

28 October 2019

Dr Paul Paterson Chair Independent Pricing and Regulatory Tribunal of NSW Level 15, 2-24 Rawson Place SYDNEY NSW 200

Dear Dr Paterson,

### Response to IPART Review of prices for WaterNSW Greater Sydney - Issues Paper

WaterNSW is pleased to respond to IPART's Issues Paper on the review of regulated charges for Greater Sydney (the '**Issues Paper**') published on 17 September 2019.

WaterNSW continues to support the pricing proposal we submitted to IPART on 1 July 2019 for bulk water prices for Greater Sydney from 1 July 2020 to 30 June 2024 (our '**Pricing Proposal**'). Our submission does not seek to repeat the contents of our pricing proposal. Accordingly, we have only provided additional information to the questions in the Issues Paper where we considered additional clarity will be useful to stakeholders and IPART.

We consider the Issues Paper to be a well-balanced document that presents our position fairly in seeking stakeholders' views. We congratulate IPART on its approach.

Specifically, we respond to the following key issues raised in the Issues Paper:

• Managing investment uncertainty (contingent projects) - WaterNSW proposes to include a separate mechanism in the 2020 determination that would allow the costs of a contingent project to be assessed within the determination once the need for the project and the costs have been established with more certainty.

If the regulator does not factor forecast expenditure for uncertain projects into the revenue requirement and the expenditure proves necessary, the infrastructure operator will be undercompensated for its provision of water infrastructure services. This may lead to reduced quality of services for customers and underinvestment in the infrastructure operator's infrastructure. This outcome is not in the long term interests of customers.

Our submission provides additional evidence of how other jurisdictions and industries address investment uncertainty during a regulatory period. WaterNSW seeks a similar approach to contingent projects for addressing investment uncertainty within a regulatory period as implemented by the AER (energy) and the ACCC (water) as well as the ESCV (water), ESCOSA (water) and Ofgem (gas and



electricity in the UK). WaterNSW's analysis highlights that a contingent projects regime is a common feature of many well-functioning regulatory frameworks in Australia and overseas.

- **Cost pass through mechanisms** It is in customers' interests for infrastructure businesses to have the reasonable opportunity to recover the efficient costs they incur as a result of unexpected events. A cost pass through event would provide an appropriate balance in the allocation of risks between WaterNSW (to recover costs to attract sufficient investment in its network) with customers (to ensure that prices are no more than necessary to provide an appropriate level of service). In our response to the Issues Paper, WaterNSW provides relevant examples of cost pass through mechanisms from other jurisdictions and industries that could be leveraged by IPART for the 2020 determination.
- **Transfer Pumping Costs** WaterNSW supports the continuation of the pass-through mechanism for drought-related Shoalhaven pumping costs, with enhancements to the formula to include all components of the cost of electricity. We are seeking the recovery of the revenue shortfall arising from the operation of the transfer formula during the current regulatory period on the basis that it is (unintentionally) biased against WaterNSW recovering its efficient costs.
- Price structure to Sydney Water We support maintaining at least some proportion of our prices to be charged on a variable basis. This reflects that not all of our costs are fixed and that maintaining a variable component in our charges is likely to send more efficient usage signals to customers. WaterNSW considers that a 90% fixed and 10% variable charge may be more appropriate than the current 80% fixed and 20% variable charge in achieving these outcomes.

We look forward to continuing our engagement with IPART and other stakeholders over the course of the review to ensure bulk water prices to our customers in Greater Sydney remain efficient.

If you would like to discuss this response further, please do not hesitate to contact me on or Mr. Michael Martinson, Manager Economic Regulation, on **Economic**.

Yours sincerely,

Joseph Pizzinga Chief Financial Officer



## Submission to the Independent Pricing and Regulatory Tribunal

Response to the IPART Issues Paper on the review of prices for WaterNSW in Greater Sydney from 1 July 2020

28 October 2019

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### Contents

1.	Introduction4					
2.	Respo	nse to Specific Questions	.5			
2.1	How IP	ART sets prices	.5			
	2.1.1	Question 1	.5			
	2.1.2	Question 2	. 5			
	2.1.3	Question 3	. 6			
	2.1.4	Question 4	. 8			
	2.1.5	Question 5	. 8			
2.2	Operating expenditure					
	2.2.1	Question 6	. 8			
	2.2.2	Question 7	. 8			
2.3	Capital expenditure					
	2.3.1	Question 8	. 9			
	2.3.2	Question 9	10			
	2.3.3	Question 10	11			
	2.3.4	Question 11	14			
2.4	Cost of	capital and tax	14			
	2.4.1	Question 12	14			
	2.4.2	Question 13	16			
	2.4.3	Question 14	18			
	2.4.4	Question 15	19			
2.5	Custom	ner numbers and sales forecasts	19			
	2.5.1	Question 16	19			
	2.5.2	Question 17	20			
	2.5.3	Question 18	20			
	2.5.4	Question 19	21			
2.6	Price structures and levels					
	2.6.1	Question 20	21			
	2.6.2	Question 21	22			
	2.6.3	Question 22	22			
	2.6.4	Question 23	22			
	2.6.5	Question 24	23			
	2.6.6	Question 25	23			
o <b>-</b>	2.6.7	Question 26	23			
2.7	Risk all	ocation and incentive mechanisms	24			
	2.7.1	Question 27	24			
	2.7.2	Question 28	24			
	2.7.3	Question 29	25			
	2.7.4	Question 30	25			
	2.7.5	Question 31	35			
	2.1.0 2.7.7	Question 22	20			
	2.1.1 2.7.9	Question 21	30 27			
	2.7.0	Question 35	37 37			
	2.7.3	Question 36	38			
	2.7 11	Question 37	38			
	2.7.12	Question 38	44			
	-					

### 1. Introduction

WaterNSW is pleased to respond to IPART's Issues Paper on the review of regulated charges for Greater Sydney (the "**Issues Paper**") published on 17 September 2019.

WaterNSW continues to support the pricing proposal we submitted to IPART on 1 July 2019 for bulk water prices for Greater Sydney from 1 July 2020 to 30 June 2024 (our "**Pricing Proposal**"). This submission does not seek to repeat the contents of our pricing proposal. Accordingly, we have only provided additional information to the questions in the Issues Paper where we considered additional clarity will be useful to stakeholders and IPART.

We consider the Issues Paper to be a well-balanced document that presents our position fairly in seeking stakeholders' views. We congratulate IPART on its approach.

Specifically, we respond to the following key issues raised in the Issues Paper:

1. **Managing investment uncertainty (contingent projects) –** WaterNSW proposes to include a separate mechanism in the 2020 determination that would allow the costs of a contingent project to be assessed within the determination once the need for the project and the costs have been established with more certainty.

If the regulator does not factor forecast expenditure for uncertain projects into the revenue requirement and the expenditure proves necessary, the infrastructure operator will be undercompensated for its provision of water infrastructure services. This may lead to reduced quality of services for customers and underinvestment in the infrastructure operator's infrastructure. This outcome is not in the long term interests of customers.

This submission provides additional evidence of how other jurisdictions and industries address investment uncertainty during a regulatory period. WaterNSW seeks a similar approach to contingent projects for addressing investment uncertainty within a regulatory period as implemented by the AER (energy) and the ACCC (water) as well as the ESCV (water), ESCOSA (water) and Ofgem (gas and electricity). WaterNSW's analysis highlights that a contingent projects regime is a common feature of many well-functioning regulatory frameworks in Australia and overseas.

- 2. **Cost pass through mechanisms –** It is in customers' interests for infrastructure businesses to have the reasonable opportunity to recover the efficient costs they incur as a result of unexpected events. A cost pass through event would provide an appropriate balance in the allocation of risks between WaterNSW (to recover costs to attract sufficient investment in its network) with customers (to ensure that prices are no more than necessary to provide an appropriate level of service). In this response to the Issues Paper, WaterNSW provides relevant examples of cost pass through mechanisms from other jurisdictions and industries that could be leveraged by IPART for the 2020 determination.
- 3. Transfer Pumping Costs WaterNSW supports the continuation of the pass through mechanism for drought-related Shoalhaven pumping costs, with enhancements to the formula to include all components of the cost of electricity. We are seeking the recovery of the revenue shortfall arising from the operation of the transfer formula during the current regulatory period on the basis that it is (unintentionally) biased against WaterNSW recovering its efficient costs.
- 4. **Price structure to Sydney Water –** We support maintaining at least some proportion of our charges as variable. This reflects that not all of our costs are fixed and that maintaining a variable component in our charges is likely send more efficient usage signals to customers. WaterNSW considers that a 90% fixed and 10% variable charge may be more

appropriate than the current 80% fixed and 20% variable charge in achieving these outcomes.

We look forward to continuing our engagement with IPART and other stakeholders over the course of the review to ensure bulk water prices to our customers in Greater Sydney remain efficient.

### 2. Response to Specific Questions

### 2.1 How IPART sets prices

### 2.1.1 Question 1

#### How long should we set prices for in the 2020 determination period?

WaterNSW agrees with IPART's preliminary view that a four-year period is appropriate. As noted in Section 4.2 of our Pricing Proposal, WaterNSW considers that the benefits of a four-year determination period in providing certainty and minimising both regulatory burden and administrative costs outweigh the costs and benefits of moving to a period shorter or longer than four years.

