we suggest that IPART must complete its review of our prudent and efficient expenditure and make a final determination within one year that ensures our ongoing financial viability (otherwise WaterNSW will risk insolvency in the second year).

Question 2 - In your view, what should WaterNSW focus on over the next 3 years?

WaterNSW response

WaterNSW's top priority is safety and we will not compromise on this. WaterNSW will strive to deliver the services our customers want under a lens of a serious threat of insolvency that will impact all aspects of WaterNSW's operations and finances over the next three years at IPART's proposed price levels.

Question 3 - Should WaterNSW's proposed safety-related costs (including dam, crane and electrical safety) be included in WaterNSW Greater Sydney's prices from 1 October 2025?

WaterNSW response

Yes.

Question 4 - Are there any other matters we should consider in making our decision to carry forward decisions from the WaterNSW Greater Sydney 2020 price review?

WaterNSW response

WaterNSW's ability to meet our regulatory obligations, maintain our current workforce, maintain customer service levels while remaining solvent is severely compromised by IPART's proposed Greater Sydney price path. WaterNSW urges IPART to reconsider its proposed price path that is heavily weighted towards customer affordability in this light.

Question 5 - Should WaterNSW's proposed safety-related costs (including dam, crane and electrical safety) be included in WaterNSW Rural Valleys prices from 1 July 2025?

WaterNSW response

Yes.

Question 6 - Should IPART further adjust WaterNSW's current Rural Valley prices to account for changes in water sales volumes from the 2021 price review (i.e., 3,964,658 ML/year) to this draft decision (i.e., 3,806,128 ML/year)?

WaterNSW response

Yes. This matter is discussed further in Section 4 above.

Question 7 - Should the Yanco Creek levy remain constant in nominal terms at $0.90 per ML or be changed (for example, indexed to CPI)?

WaterNSW response

No comment.

Question 8 - Are there any other matters we should consider in making our decision to carry forward decisions from the WaterNSW Rural Valleys 2021 price review?

WaterNSW response

WaterNSW's ability to meet our regulatory obligations, maintain our current workforce, maintain customer service levels while remaining solvent is severely compromised by IPART's proposed Rural Valley price path. WaterNSW urges IPART to reconsider its proposed price path that is heavily weighted towards customer affordability in this light.

Question 9 - Do you agree that IPART's draft pricing decisions are likely to provide adequate revenue to support WaterNSW's financeability for up to 3 years?

WaterNSW response:

No. WaterNSW will become insolvent under IPART's draft pricing decisions. This matter is discussed in detail in Section 4 and throughout this response.

Analysis of IPART's proposed approach for WaterNSW

Report for Water NSW | June 2025

Contents

Summary **1**

1 Background and context **3**

1.1 The IPART 2018 WACC methodology 3

1.2 The proposed approach for the regulatory period beginning in 2025 7

2 Analysis of IPART's proposed new approach **8**

2.1 IPART's proposed new approach for the next regulatory period 8

2.2 Rate of return implications of IPART's proposed new approach 9

2.3 Apparent rationale for IPART's proposed new approach 14

3 Financeability considerations **17**

3.1 The IPART financeability framework 17

3.2 Financeability analysis in the *Information Paper* for WaterNSW 20

Summary

1. IPART's recent *WaterNSW Information Paper*[1] proposes an approach for setting prices for WaterNSW's Greater Sydney and Rural Valleys businesses over a forthcoming 3-year regulatory period. The proposed approach:

   a. Is a very significant departure from IPART's usual regulatory approach. In fact, it bears no resemblance at all to IPART's standard approach to determining allowed revenues. Significantly, the proposed approach contains no updating of the allowed return on capital and no building block revenue calculation – it simply involves maintaining real prices after a one-off adjustment to the current figure from the previous determination.

   b. The proposed new approach produces an allowed return on equity that is materially lower than IPART's own calculation of the efficient allowance for the return on equity of a NSW water business. Indeed, for Rural Valleys, IPART's proposed approach provides equity holders with a negative real return – equity holders are required to pay (in real terms) to supply equity capital to WaterNSW.

   c. Any difference between the allowed return on equity under this new approach and IPART's own best estimate of the efficient financing costs (i.e., using IPART's usual approach for estimating WACC) would seem to remain a permanent difference, there being no proposed true-up or loss capitalisation mechanism. In other words, WaterNSW's equity investors would suffer a permanent under-recovery of their efficient cost of capital, which is at odds with IPART's long-established framework and regulatory principles.

   d. The proposed new approach also objectively fails IPART's financeability test in every year of the proposed regulatory period for both Greater Sydney and Rural Valleys.

   e. This new approach for a proposed forthcoming 3-year regulatory period is inconsistent with the important regulatory principles, established by IPART, of:

      - Accuracy – setting an allowed return that best reflects the efficient cost of finance;
      - Regulatory stability and predictability; and
      - Regulatory transparency.

      These core principles were identified by IPART as being central to its approach to setting allowed returns in its *2018 WACC Review*. The apparent departures from these long established principles, as a consequence of the approach proposed in the *Information Paper*, is likely to undermine confidence in IPART's regulatory framework.

2. We understand IPART's desire to properly consider WaterNSW's proposed CAPEX and OPEX plan and the extent to which an efficient revenue allowance might be beyond the capacity of some customers to pay. However, the benefits of IPART taking more time to perform its required function must be weighed against the material problems that are set out above.

3. In this regard we note that:

   a. There is a very significant margin between the proposed return on capital and IPART's own estimate of the efficient return on capital;

   a. The shortfall is proposed to persist for a 3-year period; and

[1] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*.

b. It appears that the under-recovery is intended to remain permanent, with no mechanism to recover the revenue shortfall.

4. Thus, the proposed arrangements result in a significant and permanent differential between the regulatory allowance and the efficient cost.

5. Consequently, our view is that IPART should.

a. Set a revenue allowance for Greater Sydney and Rural Valleys that is commensurate with a WACC allowance determined using the method that IPART confirmed, in guidance provided to WaterNSW in May 2024 and March 2024, it intended to apply for the forthcoming regulatory period. That method would involve:

- updating the WACC allowance for Greater Sydney using the 2018 WACC method;
- updating the WACC allowance for Rural Valleys using the WACC method and applying a debt transition for both the current and long-term cost of debt components; and

b. If IPART decides to set an interim 3-year pricing determination, apply a loss capitalisation mechanism to allow WaterNSW to recover in future periods (in an NPV-neutral fashion) any shortfall between WaterNSW's efficient revenue requirement over that 3-year period and the allowed revenues under the interim 3-year pricing determination.

