

20 October 2011

Mr Jim Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
Level 8, 1 Market Street
Sydney NSW 2000

Dear Mr Cox

I am writing to provide further information regarding the risk profile of Sydney Desalination Plant Pty Ltd (SDP) and the extent to which the identified risks can be covered by insurance as distinct from being included in the required rate of return necessary to compensate for risk in the Capital Assets Pricing Model (CAPM).

Our submission is that SDP is essentially a much riskier investment than a normal water distribution network business. This higher risk profile is largely attributable to three factors:

- Higher Regulatory risk associated with SDP's status as a new entity and the only private sector regulated body in the NSW potable water industry. Arguably it will take SDP some considerable time to achieve the same familiarity with the regulatory environment as other players in the water industry and its exposure to regulatory risk will be commensurately higher during this period.
- Higher Sovereign risk associated with the linking of its total revenue to the Government's water security agenda and the potential for this to be met by other means or by improved technologies not readily available to SDP. For example, changes in Government policy or the availability of new technology answers to water security will leave SDP exposed to substantial sovereign risk; and
- Higher asset risk due to the fact that SDP is a single asset business with a single customer and with many possible single points of failure. One of the engineering features of most water distribution networks is that they consciously avoid having critical "single points of failure". This outcome is not realistically available to SDP.

For example, both the inlet and waste outlet infrastructure are possible 'single points of failure' as is the potable water distribution pipeline, mains electricity feeder and a number of the critical process points in the plant itself. SDP has no realistic 'back-up' for these points. These risks are not diversifiable and SDP has no alternative source of supply to protect its revenue during any period of failure of these critical components.

We have discussed alternative means of accommodating SDP's increased risk profile arising from these factors. It has been our view that the most appropriate means of dealing with this is to allow the inclusion of a higher "beta" term in the CAPM that would compensate for the higher risk.

Alternatively some of these increased risks are of the nature of 'insurable risks' and therefore not technically related to a higher beta. You have asked if we could quantify the likely additional annual cost of insurance to potentially cover those increased risks that are of their nature "insurable". These are essentially those risks identified at the third dot point above. The remaining increased sovereign and regulatory risks are of their nature not insurable and should therefore be allowed for in a higher 'beta' factor in the CAPM

In SDP's submission to you current pricing enquiry, we have included only the actual level of insurance costs currently being met by the company. The estimated premium amount for this level of coverage included in the submission over the five years of the determination was \$2,481,903 in nominal dollars.

We have now discussed with our insurance advisors (Marsh & McLennan Associates) the likely cost of increasing the level of insurance to cover the higher level of risks identified as 'insurable' in the above dot points.

Based on advice received we consider that the annual operating costs would need to be increased by an amount of \$1.64 million per annum in real 2010/11 prices to provide adequate cover for those insurable risks identified above. [REDACTED]

I would appreciate your agreement to including this additional amount in the cash flows for SDP for the current price determination. Should you or your staff wish to discuss this further please contact Mr Alan Ramsey on [REDACTED]

Finally, I confirm that we are also preparing additional advice on the appropriate factors in the CAPM to reflect the risk profile of the desalination plant with specific reference to both Australian and international comparisons. I expect that this will be available at least in part by tomorrow.

Yours sincerely



Kerry Schott
SDP Project Team