As discussed in Section 4.5.5 of our Pricing Proposal, we suggested that the length of the determination period is reviewed in light of how IPART addresses the cost, timing and scope uncertainty associated with major projects that are currently uncertain due to drought and or Government policy.

IPART has indicated (Issues Paper, Page 78) that:

"If one or more contingent projects proceed during the regulatory period and would have a material impact on the business and it cannot wait until the next schedule price determination to correct for this impact, we consider it more appropriate that WaterNSW **seek an early price determination**. Under this scenario, we would be able to consider all efficient costs of the business, instead of only assessing a specific project. In doing so, we would be in a better position to assess net benefits and/or costs, and efficiently allocate risks between the business and its customers at the time of the price review when material change would have occurred" (emphasis added).

WaterNSW accepts that if IPART does not introduce a contingent projects regime for the 2020 determination and if a project otherwise deemed as 'contingent' proceeds placing a material impact on the business such that it cannot wait until the next scheduled determination to correct for this impact, then an early price determination may be an appropriate option. While not our preferred approach to addressing investment uncertainty, seeking an early price determination may be preferable to setting a shorter regulatory period in the first instance.

### 2.1.2 Question 2

### Do you agree that we should maintain alignment between the WaterNSW Greater Sydney and Sydney Water determinations periods?

WaterNSW considers that alignment between the WaterNSW Greater Sydney and Sydney Water determination periods is desirable for the upcoming determination. However, while alignment in the current circumstances is desirable, IPART's regulatory approach should be sufficiently flexible to accommodate different determination periods for WaterNSW and Sydney Water.

Sydney Water purchases its bulk water from both WaterNSW and Sydney Desalination Plant (SDP). However, the regulatory treatment of the bulk water purchases differs for each of the suppliers:

- WaterNSW's bulk water costs are treated as an input cost (i.e. an operating expenditure) in Sydney Water's determination. Additional costs associated with any Shoalhaven transfers are passed through to Sydney Water customers in the following year. The WaterNSW and Sydney Water determination periods are aligned.
- SDP's fixed charges are included in the Sydney Water determination as an operating expenditure, with a cost pass through for the SDP variable charges. A cost-pass through is also in place to increase / reduce Sydney Water customers' water service charges for the difference between the forecast and actual SDP charges. The SDP and Sydney Water determination periods are not aligned.

A risk with IPART's current approach for WaterNSW is the limited flexibility to address changed circumstances for WaterNSW without also triggering the need for an early determination by Sydney Water.

As an example (as outlined in our response to Question 1 and as suggested by IPART on Page 78 of the Issues Paper) if one or more contingent projects proceed during the regulatory period and would have a material impact on the business such that it cannot wait until the next schedule price determination to correct for this impact, WaterNSW could seek an early price determination.

However, it would appear necessary for a corresponding early price determination for Sydney Water to be triggered in order for Sydney Water to incorporate the additional costs in its prices, unless appropriate cost pass through arrangements are in place to enable the pass through of the amended WaterNSW prices arising from the early determination.

While the simplicity of IPART's current approach has some attraction, it creates potentially significant limitations on flexibility and can increase regulatory costs if the two determinations are inextricably linked (rather than the timing merely aligned). This may lead to increased costs for customers, the businesses and IPART if two reviews are undertaken when only one was required if pass through mechanisms were in place to allow the effects of one determination to flow to the other.

Further comments on cost pass through arrangements are in our response to Question 30.

### 2.1.3 Question 3

# Do you agree that WaterNSW-GS's prices should reflect the efficient costs of providing its regulated monopoly services and should exclude any costs that fall outside the scope of these services?

WaterNSW supports the principle that only the efficient costs of providing regulatory monopoly services should be included in the determination.

On Page 25 of the Issues Paper, IPART states that the costs of services that may fall outside the scope of regulated monopoly services should be allocated to other segments of the community (i.e. other than the customers of the regulated monopoly service) as reproduced below:

"This can occur when costs are incurred to make investments and/or undertake activities to provide **other** goods or services to the community. For example, if additional costs are incurred to deliver outcomes that are outside the scope of the regulated monopoly service (such as flood mitigation or provision of recreation services) in addition to the core water services, it may be appropriate to allocate these additional costs to other segments of the community. If it is not practical to recover these costs directly from the other segments of the community (eg, from user charges), it may be appropriate to allocate these costs to the NSW Government (on behalf of the broader community)". IPART has identified the following services that may fall outside the scope regulated monopoly services:

- Cost associated with the management of recreational areas;
- Flood mitigation functions for storage; and
- Cost resulting from mining activities in the catchment.

WaterNSW's activities and services are guided by the objectives set out in the *WaterNSW Act* 2014, which include:

- To exhibit a sense of social responsibility by having regard to the interests of the community in which it operates;
- To exhibit a sense of responsibility towards regional development and decentralisation in the way in which it operates; and
- Where its activities affect the environment, to conduct its operations in compliance with the principles of ecologically sustainable development contained in section 6(2) of the *Protection of the Environment Administration Act 1991*.

However, we note that there are some services that provide a community benefit where there is some question as to whether the services are monopoly services. One example is WaterNSW's management of recreational areas in the Greater Sydney catchment. Most of these recreational areas are located near to, and form part of, the land situated downstream of our fixed assets. In some cases (e.g. Bendeela Campsite), WaterNSW maintains the recreational area as part of a Government commitment with the community to compensate for camping areas inundated by the dam.

WaterNSW considers that there are positive recreational benefits provided by dams. Maintaining the recreational areas provides considerable community benefit, which only occurs because of the funding of the costs through the IPART determination. For instance, recreational activities such as canoeing and swimming are permitted near the waterways at Tallowa Dam. Recreational activities such as fishing and sailing are permitted in Fitzroy Falls. These activities boost the local economy by encouraging tourism and supporting privately owned businesses to provide recreational services. Bush walking and camping are also permitted in some 'Schedule 2' land managed by WaterNSW.

A key consideration for IPART would be to consider whether the cost of managing the recreational sites or assets can be appropriately allocated to the Government in proportion to the benefits recreational users receive from the recreational activities provided by WaterNSW.

In relation to flood mitigation functions, WaterNSW notes that its Greater Sydney dams do not have a flood mitigation role.

In relation to mining impacts, it should be noted that:

- The cost of mining rectification works is a regulated activity which is a function of maintaining our assets. For example, the impacts of mining subsidence on our assets;
- The costs of assessing the impact of external activities such as mining is driven by the need for WaterNSW to provide high quality drinking water to the residents of Sydney; and
- In some cases, WaterNSW's assessment of external activities is also driven by the need to ensure the structural integrity of its assets.

If IPART considers that the functions discussed above are not monopoly services and removes the funding and any offsetting revenue adjustments from customer prices in the determination, the activities would not be commercially viable and may not continue without an alternative funding source. If the services can be considered to have a monopoly component, then perhaps the matter can be addressed through IPART's consideration of customer and government user sharing arrangements which is IPART's approach under the current Rural Valley and WAMC determinations.

### 2.1.4 Question 4

### Can you identify specific costs that may be considered outside the scope of WaterNSW-GS's regulated monopoly services?

See our response to Question 3. WaterNSW will provide the costs relating to the services identified on Page 25 of the Issues Paper to IPART's consultants in response to a separate request for information as part of the expenditure review.

### 2.1.5 Question 5

### Do you support the ongoing use of a price cap as the form of price control used for WaterNSW Greater Sydney?

WaterNSW supports IPART's preliminary view to maintain a price cap of the form of control as outlined in Section 4.1.3 in our Pricing Proposal.

### 2.2 Operating expenditure

#### 2.2.1 Question 6

### Is WaterNSW's actual/forecast operating expenditure over the 2016 determination period efficient, including the step increase in the second half of the period?

The efficiency of our operating expenditure program over the 2016 determination period is the subject of a detailed technical review with IPART's consultants. We are actively participating in the consultants' review and have responded to 220 requests for information as part of the technical review in order to demonstrate the efficiency of our current programs. We are confident that our operating expenditure over the 2016 determination period represents the efficient level to provide required services to our Greater Sydney customers.

WaterNSW's proposal was to reduce prices by passing on lower operating costs than previously approved by IPART due to efficiency reforms (and lower costs from financial markets). As outlined in Section 7 of our Pricing Proposal and summarised in the Issues Paper, WaterNSW is expecting to achieve operating cost savings of \$46.5 million (11.4%) compared with IPART's allowances from the 2016-20 determination. This includes a forecast 7.9% efficiency gain in 2019-20.

### 2.2.2 Question 7

## Are WaterNSW's proposed operating costs for the 2020 determination period efficient, taking into account drivers of this expenditure, efficiency savings revealed over the 2016 determination period and the bulk water services to be delivered?

See response to Question 6 regarding operating expenditures in the 2016 determination period. We are able to keep prices down for the 2020 determination period partly due to a continuous focus on driving efficiencies and the inclusion of a 'top down' efficiency dividend.