1 Background and context

1.1 The IPART 2018 WACC methodology

Overview

6. IPART's last major review of the allowed return on capital resulted in the *Final Report* published in February 2018.[2]

7. Two key outcomes of that Review are:

    a. Estimating a WACC that best reflects efficient financing costs

    IPART's conclusion that the central objective of its WACC estimation task is to produce an estimate that is as accurate as possible – that its WACC estimate should best reflect the efficient financing costs of the regulated entity.[3]

    In this regard, IPART concluded that setting the allowed return on capital above or below the efficient financing costs would be inconsistent with the matters that IPART is required to consider under s 15 of the *Independent Pricing and Regulatory Tribunal Act 1992*.[4]

    b. The importance of regulatory stability and predictability

    IPART's recognition of the importance of regulatory certainty and stability – the importance of adopting an approach to WACC estimation that is stable and predictable over time.[5]

    In this regard, IPART drew particular attention to the very material weighting that credit rating agencies place on regulatory stability and predictability within the credit rating process – and the high score that had been applied to the IPART framework.[6]

8. Within this context, the *WaterNSW Information Paper*[7] proposes that a standard scheduled regulatory re-set be replaced by a new approach for setting allowed revenues. The proposed approach is effectively that:

    a. The length of the forthcoming review period be reduced from 5 years to 3 years;

    b. There would be no updated calculation of the allowed return on capital and no building block calculation of allowed revenues, even though an updated WACC has already been calculated by IPART;

    c. Allowed revenues would be set by applying a step change in relation to a number of specific items and then increasing by inflation thereafter, rather than by populating the usual regulatory building block model;

    d. Any difference between the allowed return on capital under this new approach and IPART's best estimate of the efficient financing costs (i.e., using IPART's usual approach

[2] https://www.ipart.nsw.gov.au/Home/Industries/Special-Reviews/Reviews/WACC/WACC-Methodology-2017/20-Feb-2018-Final-Report/Final-Report-Review-of-our-WACC-method-February-2018.

[3] IPART, February 2018, *Review of our WACC method*, p. 13.

[4] IPART, February 2018, *Review of our WACC method*, p. 15.

[5] IPART, February 2018, *Review of our WACC method*, pp. 15-16.

[6] IPART, February 2018, *Review of our WACC method*, p. 16.

[7] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*.

for estimating WACC) would seem to remain a permanent difference, there being no proposed true-up mechanism; and

e. No return on debt transition would be applied for Rural Valleys, in contrast to (a) written assurances provided by IPART in May 2024 and in May 2025 that such a transition would be applied and (b) WaterNSW's actual debt refinancing based on those assurances.

9. In this section of the report, we explore whether this new approach for setting allowed revenues for the next 3 years is consistent with the key outcomes from IPART's 2018 WACC Review:

a. Estimating a WACC that best reflects efficient financing costs; and

b. The importance of regulatory stability and predictability and transparency.

The IPART principles for WACC estimation

10. In the *Final Report* from its *2018 WACC Review*, IPART identified four key principles:

> *In making our decisions for this review, we aimed to balance the following four principles:*
>
> 1. *Our WACC method should produce estimates of the cost of capital that are as reasonably accurate as possible. This will ensure that customers do not pay more than necessary and that the regulated firms will be financially viable and have the incentive to invest in the efficient level of productive assets.*
> 2. *Our WACC method should be relatively stable over time to give stakeholders certainty.*
> 3. *Our WACC method should be predictable and replicable by stakeholders to provide transparency and reduce resources required in each review.*
> 4. *We should make incremental improvements where there is sufficient evidence that they increase the accuracy of the cost of capital faced by a benchmark firm.*
>
> *We consider these principles take account of the impact of our WACC method on regulated business and their customers, and take account of the matters we are required to consider in making our determinations and recommendations under section 15 of the IPART Act (see Box 2.1).* [8]

11. As noted above, IPART has previously identified that an "accurate" WACC is an estimate that best reflects the efficient financing costs of the regulated entity. In this context, WACC estimates that are "too high" or "too low" are those that depart from the estimate that best reflects the efficient financing costs of the regulated entity.

The objective of 'accuracy'

12. IPART further explained the reason for its focus on accuracy – obtaining the best possible estimate of the efficient financing costs of the regulated entity:

> *Our WACC method should produce as reasonably accurate as possible estimates*
>
> *Our overarching objective in setting the WACC is to produce a reasonably accurate estimate. This is important because, if we set a WACC that is too high, then customers would pay too much for the services and we risk encouraging too much investment in that business. If we set the WACC too low, then we risk the financial viability of the firm*

[8] IPART, February 2018, *Review of our WACC method*, p. 14.

and encouraging too little investment. Neither of these outcomes is in the long term interest of consumers. [9]

13. IPART further explained that setting the allowed return on capital above or below the efficient financing costs would be inconsistent with the matters that IPART is required to consider under s 15 of the *Independent Pricing and Regulatory Tribunal Act 1992*:

> *There are several matters we are required to consider in making our determinations and recommendations. Under section 15 of the Independent Pricing and Regulatory Tribunal Act 1992 (IPART Act) we must have regard to a range of factors, including, but not limited to:*
>
> 1. *cost of providing the services concerned*
> 2. *protection of consumers from abuses of monopoly power*
> 3. *appropriate return on public sector assets and associated dividends to the Government for the benefit of the people of New South Wales*
> 4. *need for greater efficiency in the supply of services so as to reduce the costs for the benefit of consumers and taxpayers, and*
> 5. *impact on borrowing, capital and dividend requirements of the government agency concerned and, in particular, the impact of any need to renew, or increase relevant assets.*
>
> *The cost of capital is a component of the costs of providing the services.* ***Setting the WACC too high is arguably inconsistent with (2) and (4), while setting it too low may conflict with (3) and (5).*** *The requirement to consider efficiency influences our definition of the benchmark entity and how we measure the WACC parameters.* [10]

The objective of regulatory stability and predictability

14. IPART also further explained the reason for its focus on the stability and predictability of its regulatory approach:

