

We have released a Draft 2017 Methodology Paper outlining updates to the Energy Adjustment Mechanism and Efficiency Carryover Mechanism

In 2012, we published a Methodology Paper¹ setting out the design of and approach to implementing the Energy Adjustment Mechanism (EAM) and Efficiency Carryover Mechanism (ECM). The Terms of Reference for our determination of the Sydney Desalination Plant's (SDP's) prices allows us to update the Methodology Paper from time to time.

We are currently reviewing the 2012 Methodology Paper to ensure it remains appropriate for future determinations. Any changes to the Methodology Paper will not affect prices in the 2017 Determination. However, they will affect SDP's incentives over the 2017 determination period and prices in future determination periods.

We have enhanced SDP's incentive to manage its surplus energy under the Energy Adjustment Mechanism (EAM)

The EAM allocates the costs or benefits to SDP customers of actual gains or losses beyond a core band that result from the difference between SDP's costs of electricity and Renewable Energy Certificates (RECs) under its contracts with Infigen and revenues from the sale of surplus electricity and RECs when in shutdown or restart.

Re-allocating risk from SDP to customers changes SDP's incentive to manage this risk prudently and efficiently. Given that SDP (rather than customers) is best placed to manage the market price risk of its surplus energy, we consider it important that SDP retain sufficient incentive to manage this risk prudently and efficiently. We have moved to better support this objective by:

1. Increasing SDP's share of gains or losses on the sale of its surplus energy.

- ▽ Under the 2012 EAM (applying from 1 July 2012 to 30 June 2016), SDP retains 10% of gains and losses on the sale of its surplus energy outside the core band.² Our energy consultant found that this limits SDP's incentive to pursue potential gains from forward selling at least a portion of its surplus electricity when in shutdown.
- ▽ Our draft decision is to increase SDP's share outside the core band from 10% to 20%. This change is symmetric in that SDP will retain a slightly larger share of both gains and losses on the sale of its surplus energy outside the core band.
- ▽ Our proposal would strengthen SDP's incentives to prudently manage its surplus energy, in the best interests of both SDP and customers.

2. Setting the core band relative to the value of surplus energy sold in the year (rather than the total value of energy contracted in the year).

- ▽ This will mean the core band better matches the contract value of surplus energy sold in each year. This will remove any potential incentive for SDP to time the sale

¹ IPART, *Sydney Desalination Plant – Efficiency and Energy Adjustment Mechanisms - Methodology Paper*, April 2012.

² The 2012 EAM specifies a core band of +or- 5% of the total value of SDP's energy contracts. SDP retains 100% of gains and losses on the sale of its surplus energy within the core band and 10% of incremental gains and losses outside the core band.

of RECs to retain a larger share of gains and smaller share of losses under the EAM.

- ▽ This will also have the effect of slightly narrowing the core band and reducing SDP's exposure to risk.

3. Signalling that we will undertake a prudence review of SDP's energy trading policy and activity when we apply the EAM at the next SDP price review.

- ▽ We have decided to adopt a more general test of the prudence of SDP's energy trading policy and activity. We agree with Sydney Water's submission that the 2012 Methodology Paper test of "no manifest imprudence" sets a standard that does not provide adequate incentives.³
- ▽ Going forward, the approach that we would take in assessing the prudence of SDP's energy would be similar to that in assessing the prudence of capital expenditure. In this case, we would engage consultants to review:
 - the prudence of SDP's energy policy, and
 - the prudence of how this policy was executed (ie, the sale of surplus energy), given information available at the time.

We have also refined and clarified some other areas of the EAM methodology, including:

- ▼ how we intend to calculate gains and losses on the sale of surplus energy
- ▼ our approach to the calculation and application of financing costs, and
- ▼ our decision to not extend the EAM to partial modes of production, as this would be inconsistent with our Terms of Reference.

We have clarified SDP's incentive to deliver permanent efficiency savings under the Efficiency Carryover Mechanism (ECM)

The ECM is intended to remove the potential incentive for SDP to delay efficiency savings. The ECM allows regulated businesses to retain permanent efficiency savings for a period of time before they are passed on to customers through lower prices. In the case of savings that might otherwise be delayed without an ECM in place, customers will benefit through lower prices sooner if SDP responds to the incentive provided by the ECM to achieve efficiency savings as soon as they are identified.

We have taken this opportunity to refine and improve the ECM by:

1. Clarifying the purpose of the ECM to focus on identifying, delivering, and passing through permanent efficiency savings to SDP's customers.

- ▽ The Terms of Reference require efficiency savings, net of efficiency losses, to be carried over by SDP before being passed on to customers. Therefore, the ECM passes through efficiency gains to customers, but not efficiency losses. We consider this appropriate, as it maintains SDP's incentive to manage its costs and avoid inefficient cost increases. This is because SDP is not able to pass inefficient cost increases on to customers.

2. Clarifying the scope of costs that are subject to the mechanism.

³ Sydney Water, Response to IPART Issues Paper, November 2016, p 6, p 46 .

3. Ensuring efficiency savings are retained by SDP for a maximum of five years.

- ▽ The 2012 ECM methodology effectively allows for efficiency savings to be held for up to six years.
- ▽ We are correcting for this by adding a clawback feature to the 2017 ECM.

We have maintained our approach in relation to mode-specific efficiency savings which are to be retained for up to five years, while SDP is in that specific mode, over a five-consecutive year period, beginning when the efficiency saving is first achieved. This approach:

- ▼ is consistent with the Terms of Reference
- ▼ means that savings are not carried over for an indefinite period until SDP re-enters a specific mode, and
- ▼ does not over-incentivise mode-specific savings relative to general savings.