We note that IPART has not formed a preliminary view on WaterNSW's proposed operating expenditure for the 2020 determination period and that it has engaged an expert consultant to review and make recommendations to IPART on the efficiency of WaterNSW's proposed operating expenditure.

We have worked diligently to respond to more than 220 requests for information as part of the technical review in demonstrating the efficiency of our proposed program and are confident that our proposal represents the least cost, efficient operating expenditure to provide required services to our Greater Sydney customers.

### 2.3 Capital expenditure

### 2.3.1 Question 8

## Has WaterNSW's capital expenditure during the 2016 determination period been efficient, taking into account drivers of this expenditure and services achieved?

WaterNSW notes that the efficiency of our current capital expenditure program is the subject of a detailed technical review with IPART's consultants. We are actively participating in the consultants' review and have worked diligently to respond to 220 requests for information as part of the technical review in order to demonstrate the efficiency of our proposed program. We are confident that our proposal represents the prudent and efficient capital expenditure to provide required services to our Greater Sydney customers.

As outlined in our Pricing Proposal (Section 5), total capital expenditure over the 2016 determination period is estimated to be \$72 million, or 28% higher than the IPART allowance demonstrates our ability to deliver a large capital program. This includes \$57 million for projects to improve the ability of the Greater Sydney system to continue to provide water under varying operating conditions and storage levels. Drought resilience projects that were not anticipated at the time of the 2016-20 Determination process are a primary reason for the expected capital expenditures being higher than previously forecast.

Excluding the unforeseen drought resilience projects, actual capital expenditure for the 2016 regulatory period would have been only \$15 million (6%) higher than IPART's 2016 capital expenditure allowance that was primarily due to the need to update key Information Technology systems that had reached the end of their useful life and the purchase of fleet assets that were previously leased. This is illustrated in Figure 5.3 from our Pricing Proposal that is reproduced below.





The figures identified above are the subject of a detailed review by IPART's expenditure consultants and may be revised during this process. WaterNSW considers that our capital

Source: WaterNSW analysis

expenditures during the 2016 determination period have been prudent and efficient in providing bulk water services to our Greater Sydney customers.

### 2.3.2 Question 9

## Is WaterNSW's proposed capital expenditure program for the 2020 determination period efficient, taking into account expenditure drivers and service outcomes to be achieved?

WaterNSW maintains that the capital expenditure program for the 2020 determination period as outlined in Section 5 of our Pricing Proposal and as summarised below is prudent and efficient when taking into account expenditure drivers and service outcomes.

The capital expenditure forecast has been centred on addressing five key categories of need necessary to continue delivering essential water services to our customers. We have allocated our proposed capital program into the service need categories. These programs are described in Section 5.8.1 of our Pricing Proposal.

The five key areas of investment service need are illustrated in Figure 5.2 below as reproduced from our Pricing Proposal.





WaterNSW is proposing to invest \$682 million (\$2019-20) of capital over the 2020-24 determination period. The capital expenditure program underlying this forecast will allow us to continue to improve the availability of water resources that are essential for the people of NSW while complying with our operating licence.

Figure 5.10 below from our Pricing Proposal sets out the proposed capital expenditure by capability driver.



Figure 5.10 – Proposed capital expenditure forecast by capability driver for 2020-2024 regulatory period (\$millions, \$2019-20)

Our proposed capital expenditure program has been developed on a bottom-up, project-byproject basis and justified for need, timing, cost and efficiency. This has been overseen by executive management and Board scrutiny of the overall forecasts to ensure that price impacts to customers are as low as possible.

Our planning, asset management, forecasting and governance processes provide assurance that the capital expenditure forecasts are prudent and efficient.

The figures identified above are the subject of a detailed review by IPART's expenditure consultants and may be revised during this process. In any case, WaterNSW considers that our proposed capital expenditure program for the 2020 determination period is both prudent and efficient in providing bulk water services to our Greater Sydney customers.

### 2.3.3 Question 10

## Can WaterNSW efficiently deliver its proposed capital expenditure program for the 2020 determination period, taking into account the size of this program and its historical capital expenditure?

WaterNSW is confident that it can deliver the proposed capital expenditure program as detailed in Section 5.9 of our Pricing Proposal and as summarised below.

### Structure for success

WaterNSW has implemented business improvements that will ensure timely and efficient delivery of the capital program. WaterNSW has invested in the development of an improved approach to capital project delivery including establishing a specialist 'major projects' business unit, solely focussed on delivery of very large projects, with dedicated project delivery teams. Additionally, the 'Asset Delivery' business unit has been restructured in a way that allows for more efficient leveraging of market capabilities for project delivery and support as required.

WaterNSW has increasingly consolidated its core competencies associated with the development of efficient project development, which are then delivered through external delivery resources, including external design services and construction.

Additionally, WaterNSW is undertaking a review of our capital program delivery model options for the 2020 determination period, including engaging with market participants for their feedback and perspectives as part of this process. WaterNSW's objectives for the new delivery model include ensuring the capital program is fully delivered over the determination period, while ensuring safety, flexibility, prudency and efficiency objectives are also achieved. A preferred model option will be developed for endorsement by the WaterNSW Board in December 2019 with the intention of being fully operational by 1 July 2020.

As the portfolio has grown in terms of project number, scale and complexity, it is becoming necessary to develop additional capability to ensure effective management of that portfolio. This additional capability includes a more robust approach to project controls to ensure consistency in delivery and management and will initially be managed through a contracted service.

### Track record of delivery

• Wentworth to Broken Hill Pipeline. The successful delivery of the Wentworth to Broken Hill Pipeline has demonstrated WaterNSW's capability to deliver large, critical infrastructure projects on time and within budget.

This \$384 million project consisted of the construction of a 270-kilometre pipeline from the Murray River at Wentworth to Broken Hill to provide an alternative water source for the town. The pipeline was 'ready for water' in December 2018 in line with the target date. Delivery of the Wentworth to Broken Hill Pipeline involved the creation of a dedicated project delivery team including dedicated project management, project engineering, environmental management, and community management resources. Project delivery also involved the development of a heavily tailored procurement approach.

- Chaffey Dam Upgrade and Augmentation. The \$50 million project involved raising the dam wall to enable the dam to store more water (from 62,000ML to 100,000ML), and secured permanent water supplies for Tamworth and Peel Valley water users. The dam was also upgraded to meet NSW Dams Safety Committee standards for extreme floods. The project was completed on time and under budget with no lost time injuries. The project showcases WaterNSW's capacity to oversee complex capital works on critical water infrastructure, efficiently and most importantly, safely.
- Shareholder confidence. On 13 October 2019, the Prime Minister Scott Morrison and the NSW Premier Gladys Berijiklian announced a jointly funded package of around \$1 billion for the planning and delivery of three new or augmented dams in NSW. This package includes:
  - The raising of Wyangala Dam;
  - A new dam on Dungowan Creek near Tamworth; and
  - Initially at least, a Final Business Case for a new dam on the Mole River in the Border Rivers region.

WaterNSW's role to plan and deliver these water infrastructure solutions is as a result of being regarded by the Federal and State Governments as having the skills and capability to deliver these large infrastructure solutions.

• WaterNSW combined capability. WaterNSW has demonstrated that as a combined entity, it can deliver significantly higher capital expenditure than its predecessor organisations. WaterNSW delivered \$298 million of capital expenditure in 2017-18 and was forecast to deliver \$304 million and \$256 million in 2018-19 and 2019-20, respectively. These results are higher than what was achieved by the predecessor organisations and demonstrate a clear improvement in the capability of WaterNSW to deliver substantial capital programs.

 Leveraging key learnings. WaterNSW is well positioned to apply the key learnings from our track record of delivery to the large projects in our Pricing Proposal. Delivery of these projects will leverage carefully customised procurement strategies and dedicated teams have been established to oversee the planning (and subsequent delivery) of these projects. A core of WaterNSW personnel will be supported by contracted resources as needed to ensure time, cost and quality parameters are met for the procurement and ongoing contractor management of the delivery contractor/partner.

### **Project commitments**

One area of improvement from the 2016 determination period is the projected starting position of project commitments. At the start of the 2016 determination period, WaterNSW had entered into contractual commitments accounting for only \$22 million of expenditure over the period, or 9% of the capital allowance for the period.

WaterNSW expects to enter the 2020 determination period with a significantly higher level and proportion of contractual commitments for its future capital program. WaterNSW has commitments of \$417 million of forecast spend over the four-year 2020 determination period, or 61% of forecast expenditure. This highlights that WaterNSW is in a strong position to procure the services and materials required to deliver our proposed capital program.

Figure 5.16 from our Pricing Proposal shows annual expenditure by commitment status as at the beginning of respective regulatory periods.





A step change in capital spending between the 2016 and 2020 determination periods (from \$254 million to \$682 million) is significantly impacted by one large project (the Avon Dam Deep Water Access), with WaterNSW having demonstrated our ability to deliver large projects (e.g. the Wentworth to Broken Hill Pipeline) as noted above. WaterNSW will further develop and continuously improve on its procurement activities in terms of both 'value for money' and project deliverability to deliver the program.