> *Our WACC method should be stable over time to provide stakeholder certainty*
>
> *Having a stable WACC method within and between regulatory periods provides certainty to regulated businesses and their customers. Increased certainty translates to reduced risk, stable revenues for businesses and stable prices for customers.* [11]

15. IPART made particular note of the very material weighting that credit rating agencies place on regulatory stability and predictability within the credit rating process:

> *For example, regulatory stability is an important influence on the credit ratings of Australian water utilities. Moody's rating agency's 'Regulated Water Utilities' methodology assigns a 15% weight to 'stability and predictability of regulatory environment'.*
>
> *Following the implementation of our 2013 WACC method, in March 2015, Moody's upgraded Sydney Water Corporation's (Sydney Water) issuer rating from A1 to Aa3. It attributed this upgrade to Sydney Water's "expectation of improved transparency in the regulatory framework". Moody's commented that:*

[9] IPART, February 2018, *Review of our WACC method*, p. 15.

[10] IPART, February 2018, *Review of our WACC method*, p. 15, emphasis added.

[11] IPART, February 2018, *Review of our WACC method*, p. 15.

> *IPART has been demonstrating increased predictability and transparency in its regulatory decisions. Although it does not have the track record of the Australian Energy Regulator which regulates transmission and distribution electricity and gas networks in the eastern and southern states, it has shown a philosophy that has become increasingly transparent, and supportive of the credit profiles of regulated entities, including Sydney Water.*

Similarly, Moody's March 2015 rating report for Hunter Water Corporation (Hunter Water) stated that IPART has "a stable and mature regulatory framework…"21 and "we believe that IPART will continue to exhibit consistency in its decision translating into increased stability in revenue outcomes for Hunter Water."

In October 2016, Moody's changed its outlook for Sydney Water to stable, stating:

> *The change in outlook to stable reflects Moody's belief that Sydney Water's shareholder, the New South Wales state government (New South Wales Treasury Corporation (TCorp), Aaa stable), will implement countermeasures to maintain the company's metrics within its rating tolerance level.*
>
> *…the rating recognizes that the transparent regulatory framework which governs Sydney Water's regulated tariffs provides visibility into likely future revenue reductions and space to implement the required countermeasures to protect its credit profile.23*

Sydney Water agreed, stating that "IPART's existing WACC methodology works well, incentivising improved financial efficiency and stability. These sentiments have been echoed by our external rating agency, which have maintained our generally stable credit rating".

We have not made broad changes to our WACC method to ensure its ongoing stability. [12]

The objective of regulatory transparency

16. IPART also explained the importance of the transparency and replicability of its regulatory approach – and the positive effect that such transparency has on credit ratings:

> *In our 2013 WACC review, we decided to publish financial market updates biannually in February and August. We publish these updates to allow our stakeholders to better replicate and anticipate our WACC decisions. In conjunction with the updates, we also release a WACC spreadsheet with a working copy of our WACC model.*
>
> *This enables stakeholders to understand how our WACC decisions are made. It reduces the resources and effort required by stakeholders in each regulatory review. This has been beneficial for both IPART and the regulated businesses. As discussed above, it has also had a positive impact on the ratings outlook for water utilities, with Moody's specifically referencing IPART's improvement of "the transparency and predictability of its revenue decisions" in its reasoning for changing the Sydney Water rating outlook from stable to positive. It stated that:*
>
> > *The improvement in IPART's transparency is reflected in a number of measures that the regulator has taken in the last 1-2 years, including the bi-annual publication of its financial market updates, following a review of its weighted average cost of capital ("WACC") methodology. As a result, the improvement in the transparency of the regulatory framework is enhancing Sydney Water's credit*

[12] IPART, February 2018, *Review of our WACC method*, pp. 15-16, emphasis added.

> *profile, which also factors in our expectation for continued stability in its financial metrics.*
>
> ***In making our decisions for this review, we sought to maintain or improve our current transparency, predictability and replicability.*** [13]

1.2 The proposed approach for the regulatory period beginning in 2025

17. Within this context, the *WaterNSW Information Paper*[14] proposes that a standard scheduled regulatory re-set be replaced by a new approach for setting allowed revenues. The proposed approach is effectively that:

    a. The length of the forthcoming review period be reduced from 5 years to 3 years;

    b. There would be no updated calculation of the allowed return on capital and no building block calculation of allowed revenues even though an updated WACC has already been computed as part of IPART's biannual WACC updating process;

    c. Allowed revenues would be set by applying a step change in relation to a number of specific items and then increasing by inflation thereafter, rather than by populating the usual regulatory building block model; and

    d. Any difference between the allowed return on capital under this new approach and IPART's best estimate of the efficient financing costs (i.e., using IPART's usual approach for estimating WACC) would seem to remain a permanent difference, there being no proposed true-up mechanism.

18. That is, IPART's proposed approach for the next 3-year regulatory period bears no resemblance to its standard approach to determining allowed revenues.

19. Moreover, the difference between allowed revenues under the new approach versus IPART's standard approach would seem to be a permanent shortfall to be borne by WaterNSW's shareholders.

20. In the subsequent sections of this report we consider the rationale for the proposed new approach and the implications of that approach on the recovery of efficient costs and on financeability.

[13] IPART, February 2018, *Review of our WACC method*, pp. 16-17, emphasis added.

[14] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*.

2 Analysis of IPART's proposed new approach

2.1 IPART's proposed new approach for the next regulatory period

21. IPART's recent *Information Paper* proposes that, for WaterNSW Rural Valleys, IPART's usual approach for determining the revenue allowance would not be used.

22. In its place, allowed revenues would be set using the following approach:

    a. A regulatory period of 3 years would be used;

    b. Prices for FY 25-26 would be set equal to prices for FY 23-24 plus observed inflation over the previous year, plus a real increase of 1.9% to reflect the cost of expenditure on various safety initiatives;

    c. Prices in subsequent years would increase by observed inflation over the previous year; and

    d. There would be no calculation or update of the allowed return on capital. For example, the updated WACC for regulated water businesses set out in IPART's biannual WACC update would not be used to compute an allowed return on capital building block component of allowed revenue.

