



The Hon. Greg Pearce MLC
Minister for Finance and Services
Minister for the Illawarra

Dr Peter J Boxall AO
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
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Dear Dr Boxall

I write regarding the Terms of Reference for Referral of Sydney Desalination Plant Pty Ltd (SDP) to IPART under Section 52 of the *Water Industry Competition Act 2006*.

I note your previous request that the Terms of Reference be amended to provide for IPART to establish an efficiency gains and losses carryover mechanism for SDP. I understand that implementation of this mechanism would involve the preparation of a methodology paper, which would be subject to public consultation prior to finalisation and publication.

I am pleased to support this proposal subject to the methodology paper also including a mechanism to adjust SDP's revenue to accommodate significant gains and losses associated with the sale of surplus electricity and Renewable Energy Certificates (RECs).

Amended Terms of Reference, which refer to this mechanism as well as IPART's proposed efficiency carryover mechanism, are attached to this letter. For clarity, the intention of the proposed energy adjustment mechanism is that:

1. It would only apply to electricity and RECs that are not required by SDP when the desalination plant is not in full operation mode when complying with the plant's operating rules, as established by the Metropolitan Water Plan and subsequently included in SDP's Network Operator Licence under the Water Industry Competition Act.
2. It would ensure that SDP customers for water (in Sydney Water's Area of Operations) receive the benefit of significant gains and bear significant losses incurred as a result of the difference between the cost of electricity and RECs under SDP's contracts with Infigen and the market price for electricity and RECs arising from the sale of SDP's surplus electricity and RECs (in the circumstances described in point 1).

3. For electricity, the mechanism would mirror the 'Calculation of Shortfall Adjustment' in SDP's Electricity Supply Agreement with Infigen, with the 'market price' defined as the half-hourly spot price and/or the price of a contracted 'available block'.
4. For RECs, the 'market price' would be the price shown in the Nextgen Greenroom Report, or another equivalent report.

I understand that IPART's intention is to publish its draft methodology paper in the near future, with the final paper due to be published by May 2012.

Yours sincerely



Greg Pearce MLC
Minister for Finance and Services
Minister for the Illawarra

16 February 2012

Terms of Reference for Referral of Sydney Desalination Plant Pty Limited to IPART under Section

52 of the Water Industry Competition Act

Background

On 29 June 2010 Sydney Desalination Plant Pty Limited (SDP) was granted a network operator licence in relation to the *desalination plant*. The Minister for Finance and Services has, under section 51 of the Water Industry Competition Act 2006, declared that SDP is a monopoly supplier in relation to the *water supply services* it provides under its network operator licence.

SDP is the only supplier of non-rainfall dependant drinking water in New South Wales. Currently, the primary purchaser of drinking water supplied from the desalination plant is Sydney Water Corporation. Sydney Water Corporation purchases bulk water from two main sources, the Sydney Catchment Authority and, since its commissioning, the *desalination plant*.

The *desalination plant* is a key element in Sydney's water security plan. Under its network operator licence, the *desalination plant* is required to maximise water production when dam storage levels in Sydney are below a prescribed threshold. Prices set by the Independent Pricing and Regulatory Tribunal (IPART) should therefore reflect the water supply services provided by SDP set out below:

- (a) the supply of non-rainfall dependant drinking water to purchasers; and
- (b) the making available of the *desalination plant* to supply non-rainfall dependant drinking water.

Matters for consideration - pricing principles

Unless indicated otherwise each *price determination* is to be consistent with the following pricing principles:

1. Maximum prices should be set so that expected revenue generated will recover the efficient costs of providing the services described at (a) and (b) above over the life of the assets. Costs include operating costs, a return on the assets and return of assets (depreciation).
2. In calculating the return on invested assets:
 - i. The rate of return (or Weighted Average Cost of Capital) should reflect the commercial risks faced by the asset owner in providing the services.
 - ii. IPART should determine an appropriate opening asset value.
3. Return of assets (depreciation) is to reflect the economic lives of the assets.
4. The structure of prices should encourage SDP to be financially indifferent as to whether or not it supplies water. As such the structure of prices should comprise separate charges for the different water supply services described at (a) and (b) above.
5. The amount of any adjustments under the mechanisms in principle 8 should each be separately quantified and published by IPART.

6. The charges for water supply services in (b) above should be a periodic payment and should reflect fixed costs including, return on assets, return of assets, and the fixed component of operating costs. SDP is to be entitled to charge for providing the water supply services in (b) above irrespective of levels of water in dam storages servicing Sydney or availability of water from other sources.
7. The charges for water supply services in (a) above should reflect all efficient costs that vary with output, including variable energy, labour costs, and maintenance costs.
8. For each *price determination* other than the first price determination:
 - i. SDP should be allowed to carryover demonstrated efficiency savings, net of efficiency losses, in operating expenditure in providing the water supply services specified at (a) and (b) above for a period of 4 years following the year in which the efficiency saving was achieved.
 - ii. In calculating the notional revenue requirement, IPART should determine the demonstrated efficiency savings and treatment of energy gains or losses in accordance with the Methodology Paper; and
 - iii. A mechanism(s) is required to allocate the costs or benefits to SDP customers (in Sydney Waters area of operation) of actual gains or losses beyond a core band that result from the difference between SDP's costs of electricity and RECs under its contracts with Infigen and revenues from the sale of surplus electricity and RECs. The mechanism would only operate at times when:
 - the desalination is in Shutdown or in a Restart Period; and
 - SDP complied with its requirements to maintain and operate the desalination plant under clause A2 of its network operator licence.
9. Any other matters that IPART may consider relevant

Methodology Paper

IPART must publish on its website a methodology paper setting out its approach to implementing pricing principle 8 above (**Methodology Paper**) IPART may update the Methodology Paper from time to time.

Timing

The determination period is to cover the period to 30 June 2017.

For each successive price determination period, IPART is to make the price determination before the expiry of the current determination period.