In order to deliver the increase in capability to deliver a larger capital program, WaterNSW is seeking to improve procurement capability, processes and maturity and leverage the capabilities of the private sector market. WaterNSW is establishing an efficient procurement framework for each tranche of the capital works portfolio.

Of our \$682 million proposed capital program (\$2019-20), \$361 million, or 53%, will be invested in major programs and projects. Specific procurement strategies for major programs and projects would consider the requirements, objectives and risks of the program and project in the development of its procurement strategy. Successful delivery of the Wentworth to Broken Hill Pipeline has demonstrated the effectiveness of a tailored procurement process from a cost efficiency, schedule management and risk management perspective.

The culmination of the above factors highlights that WaterNSW is well-positioned to deliver our proposed program of works.

### 2.3.4 Question 11

Are WaterNSW's proposed output measures for the 2020 determination period sufficient for monitoring its progress in efficiently delivering against its proposed major projects?

WaterNSW maintains that the output measures it has proposed are sufficient for monitoring progress with delivering against its proposed major projects. We believe that these output measures, combined with Annual Information Returns (AIRs) submitted to IPART each year, are sufficient to monitor compliance with the determination, noting that there is opportunity to streamline the AIR reporting process to ensure the information requested is necessary and sufficient for IPART to undertake its regulatory functions.

### 2.4 Cost of capital and tax

### 2.4.1 Question 12

# Do you agree with WaterNSW that the Braidwood land parcels were non-operational when the RAB was established in 2000 and therefore any proceeds from the sale of this land should not be shared with customers?

In our Pricing Proposal (Section 7.4.2), WaterNSW indicated that we intend to dispose of land parcels at Braidwood, which we consider are in excess of our operational requirements. The Braidwood land parcel consists of approximately 28,050 hectares, which were originally acquired by the then Sydney Water Board between 1968 and the 1980s with the intention of building the 'Welcome Reef Dam' as part of Stage 2 of the Shoalhaven Scheme.

IPART indicated in the Issues Paper (Page 44) its policy position on asset disposals - if a business can make a convincing case that an asset was clearly non-operational at the line-in-the-sand, then, on an exception basis, IPART would not adjust the RAB for that asset sale.

IPART's rationale is that the RAB represents the economic value of the utility's assets used to provide customers with regulated or 'monopoly' services and that if an asset is not used to supply customers with these services then it should not be in the RAB. It follows that if an asset's value has never been included in the RAB (which means that customers have not been paying for its use) then its value should not be deducted from the RAB when it is sold.

In addition, WaterNSW notes that the stated reason behind IPART's policy position on the treatment of non-operational assets is because the Initial RAB established for the SCA and Sydney Water was not determined by reference to the value of the physical assets. IPART indicates in its 2017 Asset Disposals Policy Paper that:

- The Initial RAB was calculated by *discounting the operating profit of Sydney Water* using the Weighted Average Cost of Capital (WACC). That is, the initial RAB did not represent the aggregation of the accounting value of its physical assets and hence it is *not possible* to identify which specific assets contributed to that RAB and in what proportion;
- Given the difficulty of unravelling which assets were operational (and therefore included in the RAB) and which were non-operational at the time the line-in-the-sand was drawn (and the Initial RABs established), IPART considers that it should remove the regulatory value of all pre line-in-the-sand assets from the RAB when they are sold (by applying the RAB to DRC ratio to the sale values of these assets); and
- However, if a business can make a convincing case that an asset was clearly nonoperational at the line-in-the-sand, then, on an exception basis, IPART would not adjust the RAB for that asset sale.<sup>1</sup>

The line of reasoning cited above was applied by IPART in its 2016 Sydney Water Determination when IPART decided that Sydney Water was not required to share the proceeds of the sale of its Central Workshops site with customers, as the site was non-operational in 2000.<sup>2</sup>

WaterNSW notes that IPART set an Initial RAB valuation for the former SCA which was derived from a number of valuations provided by Sydney Water and determined by IPART in its 1996 Sydney Water determination. The initial valuation was developed by Price Waterhouse Coopers (PWC) taking into account a number of factors including the net book value, economic values indicated in Sydney Water's 1996 price determination, and the Modern Engineering Equivalent Replacement Asset (MEERA) / Depreciated Optimised Cost (DOC) valuation. As part of the review, PWC was required to consider a number of issues including:

- Minimising the account and taxation adjustment which may be required on transfer and in the figure;
- Assessing the implications for the treatment of the remining asset within Sydney Water;
- Achieving an acceptable commercial rate of return, recovery of costs through revenue; and
- Supporting a level of debt reflective of an appropriate capital structure of the SCA and one which satisfies a credit rating of around 'A'.<sup>3</sup>

WaterNSW also notes that in the 1996 IPART determination, the value of Sydney Water's RAB, which incorporated bulk water assets, was determined using the *capitalisation of the current level of gross operating surplus*.<sup>4</sup>

If Sydney Water's Central Workshop land was assumed to have not entered the RAB, then it follows that the same treatment should apply to the Braidwood land parcels given that both land parcels were non-operational in 2000 and noting that the Initial RAB established for the former SCA was initially derived from a Sydney Water IPART valuation.

In summary, WaterNSW maintains that the land parcels meet the criteria for being nonoperational (and hence not included in the RAB) at the time the 'line-in-the-sand' RAB was established in 2000. Therefore, the RAB should not be adjusted for the proceeds of any future Braidwood land sales.

<sup>&</sup>lt;sup>1</sup> See IPART Asset Disposals Policy Paper 2017. Page 24.

<sup>&</sup>lt;sup>2</sup> See IPART Review of prices or Sydney Water Corporation from 1 July 2016 to 30 June 2020 Final Report June 2016. Page 119.

<sup>&</sup>lt;sup>3</sup> Page 8 Sydney Catchment Authority Prices of Water Supply Services Mid term review of price path from 1 October 2000 to 30 June 2005 Independent Pricing and Regulatory Tribunal May 2003.

<sup>&</sup>lt;sup>4</sup> <u>https://www.ipart.nsw.gov.au/files/sharedassets/website/trimholdingbay/sydney\_water\_corporation\_</u> \_prices\_of\_water\_supply\_sewerage\_and\_drainage\_services\_-\_medium\_term\_price\_path\_from\_1\_july\_1996.pdf

If the land is ultimately sold it would be inconsistent with IPART's policy position and the Sydney Water Central Workshop precedent to reduce the RAB for the asset sale.

### 2.4.2 Question 13

Should we update the cost of debt component of WaterNSW's WACC annually (ie, factored into prices each year), or should this be subject to a true-up at the next determination (ie, netted out and applied across all years of the next determination period)?

WaterNSW supports the approach of annually updating, rather than trueing up, the cost of debt.

Under IPART's new trailing average approaches for estimating the historic and current costs of debt, IPART needs to update its decision on the cost of debt each year. Regarding the choice of whether prices should update each year to reflect the updated cost of debt, or the regulated business should store the price changes until the start of the next regulatory period, when IPART would implement them through an NPV-neutral true-up to the regulatory revenue requirement, IPART stated in its 2018 WACC Review, that:

"...we will decide whether to apply annual price adjustments or a true-up on a case-bycase basis, as part of our review process. In making this decision, we will have regard to any evidence the regulated firm or its customers put forward to support one approach or the other. Neither option would be a default." <sup>5</sup>

Our Pricing Proposal and this response provide WaterNSW's evidence of its support and the previous support of our major customer for annually updating the cost of debt. We encourage IPART to consider our circumstances and preferred approach rather than adopting a 'one size fits all' approach based on a true-up.

In Section 8.5.2 of our Pricing Proposal, we outlined several benefits in favour of the annual adjustments mechanism, including customer benefits (i.e. minimise price variability), debt management benefits (i.e. better alignment with actual debt costs), and the ability to pass on the efficiencies from the cost of debt allowances in the following year (i.e. customers receive the benefit of any cost of debt reductions as soon as possible). WaterNSW maintains that annually updating the cost of debt is preferable to trueing-up the cost of debt up at the next determination.

We also highlight that Sydney Water previously indicated its support for WaterNSW and SDP to apply annual updates as set out in Sydney Water's response to the IPART WACC 2018 Review:

"Therefore, in principle, Sydney Water is not, in the long-run, averse to annually updated prices particularly when combined with a benchmark CoD based on a 10-year trailing average, which we have always supported. To this end, and acknowledging that the single NPV-neutral true-up approach in principle is less flexible than an annual price update approach, we encourage IPART to consider applying a flexible hybrid approach to this issue. A hybrid approach could include allowing:

1. Sydney Water to apply a single NPV-neutral true-up for its own CoD changes.

2. Bulk water suppliers apply an annual update of CoD changes and pass-through to Sydney Water these costs annually (emphasis added)".<sup>6</sup>

WaterNSW requests that IPART reconsider its approach and adopt annual updates for the cost of debt for the 2020 determination period, on the following basis:

<sup>&</sup>lt;sup>5</sup> See IPART Review of our WACC method, Final Report- February 2018. Page 38.