23. This approach is, of course, fundamentally different from IPART's standard regulatory review process which involves:

    a. A process of submissions from stakeholders and the preparation of draft and final reports;

    b. An update of the allowed return on capital to reflect market data available at the time of the determination – using IPART's standard WACC estimation approach; and

    c. The population of IPART's regulatory building block model to generate the set of allowed revenues.

24. To the extent that the proposed new approach produces a lower regulatory allowance than IPART's standard approach, the shortfall would seem to be permanent given the absence of any discussion of loss capitalisation or true-up mechanisms.

25. Moreover, the *Information Paper* does not consider any return on debt transition for Rural Valleys, in contrast to (a) written assurances provided by IPART that such a transition would be applied and (b) WaterNSW's actual debt refinancing based on those assurances.

26. IPART's proposed approach for Greater Sydney is the same as that proposed for Rural Valleys except that the real increase would be 6.9% (rather than the 1.9% figure for Rural Valleys). The 6.9% real increase incorporates expenditure on safety and resilience issues, compensation for the effect of prices not being increased by inflation in the usual manner during the previous regulatory period, and compensation for delaying price increases for 3 months.

27. In both cases, the approach to determining allowed revenues and consumer prices over the next regulatory period is entirely different from IPART's standard approach for determining these things.

2.2 Rate of return implications of IPART's proposed new approach

A material reduction in allowed revenues

28. We have been provided with IPART's regulatory pricing models for each of Greater Sydney and Rural Valleys. Those pricing models are each populated with the standard building block components of OPEX, CAPEX, return of capital, return on capital, and so on.

29. The **WACC** tab of each model sets out the calculation of the allowed return on capital, as it would be computed by applying IPART's standard WACC methodology to the most recently available data.

30. Consequently, it is straightforward to compute the annual revenue requirement that would be obtained from a mechanical application of IPART's standard approach. This mechanical update would reflect IPART's own figures for OPEX, CAPEX, and IPART's own mechanical update of its estimate of the WACC. It is also straightforward to compute the NPV of these annual required revenues, again within IPART's standard regulatory model.

31. However, the proposed annual revenue allowance is not computed in the usual way as the sum of the usual building block components. Rather, IPART's proposed approach is to set prices by making a step change to prices from the last year of the current regulatory being (being a step of 1.9% for Rural Valleys and 6.9% for Greater Sydney) and to hold those prices constant in real terms for the duration of the 3-year regulatory period. It is straightforward to compute the NPV of these proposed revenue allowances, again within IPART's standard regulatory model.

32. Thus, it is straightforward to compute and compare:

    a. The NPV of the revenues that IPART proposes to allow over the forthcoming 3-year regulatory period; and

    b. The NPV of the revenue requirement that would be allowed under IPART's standard approach, including the allowed return on capital computed by applying IPART's standard WACC methodology to the most recently available data.

33. Table 1 below shows that the proposed revenue allowance is materially lower than the revenues that would ordinarily be allowed via the routine application of IPART's standard regulatory approach – for both Rural Valleys and Greater Sydney. Table 1 contains the calculated NPV shortfall as between IPART's proposed revenue allowance and:

    a. The revenue requirement from a mechanical implementation of IPART's standard regulatory model;

    b. The revenue requirement from an implementation of IPART's regulatory model, with corrected calculations for WACC and forecast inflation;[15] and

    c. The revenue requirement from (b) above, but using WaterNSW's proposed OPEX and CAPEX forecasts.[16]

[15] These corrections are described in paragraph 41 below.

[16] For Greater Sydney, IPART applied the "BAU + CPI+X% items" scenario for OPEX and "RAB value maintenance + dam safety capex" for CAPEX. For Rural Valleys, IPART the applied "Atkins lower" option for OPEX and "2024-25 allowed depreciation plus selected disposals" for CAPEX.

34. Table 1 shows that the proposed revenue allowance is materially lower than all of these estimates of required revenues.

Table 1: NPV of allowed revenues over next 3 years ($ millions)

	Greater Sydney	Rural Valleys
Allowed revenue	**679.9**	**223.0**
Revenue requirement as per IPART pricing model	719.6	269.0
Revenue shortfall	**39.7**	**46.0**
Revenue requirement as per IPART pricing model, with correct WACC	734.2	278.0
Revenue shortfall	**56.0**	**59.3**
Revenue requirement as per IPART pricing model, with correct WACC and WaterNSW forecast OPEX/CAPEX	874.3	354.8
Revenue shortfall	**196.1**	**134.1**

Source: IPART regulatory models; Frontier Economics calculations.

Note: The NPV of the allowed revenues falls slightly under the scenarios with correct WACC, to $678.2m for Greater Sydney and $220.7m for Rural Valleys.

Shortfall is borne by equity holders

35. The shortfall in allowed revenues identified in Table 1 is borne by investors via a reduction in the allowed return on capital. OPEX is paid as it is incurred, tax is paid as required, and regulatory depreciation proceeds in the usual mechanical way. What is left over after these items have been paid out of the allowed revenue is available as a return on capital to investors. That is, it is the (residual) return on capital to investors that 'plugs the gap' between IPART's standard regulatory allowance and the (lower) proposed allowance over the next 3 years.

36. Moreover, debt holders have a contractual claim that entitles them to be paid in full ahead of any distribution to equity holders. Consequently, the difference between (a) the allowance from a routine application of IPART's standard approach and (b) the allowance under the proposed approach for the next 3 years is ultimately borne by the equity holders.

37. To quantify the impact on the allowed return on capital, we have performed the following calculation:

    a. We compute the NPV of the revenues that IPART proposes to allow over the forthcoming 3-year regulatory period; and

    b. We then solve for the allowed return on capital that, when holding all other inputs in the IPART pricing model constant, produces that NPV.

38. To quantify the impact on the allowed return on equity, we have performed the following calculation:

a. We compute the NPV of the revenues that IPART proposes to allow over the forthcoming 3-year regulatory period; and

b. We then solve for the allowed return on equity that, when holding all other inputs in the IPART pricing model constant, produces that NPV.

39. The allowed return on capital and the allowed return on equity that is implicit in IPART's proposed allowance over the next 3 years is summarised in Table 2 below.

Table 2: Post-tax real rates of return for WaterNSW

Rate of return	Greater Sydney	Rural Valleys
Updated WACC using standard IPART approach (computed by IPART)	3.4%	3.4%
Implied WACC under proposed approach for next 3 years[17]	**2.9%**	**1.0%**
Updated allowed return on equity using standard IPART approach (computed by IPART)	4.6%	4.6%
Implied allowed return on equity under proposed approach for next 3 years	**3.4%**	**-1.3%**

Source: IPART regulatory models; Frontier Economics calculations.