<sup>&</sup>lt;sup>6</sup> See Sydney Water's submission to IPART's WACC review draft report 2017-18, 8 December 2017. Page 11.

• **Customer interests** – Annual updates provide smaller, incremental price changes to customers and reduce the risk of large price-shocks between regulatory periods.

Applying annual updates to reflect changes in the cost of debt is more likely to mitigate against larger price shocks for customers, as the alternative approach of aggregating and trueing-up the annual changes at the subsequent determination may build in greater price volatility, particularly if interest rates movements do not offset and 'cancel out' within the regulatory period.

• **Cashflow timing impacts** – Without annual updates, the cashflow impact of differences between the cost of debt allowance and actual interest costs are borne by the firm – and may impact on cashflow coverage ratios and credit ratings – particularly at higher leverage, where a firm is close to debt covenants or has a weak credit rating outlook.

This may impact the financeability of the firm, particularly if the firm needs to raise additional debt to fund capital or operating expenditure not factored into the determination allowances and caused by unforeseen circumstances.

• Incentive to incur efficient debt raising costs – A desirable feature of a regulatory framework is to provide a return on debt that aligns to the debt management practices of an efficient benchmark firm.

This includes the firm having the ability to manage its interest rate risk with various debt instruments (e.g. swaps and hedges) within the regulatory period. Businesses are not able to fully hedge their debt portfolios under a true-up mechanism. Annual adjustments to reflect the annual cost of debt would provide better matching of the annual debt costs and the regulatory allowances, which would assist the debt management process.

 Administratively simple – Annual updates are a core feature of most well-functioning regulatory frameworks and determinations, including IPART's determinations, where the application of inflation plus other price adjustments is commonplace. A mechanical adjustment to prices each year to reflect the updated cost of debt would be a straightforward and administratively simple addition to the annual price setting process.

Sydney Water also acknowledged the simplicity of the annual update process in its submission to the IPART 2018 WACC Review as stated below:

"Administering the cost pass-through to Sydney Water's customers of SDP and WaterNSW's updated CoD allowances would be relatively simple to implement..."<sup>7</sup>.

IPART's preliminary position is to not pass through the annually updated cost of debt and instead apply an NPV-neutral true-up at the next determination. IPART states that (Page 48 of the Issues Paper):

"We prefer the option of applying a regulatory true-up at the subsequent determination period because it provides certainty to customers about their prices over the upcoming determination period. In contrast, if we applied an annual update, a large change in the cost of debt would flow through to customer prices in the following year of the determination period, unless additional side constraints were imposed in the determination.

It is also our position to not make assumptions about the direction of change in the cost of debt over the determination period. The revenue adjustment for the change in the cost of debt is based on a 10-year rolling average which makes forecasting the direction of the adjustment highly unreliable over a 4-year period. We therefore do not let expectations of future changes in interest rates influence the decision as to whether a true-up or annual update is best".

<sup>&</sup>lt;sup>7</sup> See Sydney Water's submission to IPART's WACC review draft report 2017-18, 8 December 2017. Page 13.

We do not agree that providing a regulatory true-up provides certainty to customers about their prices and consider that annual changes are superior based on the following:

- Earlier debt tranches will necessarily roll off the historic trailing average calculation for the cost of debt each year of the 2020 determination period, noting that earlier tranches had contained costs of debt higher than prevailing rates. *A priori*, this is likely to reduce the cost of debt over the upcoming regulatory period unless the prevailing rate for new debt tranches rises to the post-Global Financial Crisis (GFC) levels. Given the current low-interest rate environment, the probability of this occurring appears low. In this circumstance, and under a 'true-up', there would be a delay in the time in which customers would benefit from the lower cost of debt through lower prices.
- IPART suggests that it is not its position to make assumptions about the direction of the change in the cost of debt over the determination period and that the revenue adjustment for the change in the cost of debt is based on a 10-year rolling average which makes forecasting the direction of the adjustment highly unreliable over a four-year period. While as a general proposition we agree that forecasting interest rate movements is speculative, we note that the operation of the 10-year trailing average is mechanical and to some extent predictable, as we know the higher post-GFC debt tranches are removed from the trailing average and are replaced with contemporaneously (and historically) low interest rates. This would suggest downward movement is not purely random.

Under the regulatory true up mechanism, and as explained in WaterNSW's Pricing Proposal, customers may experience price shocks as the cost of debt allowances are updated from one determination period into the next. Furthermore, customers may incur additional costs in excess of the debt allowances they would have paid under the annual adjustments mechanism. For example, any shortfalls in the cost of debt allowance incurred in one year in a regulatory period would be inflated by a discount rate to ensure an NPV neutral outcome for WaterNSW. If the customer's discount rate is lower than the regulatory WACC, customers would be worse off under a true-up if the cost of debt is falling and would, presumably, rather take the savings sooner rather than later. The situation would work in reverse if the cost of debt is rising or if the customers' discount rate is higher than the regulatory WACC.

We note that not passing through cost savings to customers in a timely manner has received considerable attention recently in other sectors. For example, the Federal Government has directed the ACCC to immediately commence an inquiry into home loan pricing. The ACCC is to investigate a wide range of issues ranging from the rates paid by new vs existing customers, how the cost of financing for banks has affected bank decisions on interest rates and why RBA cuts aren't always passed on in full<sup>8</sup>.

We acknowledge that a true-up is administratively simpler than annual adjustments to the cost of debt, and that by not changing prices as a result of changes in the cost of debt minimises pricing volatility <u>within</u> a regulatory period. This, in our view, should not be the primary consideration. Instead, the risk of more significant price shocks <u>between</u> regulatory periods under a true-up, combined with the ability to align the regulatory cost of debt allowance with efficient debt management practices and delays for customers receiving the benefits of a lower cost of debt suggests that IPART should reassess their stance on annual adjustments for WaterNSW.

### 2.4.3 Question 14

Should we adopt WaterNSW's proposal to calculate regulatory depreciation based on an average asset life of 60 years?

Please see our response to Question 15.

<sup>&</sup>lt;sup>8</sup> See <u>https://www.accc.gov.au/topics/banking-finance</u>

### 2.4.4 Question 15

What other factors should we consider? For example, do you agree that there is merit in this review (or a future review) to take a more disaggregated approach to the calculation of WaterNSW-Greater Sydney's regulatory depreciation by unbundling its RAB into separate asset categories each with an asset category-specific asset life?

WaterNSW has not undertaken a detailed disaggregation of the RAB into asset categories for the upcoming determination period on the basis that the current approach is considered fit-forpurpose and is consistent with the methodology approved by IPART in previous WaterNSW determinations.

WaterNSW has, however, provided a detailed disaggregation of its forecast capital expenditure needs by asset class over the upcoming determination period, producing an estimated average useful life of approximately 62 years for new assets which is consistent with WaterNSW's position to adopt an average useful life of 60 years for new and existing assets.

For the subsequent determination (i.e. the 2024 determination), WaterNSW plans to undertake a detailed review into alternative approaches to structuring the RAB to assess if a greater degree of precision can be achieved with greater disaggregation that better reflects the remaining lives of our assets. This review will include examining unbundling the RAB into asset categories (each with a specific life) as well as assessing the 'year-on-year' approach to calculating the RAB that is commonplace in other regulatory jurisdictions.

WaterNSW observes that IPART could establish a forecast RAB for each asset class using WaterNSW's forecast expenditure disaggregated into asset classes (that is, excluding the existing RAB and current period actuals). Notwithstanding, without preempting the outcomes of any such review, we do not consider that a more detailed breakdown would necessarily result in revenues and prices that are materially more efficient for this determination. Most of WaterNSW's future capital expenditure will be incurred on long lived assets and on this basis any lack of precision under the current methodology would not give rise to significant intergenerational equity issues.

In any case, a detailed depreciation review could not be undertaken with sufficient robustness in the time available to warrant its consideration for the 2020 determination.

### 2.5 Customer numbers and sales forecasts

### 2.5.1 Question 16

### Are WaterNSW's forecast customer numbers for the 2020 determination period reasonable?

As shown in Table 10.1 in our Pricing Proposal, WaterNSW's customer numbers in Greater Sydney show little variation over time. Since 2014-15, the only change in the number of customers has been in raw water customers, who represent a small proportion of WaterNSW's total sales in the Greater Sydney determination. Therefore, we consider that a forecast of stable customer numbers is reasonable for the purposes of the determination.

	2016-17	2017-18	2018-19	2019-20
Wholesale customers	4	4	4	4
Raw water	7	6	6	6
Unfiltered water	53	53	53	53
Total customers	64	63	63	63

### Table 10.1 – Actual customer numbers for the 2016-20 Determination period

Source: WaterNSW analysis

### 2.5.2 Question 17

### Is it reasonable that WaterNSW has adopted Sydney Water's demand forecast (gross of losses in Sydney Water's network) for the 2020 determination period?

Section 10.2 of our Pricing Proposal outlined the reasons why WaterNSW does not develop its own water demand forecast for Sydney Water's end use customers for pricing purposes in the determination. WaterNSW does not have access to Sydney Water's detailed usage, billing, and other data for their customers which are key components in forming an accurate demand forecast. On this basis, we adopted the latest demand forecast provided by Sydney Water for operational planning and financial modelling purposes.

WaterNSW agrees that additional volumes required by Sydney Water to account for losses in their network should be included in the forecast of sales for WaterNSW. If this water is purchased from WaterNSW and required to meet customers' water needs, it should form a component of Sydney Water's total demand for price setting purposes.

We note that the review of our sales forecasts is a component of the IPART expenditure review process and we have been assisting IPART's consultants in their assessment of this matter.

### 2.5.3 Question 18

### Are WaterNSW's demand forecasts for Councils reasonable?

WaterNSW's proposed pricing structure for Council customers and raw water and unfiltered water customers in our Pricing Proposal (Section 12.2) takes as its starting point current prices and then indexes these prices by the average price change across all customers.

This approach was adopted to promote pricing stability and predictability. Implicitly, this approach reflects the outcomes from the cost allocation and pricing process from the 2016 determination, which we believe remain fit-for-purpose while maintaining cost reflectivity.

As proposed prices are initially based on customers' current prices, the approach moves away from more detailed cost allocation at each review, that could result in significant pricing volatility, to an approach that promotes greater pricing stability.

Therefore, as we are proposing a price cap that is anchored to current prices, the sales forecasts are primarily used to assess the proportion of the total revenue that should be recovered by Sydney Water. That is, the sum of the calculated revenue for Councils and raw and unfiltered water customers is subtracted from the target revenue, with the difference, or residual, recovered from Sydney Water.

This approach is considered reasonable and in customers' interests as it results in:

- A revenue calculation that is not inconsistent with the methodology undertaken at the 2016 determination as it uses current prices from the determination as the starting point; and
- Pricing stability and predictability, as forecast prices are based on current prices indexed by the average price movement across all customers.

WaterNSW considers that the sales forecasts for Council, raw water and unfiltered water customers, which are based on forecasts provided by Councils (where available) and estimates based on historical usage for other customers in these segments, are reasonable for price setting purposes for the 2020 determination.

### 2.5.4 Question 19

### Is WaterNSW's assumption of constant demand from raw and unfiltered water customers reasonable?

Please see our response to Question 18.

For raw and unfiltered water customers, WaterNSW has used an average of recent historical demand to form a forecast of demand over the 2020 determination period.

As noted in the response to Question 18, WaterNSW has primarily used the expected revenue from Council customers and raw and unfiltered water customers to determine the residual revenue to be recovered from Sydney Water. Future prices are proposed to be anchored to current prices adjusted for the annual price change across all customers. There is nothing to suggest that there would be any material variation in the revenue requirement for Sydney Water resulting from a demand forecast for raw and unfiltered water customers that captured short term variability.

We therefore consider that our proposed sales forecast for raw and unfiltered water customers is reasonable and appropriate for the 2020 determination.

### 2.6 Price structures and levels

### 2.6.1 Question 20

## Do you agree with WaterNSW's proposal that the cost allocation between customers should remain unchanged? If not, what factors should we consider when allocating costs between different types of customers?

Please see our response to Question 18.

WaterNSW considers that anchoring current prices and applying the average price change across all customers is the most practical and equitable approach to price setting for the 2020 determination. This approach implicitly builds on the cost allocation between customers from the 2016 determination, which WaterNSW considers remains appropriate for the 2020 determination.

This approach minimises the potentially significant price shocks that could otherwise occur for raw water and unfiltered water customers if prices were recalculated based on a 'bottom-up' approach at each review.

### 2.6.2 Question 21

# Is WaterNSW's proposal to maintain the existing price structure to Sydney Water (i.e. 80% fixed and 20% volumetric) reasonable? Or should we change the price structure to Sydney Water to more closely align it with WaterNSW's cost structure?

WaterNSW's original proposal sought to maintain an 80% fixed and 20% variable structure to our Sydney Water tariffs that also included:

- Introducing a Demand volatility adjustment mechanism;
- Maintaining the current approach to SDP pricing; and
- Maintaining the current approach to Shoalhaven transfers (subject to the amendments to the formula as discussed in our response to Question 23).

WaterNSW considers that the above regulatory instruments are integral features of the regulatory framework for any price structure with a variable charge.

IPART has suggested that a simpler and potentially more effective approach may be to change the price structure to Sydney Water to a fully fixed charge (i.e. 100% fixed and 0% variable). WaterNSW does not support a 100% fixed charge as the approach does not reflect the principles of efficient pricing where at least some of WaterNSW's costs are variable and should be reflected in variable charges to Sydney Water in order to send efficient usage signals.

We maintain the approach as set out in our Pricing Proposal to maintain a tariff structure that is predominantly fixed, but suggest that a higher fixed charge of 90% fixed with a 10% variable structure may address some of IPART's concerns and better align our cost and pricing structures. Increasing the fixed charge to 90% would not, however, eliminate the need for a demand volatility adjustment, the current approach to SDP pricing and a pass through of the costs of Shoalhaven transfers.

WaterNSW is amenable to the adoption of a higher (but less than 100%) fixed charge to Sydney Water and look forward to exploring this option further with IPART in the leadup to the draft determination.

### 2.6.3 Question 22

## Should we maintain the approach of increasing the volumetric charge in proportion to SDP's water sales to Sydney Water?

Under the current pricing arrangements with an 80% fixed and 20% variable charge (or under a 90% fixed and 10% variable charge or any other pricing structure with a fixed charge of less than 100%), we support IPART's preliminary view to maintain the current approach of tying WaterNSW's volumetric charge to Sydney Water to SDP's operating regime as recommended in our Pricing Proposal. As indicated by IPART, this approach reduces revenue risk to WaterNSW (which therefore assists in ensuring WaterNSW is able to recover its efficient costs) and is a move towards bulk water prices that better reflect the scarcity value of dam water.

WaterNSW suggests that a similar mechanism should apply to any other bulk water supply (e.g. a new or expanded desalination plant) that may arise during the 2020 determination period.

### 2.6.4 Question 23

Should we maintain the cost pass through mechanism for the costs of Shoalhaven transfers?

WaterNSW supports IPART's preliminary view to continue the cost pass through mechanism to allow WaterNSW to recover the efficient costs of transferring water from the Shoalhaven and that the mechanism is consistent with IPART's cost pass through criteria.

WaterNSW has identified that the current pass through formula does not enable WaterNSW to recover the efficient costs of Shoalhaven transfers. In particular, the current formula provides insufficient revenue to recover the efficient costs of electricity for pumping during the transfers. Specifically, the current allowance does not include all the component charges that comprise the retail cost of electricity (such as network charges and the costs of complying with greenhouse gas legislation). WaterNSW has proposed adjustments to the current charging arrangements in our Pricing Proposal (Section 4.4 and Appendix D) to ensure that the formula does not continue to systemically undercompensate WaterNSW (in the order of 30%) for each megalitre transferred.

We support IPART's intention to review the effectiveness of the cost pass through formula to enable WaterNSW to recover the efficient costs of the Shoalhaven transfers moving forward. We have also proposed a mechanism for WaterNSW to recover the revenue shortfall from the current regulatory period during the 2020 determination period to reflect that the current formula provides an unintended bias against WaterNSW having the opportunity to recover our efficient costs. This is discussed in our response to Question 32.

### 2.6.5 Question 24

## Is WaterNSW's proposal to maintain the existing price structure to the Councils (ie, 80% fixed and 20% volumetric) reasonable?

Please see our response to Question 20.

WaterNSW's has maintained the 80% fixed and 20% variable structure of our tariffs to Council customers and consider that this is a reasonable basis for setting prices for these customers for the 2020 determination.

However, WaterNSW supports alignment between the price structures of the Councils and Sydney Water regarding the proportion of charges that are fixed. The price structures should reflect the highly fixed cost nature of WaterNSW's business. Therefore, if IPART decides to increase the fixed charge for Sydney Water, then it should also consider whether this would be appropriate for Council customers.

### 2.6.6 Question 25

### Do WaterNSW's proposed prices allocate a reasonable share of costs to the Councils?

Please see our response to Question 20.

WaterNSW considers that our proposed prices allocate a reasonable share of costs to Councils in proportions consistent with the 2016 determination.

This approach promotes pricing stability and minimises potential price shocks that could otherwise occur for these customers if the sharing of costs continued to be based on volume forecast assumptions. Further, the sensitivity of the cost sharing arrangement to volume forecast assumptions may unintentionally result in significant price volatility between Councils based on the accuracy of the Council forecasts.

### 2.6.7 Question 26

Are WaterNSW's proposed prices and price structures to raw water and unfiltered water customers reasonable?

Please see our response to Question 20.

WaterNSW considers that applying the average price change equally to all customers, including raw water and unfiltered water customers, is appropriate as it promotes pricing stability. WaterNSW maintains that the existing pricing structures for these customers from the 2016 determination and as outlined in our Pricing Proposal are appropriate.