40. Table 2 shows that IPART's proposed approach for the next 3 years implies an allowed return on equity that is materially lower than IPART's own calculation of the efficient allowance for the return on equity of a NSW water business. Indeed, for Rural Valleys, IPART's proposed approach provides equity holders with a negative real return – equity holders are required to pay (in real terms) to supply equity capital to WaterNSW.

Shortfall is even greater after updates and corrections

41. We further note that the estimated WACC figures in the IPART models should be corrected in two respects:

a. The calculation of expected inflation should use the forecast of inflation to June 2026 in the May 2025 *RBA Statement on Monetary Policy* (**SMP**) rather than the forecast of inflation to December 2025 in the February 2025 RBA SMP; and

b. The long-term and current components of the WACC for MDB Valleys should reflect prevailing rates, to undergo a transition to a trailing average, as the ACCC method applied on-the day rates in the previous determination.[18]

42. In respect of the second of these considerations, we note that a letter dated 16 May 2024 from IPART's Acting CEO to WaterNSW advised that for the Rural Valleys pricing decision IPART's 2018 WACC method would apply, with a debt transition for both the current and long-term cost of debt components:

[17] Computed to reconcile with NPV of allowed revenues under IPART's proposed new approach.

[18] As noted above, the *Information Paper* does not consider any return on debt transition for Rural Valleys, in contrast to (a) written assurances provided by IPART (set out below) that such a transition would be applied and (b) WaterNSW's actual debt refinancing based on those assurances.

> *I confirm that IPART will apply its 2018 WACC method for all rural valleys from July 2025, including those that were previously subject to the ACCC WACC methodology.*
>
> *The Tribunal has decided that the WACC calculations for WaterNSW's MDBA valley prices (which have never previously been subject to IPART's WACC method) would commence a 5 year transition to a 5 year trailing average for current debt and a 10 year transition to a 10 year trailing average for long-term debt in the first year of the 2025 price determination.*

43. That same letter confirmed the WACC method that would apply for the Greater Sydney pricing decision:

> *I confirm that IPART will apply its 2018 WACC method to the 2025 price reviews, including by matching the number of tranches of current debt to the length of the regulatory period (ie, 5 years going forward).*
>
> *The Tribunal has decided that the WACC calculations for all 2025 water price reviews will be based on an immediate change to a 5 year trailing average for current debt.*

44. Then, a later dated 26 March 2025 from IPART's CEO to WaterNSW reaffirmed the WACC approach for the Rural Valleys pricing decision that was set out in the 16 May 2024 letter:

> *I refer to our letters of 16 May 2024 and 20 February 2025, and our officer level meeting with your staff on 25 February 2025 on this subject. We appreciate your prompt attention to this question and your staff time.*
>
> *The Tribunal notes the issues raised by your staff and has decided to defer making any changes to our May 2024 advice for the time being.*

45. We understand that, based on these assurances from IPART, WaterNSW has refinanced its debt portfolio so that its actual cost of debt would align as closely as possible with the cost of debt allowance IPART indicated it would apply to in the Rural Valleys and Greater Sydney pricing decisions.

46. The changes described at paragraph 41 above have the effect, other things being equal, of:

   a. Increasing the real WACC computed using IPART's WACC approach because:
      - Lower forecast inflation has the effect of increasing the real rate of return; and
      - Higher interest rates for MDB Valleys has the effect of increasing the real rate of return;

   b. Increasing the real required return on equity because:
      - Lower forecast inflation has the effect of increasing the real rate of return; and
      - A higher risk-free rate for MDB Valleys has the effect of increasing the real rate of return; and

   c. Decreasing the implied allowed return on equity under IPART's proposed new approach because, other things being equal, a higher real return on debt results in less being available to provide a return on equity.

47. Table 3 below repeats the analysis of Table 2, but where we have applies the corrections for the allowed return and inflation forecast. We show calculations for 3-year and 5-year regulatory periods, noting that the results differ slightly because forecast inflation depends on the length of the regulatory period.

48. That is, after applying the above two corrections, there is an even more significant margin between the return on capital under IPART's proposed approach and IPART's own estimate of the efficient return on capital.

49. Finally, we note that the results presented in Table 3 do not adopt the OPEX and CAPEX forecasts proposed by WaterNSW. If these forecasts were used, the implied return on capital under IPART's proposed approach would be even lower.

Table 3: Post-tax real rates of return for WaterNSW – after updates and corrections

Rate of return	Greater Sydney	Rural Valleys – Inland Valleys
Updated WACC using standard IPART approach (assuming a 3-year regulatory period)	3.6%	4.1%
Updated WACC using standard IPART approach (assuming a 5-year regulatory period)	3.3%	4.2%
Implied WACC under proposed approach for next 3 years[19]	**2.9%**	**1.0%**
Updated allowed return on equity using standard IPART approach (assuming a 3-year regulatory period)	4.8%	5.9%
Updated allowed return on equity using standard IPART approach (assuming 5-year regulatory period)	4.5%	6.0%
Implied allowed return on equity under proposed approach for next 3 years**	**3.1%**	**-1.7%**

Source: IPART regulatory models; Frontier Economics calculations.

Note: The rates for Inland Valleys are reported, implied rates were obtained by reducing rates for both inland and coastal valleys by the same amount until NPV equivalence is achieved.

***: Computed while assuming rate of return parameters (other than the return on equity) are those corresponding to a 3-year regulatory period.*

50. That is, after applying the above two corrections, there is an even more significant margin between the proposed return on capital and IPART's own estimate of the efficient return on capital.

Potential remedies

51. In this section, we establish that:

   a. There is a very significant margin between the proposed return on capital and IPART's own estimate of the efficient return on capital;

   b. The shortfall is proposed to persist for a 3-year period; and

   c. It appears that the under-recovery is intended to remain permanent.

[19] Computed to reconcile with NPV of allowed revenues under IPART's proposed new approach.

52. Thus, the proposed arrangements result in a significant differential between the regulatory allowance and the efficient cost.