However, WaterNSW supports alignment between the price structures of raw water and unfiltered water customers, Councils and Sydney Water regarding the proportion of charges that are fixed. The price structures should reflect the highly fixed cost nature of WaterNSW's business. Therefore, if IPART decides to increase the fixed charge for Sydney Water, then it should also consider whether this would be appropriate for raw and unfiltered water customers.

### 2.7 Risk allocation and incentive mechanisms

### 2.7.1 Question 27

Do you agree that WaterNSW should not apply for an ECM carry forward on the underspends against its regulatory operating allowance in this current determination period?

WaterNSW considers that applying for an ECM carry forward to provide financial benefits in the 2020 determination period for savings made during the 2016 determination period would, everything else being equal, result in upward pressure on bulk water prices over the 2020 determination period. This would not be in customers' interests.

As outlined in our Pricing Proposal (Section 4.8.1.1), the significant operating cost savings we expect to achieve during the 2016 determination period are driven by Management's motivation to achieve efficiencies to keep prices low and our statutory obligations under the *State Owned Corporations Act 1989* to operate at least as efficiently as any comparable businesses rather than the incentives being primarily influenced by the incentives of the ECM (noting that the incentives are not inconsistent).

Therefore, while WaterNSW strives to achieve ongoing operating expenditure savings, we consider that applying for an ongoing financial benefit through an adjustment to revenues in the 2020 determination period through an ECM carry forward – that is, increasing revenues in the 2020 determination period as a reward for achieving savings in the 2016 determination period – is not in customers' best interests. On this basis, WaterNSW decided not to apply for an ECM carry forward, which we trust will be considered by IPART when reviewing our operating expenditure allowance.

### 2.7.2 Question 28

### Should we continue to apply an ECM to WaterNSW's operating expenditure? Are there any specific improvements we should consider to our ECM? If so, what are these?

Even though WaterNSW has not applied for an ECM carry over from the current regulatory period, WaterNSW considers it appropriate to maintain the ECM in its current form for the 2020 determination. Clarity around whether an ECM carry forward application should be based on a project-specific cost saving - and how such a claim would be assessed by IPART - and or whether the ECM should be a mechanical adjustment for the difference between the total allowed operating expenditure and the actual operating expenditure with only a limited number of exclusions would improve the transparency of how the mechanism may be applied in future and may increase the likelihood of future ECM carry forward applications.

WaterNSW suggests that any significant changes to incentive mechanisms should only be undertaken as part of a comprehensive review that would should take place outside of the current determination.

### 2.7.3 Question 29

## What efficiency incentive mechanisms should we consider for capital expenditure in future reviews?

WaterNSW supports IPART's preliminary view to not introduce a capital expenditure ECM for the 2020 determination period.

When assessing whether to extend the ECM to capital expenditure (as discussed in Section 4.8.1.2 of our Pricing Proposal), WaterNSW considered a number of factors, including:

- A capital ECM would presumably (at best) be applicable to recurrent capital expenditure or approximately 25% of our overall capital expenditure program;
- The 'lumpy' nature of the WaterNSW capital expenditure program means that there can be significant year-on-year movements. The factors for annual variations can be related to the stage of the investment asset life-cycle and government-directed investment, rather than efficiency;
- We query the scope for efficiency savings in capital expenditure given that:
  - Capital expenditure construction is procured from third parties; and
  - The market-testing of procurement results in the most efficient provider delivering the works. This reduces the need for extending the ECM to capital expenditure as it is already market-tested;
- The ECM does not help to demonstrate whether a capital expenditure project/program is prudent. This is demonstrated by our governance, decision-making and planning processes. Therefore, an ECM for capital expenditure will not improve the prudency of the investment or remove the need for regulatory scrutiny of the capital expenditure program at each reset.

We consider that extending the ECM to include capital expenditure or advocating an alternative capital incentive scheme (such as the Australian Energy Regulator's (AER) Capital Expenditure Sharing Scheme), would not improve incentives for capital efficiency or result in improved outcomes for the organisation and its customers at this time.

We suggest caution is exercised when contemplating more significant changes to the regulatory framework to address capital incentives (such as the merits of a total expenditure, or 'totex' approach) without first undertaking a comprehensive review outside of the current determination process to fully assess and examine the associated impacts, including the potential incentives, mechanistic calculation methodologies, costs and any unintended consequences that may be created.

### 2.7.4 Question 30

Do you agree with WaterNSW that there is a need to have a cost-pass through mechanism for regulatory changes and catastrophic events? If so, what should the mechanism look like?

WaterNSW considers that there is a need to have a cost pass through mechanism for regulatory changes and catastrophic events and we have specified the details of what the mechanism should look like (set out in in Section 4.3 and Appendix B of our Pricing Proposal). The following

dot points outline IPART's initial observations (shown in bold italicised text) and our responses regarding the need for an expanded cost pass through framework:

- The proposed pass through events are very broad and it is unlikely that IPART can assess the efficient costs and scope of the trigger event. By their very nature, regulatory change events are designed to address a range of events that are unforeseen and therefore it is impractical, if not impossible, to identify all potential events at the time of the determination. WaterNSW has provided detailed drafting of a regulatory changes event clause in Appendix B of our Pricing Proposal.
- The regulated business cannot influence the likelihood of the trigger event or the resulting cost. The following points examine the roles of the trigger and cost in assessing whether this is reasonable basis for not incorporating regulatory change events in the regulatory framework:
  - Influence the likelihood of the trigger event. While in some (limited) cases, WaterNSW may have a role in influencing a legislative or regulatory change, we do not, as IPART suggests, have *"no incentive to plan for, and engage with, potential regulatory changes"* if a regulatory event and a catastrophic event were incorporated in the 2020 determination. WaterNSW has principal objectives under the *State Owned Corporations Act 1989* (SOC Act) including to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates and to operate at least as efficiency as any comparable business. Meeting these principal objectives drives our continued efforts to minimise the triggering (and costs) of potential regulatory changes. This is not minimised by the introduction of a regulatory change pass through event. We have no ability to influence the likelihood of a catastrophic event; and
  - Influence the cost of the event. For similar reasoning regarding our ability, or incentive, to trigger a regulatory change event as discussed above, WaterNSW is guided by the principal objectives under the SOC Act to reduce the costs of any potential regulatory change event. This is also the case for a catastrophic pass through event where our clear objective would be to restore operations as quickly and efficiently as possible. In any case, any cost pass through under our proposed approach would require IPART to review and determine the efficient costs of complying with or rectifying the event. This should remove any concern that IPART has over our ability or incentive to influence the costs of the event.

As WaterNSW has little or no ability to influence the likelihood of an event being triggered and is incentivised to reduce the costs of the event (due to the primary objectives under the SOC Act and the IPART efficiency review), we think no weight should be placed on this concern.

- If an event does have a material adverse impact on WaterNSW's operating environment and financial position, for it to seek an early price review and determination. WaterNSW does not support an early price review for matters that can better be addressed through a relatively straightforward and administratively less burdensome approach. Seeking an early determination is a very blunt instrument that is disproportionate to the level of costs in question (e.g. cost pass through materiality thresholds in other jurisdictions are in the order of 1% to 3% of the annual revenue requirement). Providing infrastructure businesses with the reasonable opportunity to recover the efficient costs they incur as a result of unexpected events should be a core feature of the regulatory framework and not one that could be seen as a disincentive, or penalty, that is only applied for the harshest of events.
- Due to asymmetric information between regulated businesses and the regulator, a broader cost pass through mechanism could be used to retain upside risk and

**pass downside risk onto customers.** Any potential risk of this occurring can be addressed by placing a positive obligation on WaterNSW to seek to pass through the costs associated with regulatory changes that reduce costs for customers or for IPART to initiate the triggering of a negative pass through event. Our proposed pass through mechanism is symmetric and would require WaterNSW to seek to pass through the costs of a regulatory change irrespective of whether the costs are higher or lower (and subject to the same materially threshold). While a catastrophic event is unlikely to result in lower costs, we nonetheless have proposed a symmetric framework that applies the same principles for positive and negative change events.

- WaterNSW has not proposed a cost pass through methodology and process for these pass through events apart from having a materiality threshold. We have provided details below on the definitions of the proposed pass through events and the threshold above which the events are triggered.
- In principle we acknowledge that there may be an argument for including a costpass through event for tax changes, but that there is a "low likelihood of further tax changes over the 2020 determination". IPART has suggested that, given the low likelihood of further tax changes over the 2020 determination period (i.e., there has been no further announcement or indication from the Government that it would make further income tax changes), IPART's preliminary view is that the introduction of a tax event is not warranted at this stage.

Water NSW notes that our proposed tax event would apply to matters beyond the company tax rate changes, such as a change in a relevant tax, in the application or official interpretation of a relevant tax, in the rate of a relevant tax, or in the way a relevant tax is calculated or the removal of a relevant tax. Incorporating a tax event as part of the regulatory change event would enable WaterNSW to respond to the introduction (or removal) of a relevant tax and adjust its prices accordingly within the regulatory period.

It is important for infrastructure businesses to have the reasonable opportunity to recover, in future regulatory years, the efficient costs they incur as a result of unexpected events. The inability to recover the costs of uncertain events would have a significant financial effect on the ability of water networks to invest in and operate their networks.