53. Consequently, our recommendation is that either:

    a. The period of such under-recovery is limited to one year, as proposed by WaterNSW; and/or

    b. The shortfall is the subject of a true-up or loss capitalisation mechanism designed to ensure that the shortfall is recovered in an NPV-neutral manner.

2.3 Apparent rationale for IPART's proposed new approach

Balancing considerations

54. IPART's recent *Information Paper* identifies a tension between:

    a. Setting allowed revenues, and prices paid by consumers, at a level that reflects the efficient cost of providing the relevant services; and

    b. The willingness and ability of consumers to pay the efficient cost of the services provided to them.

55. For example, the *Information Paper* states that:

> *The Tribunal is very aware of current cost of living pressures affecting residents, communities and businesses in NSW. We are required to consider the social impact of our water pricing determinations, including what effect any increase in water prices would have on residents, communities and businesses in NSW regions, towns, cities and on the NSW agriculture sector.*
>
> *Other factors considered by IPART include the prudent and efficient costs of WaterNSW providing services to the required level and protection of customers from monopolistic prices.* [20]

and further that:

> *WaterNSW's proposal puts a spotlight on the tension between setting prices that enable recovery of prudent costs and the potential impacts of such prices.* [21]

56. The *Information Paper* contains a section addressing the affordability of the price increases required to cover the annual revenue requirement proposed in WaterNSW's submission:

> *Proposed price increases are unaffordable*
>
> *Many stakeholders across a range of sectors and organisation types raised concerns that WaterNSW's proposed price increases would be unaffordable.*
>
> *Greater Sydney stakeholders emphasised that price increases would be unaffordable, especially in the context of a cost of living crisis…*
>
> *Agricultural customers submitted the proposed price increases would hinder farming operations and greatly impact their profitability. Some stakeholders believed that this would lead to the closure of some agricultural operations and the potential selling of water licences by irrigators, which could place further upward pressure on prices.* [22]

[20] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 6.

[21] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 35.

[22] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 29.

57. The *Information Paper* also sets out a number of specific concerns with WaterNSW's proposal, including: [23]

   a. The size of the proposed increases in CAPEX and OPEX;

   b. The proposed price increases being unaffordable for many customers, following large price increases at the last determination;

   c. The effect that the proposed price increases would have on the margins obtained by rice and cotton farms;

   d. The fact that the proposed prices would be higher than those in other jurisdictions; and

   e. The willingness and ability of consumers to pay the efficient cost of the services provided to them. [24]

58. However, the *Information Paper* also recognises the requirement that IPART compute the level of allowed revenues and prices that would permit the recovery of efficient costs:

> *Cost recovery is an important part of the regulatory framework. We consider prices should be set so that forecast revenue is likely to meet the prudent and efficient costs of WaterNSW. This is consistent with our standing reference to consider section 29(2)(b) of the Water Charge Rules 2010.* [25]

and that:

> *We remain committed to considering prices that ensure WaterNSW's forecast revenue recovers prudent and efficient costs.* [26]

59. In relation to this tension between customer affordability and the recovery of efficient costs, the *Information Paper* concludes that:

> *While WaterNSW identified and acknowledged the challenges it faces from needing more revenue to implement its plans than its customers are willing to pay, it did not propose a firm solution other than to ask IPART to work with it and the NSW Government to consider alternative scenarios including subsidies. While additional government funding cannot be decided by IPART, we will assist by providing advice and working constructively to enable solutions to this issue as appropriate.* [27]

A two-step approach

60. In its recent *Information Paper*, IPART proposes a two-step approach:

> *The first step for IPART to determine **how much revenue an efficient water business would need** to deliver quality water services to the level of quality, reliability and safety required must be completed before other steps in the review, to avoid passing on inefficient costs to customers, the government or taxpayers. The Tribunal is continuing its assessment of the efficient level of revenue needed by WaterNSW to deliver services of the required quality, reliability and safety.*
>
> *The next step is then to determine **how much of that revenue should be paid for by customers**. This is particularly important in rural and regional NSW where a share of the efficient costs is borne by customers, and a share of the efficient costs may be*

[23] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 29.

[24] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 31.

[25] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 35.

[26] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 35.

[27] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 32.

> *borne by government. IPART anticipates our review of these cost shares will require additional time to decide how much of the efficient revenue should be funded through customer fees and charges.* [28]

61. We agree that the first step in a best-practice regulatory review is to determine the revenue required to cover the efficient costs of delivering the required services, including a reasonable return on capital.

62. In the event that customers are unable or unwilling to pay the efficient cost of the service that is provided to them, the options available are:

    a. To reduce the quality of the service provided so that prices can be reduced;

    b. To arrange for someone else to pay the difference, including:

        - Taxpayers via some form of government subsidy; or
        - Other customers of the business via some form of cross subsidy; or
        - Future customers via some form of true-up or loss capitalisation model;

    c. To allow the service provider to recover less than the efficient cost in breach of the regulatory compact, with implications for the incentive for efficient investment and the longer-term sustainability of the business.

63. The extent of IPART's role in determining which method might be used to bridge the gap between affordable prices and efficient prices is not clear to us. In any event, the first step is to determine efficient costs and prices and to ensure that the service provider ultimately receives an allowed return that is commensurate with the efficient cost of capital.

[28] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 32.

3 Financeability considerations

3.1 The IPART financeability framework

64. IPART's last major review of its approach to testing financeability resulted in the *Final Report* published in November 2018.[29]

65. In its *Final Report*, IPART noted that nearly all stakeholders were in favour of IPART providing a transparent process for identifying a financeability concern. In response, IPART developed a formal decision-making process, which is summarised below in **Figure** 1. That process involves the following steps:

    a. **Step 1: Calculate financial ratios**

    The first step in IPART's decision-making process is to compute each of the three financeability metrics (both using benchmark assumptions and actual data from the regulated business) and compare those ratios to the relevant target ratios for each metric.

    IPART stated that if a particular business met all of the target ratios in all years of the regulatory period, IPART would conclude that the business does not face any financeability concerns and the test would end at that point.[30]

    b. **Step 2: Further examination of financial ratios**

    The second step in IPART's decision-making process involves further examination of any financial ratios that fail to meet the required threshold in one or more years of the regulatory period. In particular, IPART indicates that:

    - Rank the three ratios to identify which ratio(s) fall furthest short of the required threshold; and
    - Examine whether there is evidence of the ratios improving or further deteriorating over the regulatory period.[31]

    c. **Step 3: Select appropriate remedial action**

    The third step in IPART's decision-making process involves the application of remedial action in the event that a financeability problem is identified. IPART identifies that the appropriate remedial action depends on whether the regulated entity fails the benchmark test (i.e., metrics applied to the benchmark entity using the regulatory model) or the actual test (i.e., metrics applied to the actual accounts of the service provider):

    - If the above steps identified that the *benchmark* business faced a financeability concern, IPART would reassess its pricing decisions and adjust its regulatory settings;[32] and
    - If the above steps identified that the *actual* business faced a potential financeability concern, IPART would then liaise with the business to:

[29] https://www.ipart.nsw.gov.au/Home/Industries/Special-Reviews/Reviews/Financeability-Tests/Review-of-financeability-test-2018/13-Nov-2018-Final-Report/Final-Report-Review-of-our-financeability-test-November-2018?timeline_id=8374.

[30] IPART, *Review of our financeability test*, Final Report, November 2018, p. 58.

[31] IPART, *Review of our financeability test*, Final Report, November 2018, p. 58.

[32] IPART, *Review of our financeability test*, Final Report, November 2018, p. 58.

- confirm the validity of the data IPART had used
- seek further data from the business to extend the period of analysis to two or three years before and after the regulatory period, to check for evidence of a potential persistent financeability concern, and
- consider whether it is appropriate to include any other idiosyncratic factors into the analysis. [33]

66. IPART further identified three potential scenarios in which a financeability concern is identified:

> *We identified three potential sources of a financeability concern:*
>
> 1. *Regulated prices are set too low for even a benchmark efficient business to maintain an investment grade credit rating over the regulatory period.*
> 2. *Regulated prices are sufficient for a benchmark efficient business but insufficient for the actual regulated business to maintain an investment grade credit rating. This could occur if the owners previously made imprudent or inefficient decisions, such as engaging in inefficient spending which led to a higher gearing ratio and/or interest payments. It could also occur in the future if, for example, the business intended to return excessive dividends to its shareholders over the regulatory period.*
> 3. *Regulated prices are sufficient for the actual regulated business to maintain an investment grade credit rating on average, but the timing of cash flows might create short-term financial problems from time to time.* [34]

67. In relation to the first type of financeability concern – where the regulatory allowance is insufficient to support an investment grade credit rating over the regulatory period - IPART identified the appropriate remedy as follows:

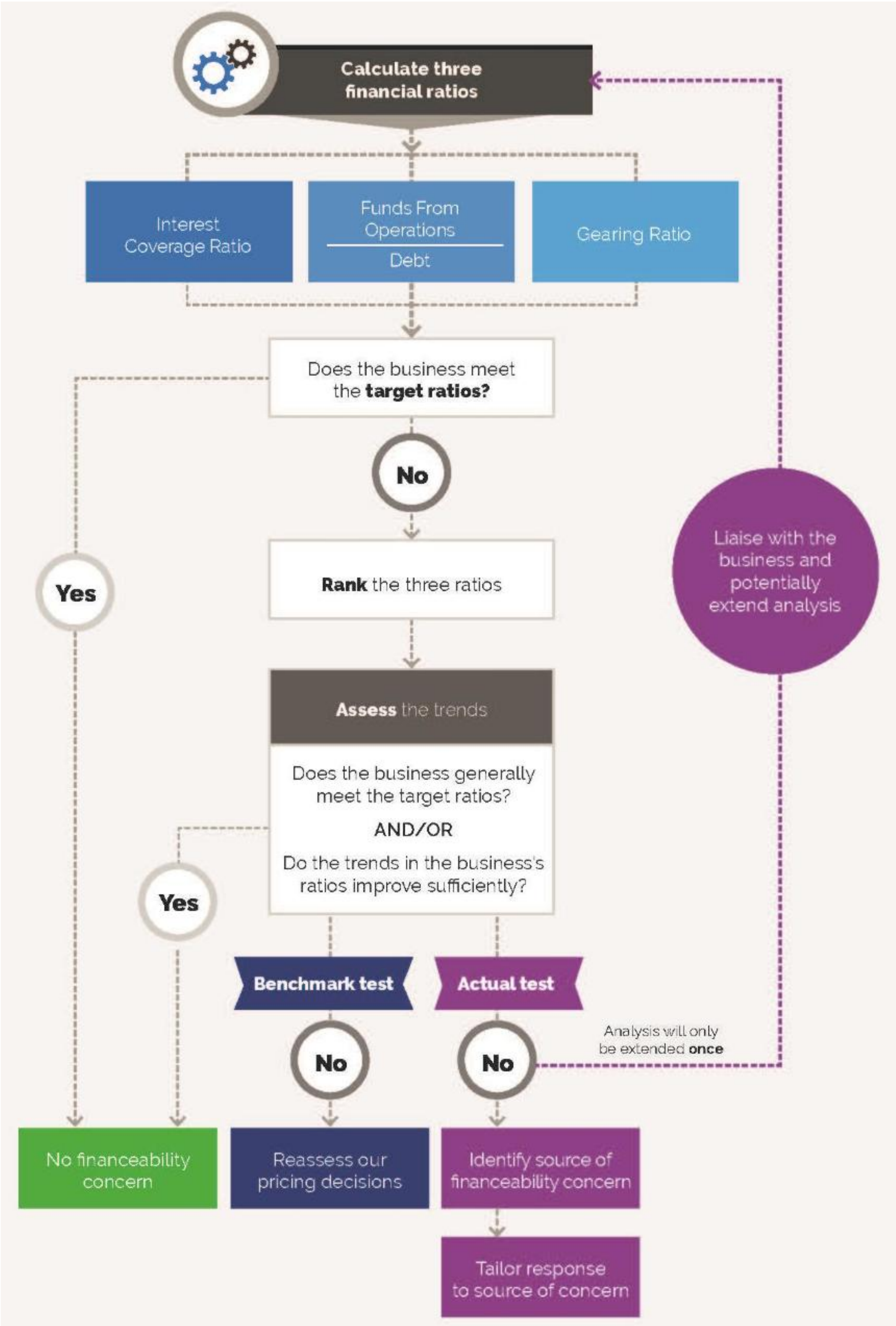
> *Remedies when the regulatory allowance is set too low*
>
> *If IPART were to set the regulatory allowance too low for a business, it would create a financeability concern. Therefore, we can use the benchmark financeability test to provide some confidence that the regulatory allowance is appropriate. If this benchmark test identifies a concern, then we would seek to pinpoint the cause and revise the pricing calculation. We anticipate doing this before the pricing decision is publicised.* [35]

[33] IPART, *Review of our financeability test*, Final Report, November 2018, p. 58.

[34] IPART, *Review of our financeability test*, Final Report, November 2018, p. 60.

[35] IPART, *Review of our financeability test*, Final Report, November 2018, p. 65.

Figure 1: Process adopted by IPART in 2018 for identifying a financeability problem



Source: IPART, Review of our financeability test, Final Report, November 2018, Figure 5.3, p. 57.

3.2 Financeability analysis in the *Information Paper* for WaterNSW

68. IPART's recent *Information Paper* purports to apply the IPART financeability test over its proposed 3-year regulatory period.

69. Table 4 below sets out the three financeability test ratios for Rural Valleys. For each ratio, we set out:

    a. The threshold value adopted in IPART's financeability test;

    b. The ratios from the previous IPART determination;

    c. The ratios that would apply under the proposed 3-year determination (taken directly from the *Information Paper*); and

    d. The ratios that would apply under the proposed 3-year determination with inflation forecasts taken to properly align with the 3 years of the proposed regulatory period, using the May 2025 RBA SMP. And, for Inland Valleys only, setting the cost of debt using prevailing rates, so that a transition to a trailing average is commencing, for both the long term and current component.

Table 4: IPART financeability test: Rural Valleys

Financial ratio	Year 1	Year 2	Year 3	Year 4
Real interest coverage				
Threshold	>2.2	>2.2	>2.2	>2.2
Previous review period[36]	8.4	8.5	8.9	9.0
Proposed review period – IPART WACC	2.7	2.8	2.8	
Proposed review period – correct WACC	2.4	2.4	2.5	
Proposed review period – correct WACC and WaterNSW proposed OPEX/CAPEX	2.3	2.1	2.0	
Real FFO/Net Debt				
Threshold	>7%	>7%	>7%	>7%
Previous review period	4.9%	5.0%	5.3%	5.4%
Proposed review period – IPART WACC	4.6%	4.7%	4.8%	
Proposed review period – correct WACC	4.1%	4.2%	4.3%	

[36] The interest coverage ratios for Rural Valleys in the last review period were particularly high because the allowed return was computed using the ACCC method, which adopts a rate-on-the-day allowance for the return on debt. That approach produced return on debt allowances of 0.6% for MDB Valleys and 1.85% for Coastal Valleys. The low rates resulted in low forecast interest payments and hence high interest coverage ratios.

Financial ratio	Year 1	Year 2	Year 3	Year 4
Proposed review period – correct WACC and WaterNSW proposed OPEX/CAPEX	3.7%	3.2%	2.9%	
Net Debt/RAB				
Threshold	<70%	<70%	<70%	<70%
Previous review period	60%	60%	60%	60%
Proposed review period – IPART WACC	60%	60%	60%	

Source: IPART, May 2025, Information Paper; IPART, September 2021, Final Report for WaterNSW Rural Bulk Water.

70. Table 4 shows that:

    a. The proposed revenue allowance fails IPART's financeability test in that the FFO/Net Debt ratio is uniformly very significantly below the threshold level required by that test;

    b. The interest coverage ratio also falls below the required threshold in some years if the OPEX and CAPEX forecasts proposed by WaterNSW are used; and

    c. The failure of the test is more pronounced than under the previous regulatory determination.

71. The same conclusions apply to Greater Sydney, where the relevant figures are set out in Table 5 below.

Table 5: IPART financeability test: Greater Sydney

Financial ratio	Year 1	Year 2	Year 3	Year 4
Real interest coverage				
Threshold	>2.2	>2.2	>2.2	>2.2
Previous review period	4.1	4.1	4.0	4.1
Proposed review period – IPART WACC	3.4	3.4	3.4	
Proposed review period – correct WACC	3.1	3.2	3.1	
Proposed review period – correct WACC and WaterNSW proposed OPEX/CAPEX	2.4	2.4	2.1	
Real FFO/Net Debt				
Threshold	>7%	>7%	>7%	>7%
Previous review period	6.8%	6.8%	6.6%	6.8%
Proposed review period – IPART WACC	6.4%	6.4%	6.3%	
Proposed review period – correct WACC	6.0%	6.1%	6.0%	

Financial ratio	Year 1	Year 2	Year 3	Year 4
Proposed review period – correct WACC and WaterNSW proposed OPEX/CAPEX	3.9%	3.9%	3.2%	
Net Debt/RAB				
Threshold	<70%	<70%	<70%	<70%
Previous review period	60%	60%	60%	60%
Proposed review period – IPART WACC	60%	60%	60%	

Source: IPART, May 2025, Information Paper; IPART, June 2020, Final Report for WaterNSW Greater Sydney.

72. The *Information Paper* does not address the clear objective failure of IPART's financeability test. Rather the *Information Paper* simply asserts, with no analysis or reasoning, that:

> *In summary, we consider the benchmark test results indicate that draft prices are consistent with it being financeable in the short to medium term.* [37]

73. Moreover, the financeability results presented by IPART in the *Information Paper* adopt expenditure forecasts that are materially lower than those proposed by WaterNSW. We note that IPART has not determined that WaterNSW's proposed (higher) OPEX and CAPEX is inefficient, just that it requires more time to assess. To the extent that efficient OPEX and CAPEX is higher than the assumed figures, the interest coverage and FFO/Net Debt metrics deteriorate further as shown in **Table** 5 above.

74. In our view, this undermines the integrity of the regulatory process because no stakeholder could in future have confidence that:

    a. IPART would apply consistently and faithfully the process it established in 2018 for identifying financeability concerns; or

    b. IPART's financeability framework provides the intended checks and balances on its decisions.

75. Indeed, it is not clear that IPART's financeability regime serves any useful purpose. If the test has no effect, regardless of whether it passes for fails, there would seem to be little point in continuing to apply it.

[37] IPART, May 2025, *Prices for WaterNSW bulk water services: Information Paper*, p. 48.

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