A cost pass through event would also provide an appropriate balance in the allocation of risks between WaterNSW (to recover costs to attract sufficient investment in its network) with customers (to ensure that prices are no more than necessary to provide an appropriate level of service).

Providing an effective cost pass through framework is likely to improve customer outcomes by not providing an incentive to delay critical works to the subsequent determination period, which may not be in consumers' interests due to impacts on service levels and the potential that overall cost savings to consumers would also be deferred. It will also assist the business in being able to meet its financeabilty requirements.

To provide support for our proposal to introduce an expanded cost pass through mechanism, we have assessed how other regulatory jurisdictions and industries have addressed cost pass throughs, as outlined below.

### Australian Energy Market Commission

The Australian Energy Market Commission (AEMC) has implemented a cost pass through framework for electricity network businesses to provide an appropriate balance in the allocation of risks between a network business (to recover costs to attract sufficient investment in its network)

with end customers (to ensure that prices are no more than necessary to provide an appropriate level of service).

Confirmation and clarification of the pass through arrangements in the National Electricity Market (NEM) occurred as a result of a National Electricity Rule (NER) change proposal submitted by Grid Australia to the AEMC in 2011.<sup>9</sup> Grid Australia made a request to the AEMC to review the cost pass through provisions for network service providers as contained in the National Electricity Rules (the 'rule change request'). The rule change request consisted of four components:

- Introduction of a definition for a prescribed 'natural disaster event';
- Introduction of a definition for a prescribed 'insurance cap event';
- Provision of the ability for transmission network service providers to nominate additional pass through events; and
- Provisions to address the 'dead zone' issue for events that occur in a previous regulatory control period, but which have not been incorporated in the network service providers' forecasts for the subsequent regulatory control period.

When assessing whether to approve the rule change request and relevant for IPART's consideration in the present circumstance, the AEMC concluded that:

Cost pass throughs are an important mechanism under the NER in respect of economic regulation of NSPs. They are needed because of the inability of NSPs, and the AER, to forecast all possible events that could affect the ability of NSPs to provide network services at the time of setting the revenue or regulatory determinations. NSPs should be provided with the reasonable opportunity to recover, in future regulatory years, the efficient costs they incur as a result of unexpected events. The inability to recover these costs would otherwise have a significant financial effect on the ability of NSPs to invest in and operate their networks (emphasis added).<sup>10</sup>

WaterNSW considers that the matters considered relevant by the AEMC should also apply to water networks in NSW.

### Australian Competition and Consumer Commission

### Water Charge (Infrastructure) Rules 2010

The Water Charge (Infrastructure) Rules 2010 (WCIR) is Commonwealth legislation that applies to water infrastructure fees and charges levied by bulk water and irrigation infrastructure operators in the Murray-Darling Basin.

Under Part 6 of the WCIR, the ACCC or an accredited state agency will be responsible for approving or determining the regulated charges levied by non-member operators that provide services in relation to at least 250 gigalitres of water access entitlements (Part 6 operators). WaterNSW owns and operates thirteen rural valleys in NSW that are currently subject to the WCIR and regulated by IPART (as an accredited state agency) in the 2017 Rural Valleys determination.

The WCIR (Rule 40) provide that a Part 6 operator may apply in writing to the Regulator for a variation of the approval or determination of its regulated charges in respect of a regulatory period if:

<sup>&</sup>lt;sup>9</sup> AEMC RULE DETERMINATION National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012 Rule Proponent(s) Grid Australia 2 August 2012.

<sup>&</sup>lt;sup>10</sup> AEMC RULE DETERMINATION National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012 Rule Proponent(s) Grid Australia 2 August 2012. Page 9.

- An *event* occurs during the regulatory period that materially and adversely affects the operator's water service infrastructure or otherwise materially and adversely affects the operator's business; and
- The operator could not reasonably have foreseen the event.

An application under Rule 40 of Division 4 of the WCIR must set out the matters as listed below:

- (2) An application under subrule (1):
  - (a) must set out details of the event; and
  - (b) must state the Part 6 operator's proposals for rectifying the material and adverse effects of the event; and
  - (c) must state—
    - (i) the total amount that the Part 6 operator anticipates will be required during the remainder of the regulatory period to rectify those material and adverse effects;
    - (ii) whether that amount is likely to exceed \$15 million or 5% of the value of the operator's regulatory asset base as at the beginning of the regulatory period whichever is the lesser amount; and
    - (iii) whether it is reasonably likely (in the absence of any reduction of any other expenditure) that the total expenditure during the remaining part of the regulatory period will exceed the total forecast expenditure for that remaining part; and
  - (d) must demonstrate that the Part 6 operator is not able to reduce its expenditure to avoid the consequences referred to in subparagraphs (c) (ii) and (iii) without materially and adversely affecting the reliability and safety of the operator's water service infrastructure or the operator's ability to comply with any relevant regulatory or legislative obligations; and
  - (e) must set out details of the variation of its regulated charges sought by the Part 6 operator.

The approach to dealing with events under the WCIR is similar in nature to the 'reopener' provisions in the NER where there is a relatively high materiality threshold (\$15 million or 5% of the RAB at the beginning of the regulatory period (whichever is the lesser amount) and the business must demonstrate that the total expenditure during the remaining part of the regulatory period will exceed the total forecast expenditure for that remaining part.

As discussed below, the approach to addressing variations, including cost pass throughs and contingent projects, has changed dramatically as a result of a thorough review that has underpinned the amended Commonwealth Water Charge Rules.

### Water Charge Rules 2010

The ACCC undertook a review of the water charge rules in 2016. Based on the ACCC's advice, the Minister for Agriculture and Water Resources amended the water charge rules through the Water Charge Amendment Rules 2019 and incorporated the three sets of rules into the Water Charge Rules 2010. The rule changes were intended to streamline requirements and provide greater transparency for customers. The new Water Charge Rules 2010 (WCR) apply from 1 July 2020.

The WCR retained the ability for an operator to apply for a variation of approval or determination in certain circumstances. However a number of fundamental changes to the approach to detailing with uncertainty and variations to determinations are included in the WCR. These changes included the addition of mechanisms to address a **taxation event**, a **regulatory event** and **contingent projects** (as discussed in our response to Question 37). The changes are summarised below:

*taxation event*: an event that consists of:

- (a) a change in a relevant tax, in the application or official interpretation of a relevant tax, in the rate of a relevant tax, or in the way a relevant tax is calculated; or
- (b) the removal of a relevant tax; or
- (c) the imposition of a relevant tax;

is a **taxation event** for an infrastructure operator if, as a consequence, the costs to the service provider of providing an infrastructure service are increased or decreased.

relevant tax means any tax payable by an infrastructure operator, other than:

- (a) income tax and capital gains tax; or
- (b) stamp duty, financial institutions duty and bank accounts debts tax; or
- (c) penalties, charges, fees and interest on late payments, or deficiencies in payments, relating to any tax; or
- (d) any tax that replaces or is the equivalent of or similar to any of the taxes referred to in paragraphs (a) to (c) (including any State equivalent tax).

#### regulatory event means:

- (a) a change to the regulatory requirements imposed on an infrastructure operator relating to the provision of an infrastructure service; or;
- (b) the determination or approval by the ACCC or by an agency of a State under a law of the State of regulated water charges incurred by an infrastructure operator;

but does not include a requirement to pay a fine, penalty or compensation in relation to a breach of any law.

The Water Charge Rules 2010 also inserted included a rule (43A(1)) that the ACCC may, on its own initiative, vary a determination or approval of an infrastructure operator's infrastructure charges if it is satisfied that a regulatory event or taxation event provides a benefit to the infrastructure operator of more than 1% of the operator's aggregate revenue requirement.

WaterNSW notes that adopting a similar mechanism should provide IPART with comfort that any lower costs arising from regulatory events would be passed through to customers.

The ACCC provided the following views with respect to the introduction of a taxation event and a regulatory event in its advice to the Commonwealth on changes to the WCIR:

Notwithstanding the costs of the variation process, and the fact that, to some extent, the regulator can deal with this change in tax or regulatory events at the next approval / determination process, the ACCC considers that **there are compelling reasons for allowing the regulator to initiate a variation** in this context (emphasis added):

- in many cases the intention of the government in making taxation and regulatory changes is that the benefits of these changes should be passed onto customers. Where such a policy intent is clearly evident, the regulator should not frustrate this clear intention.
- extra revenue or lower costs from a taxation or regulatory change is a windfall gain. It is not apparent why Part 6 operators should solely benefit from this windfall gain rather than passing it (at least in part) on to customers.
- the costs for undertaking the variation review are unlikely to be high because the main question to be decided is the monetary cost of the taxation and regulatory events. These should be measurable.

 it is consistent with other regulatory frameworks, such as the National Electricity Rules. Under the National Electricity Rules, the regulator is allowed to seek the variation of the original approval / determination in certain circumstances.<sup>11</sup>

The inclusion of regulatory events and taxation events (as well as contingent projects as discussed later in this submission), resulted in the change of the materiality of 'other events' from the lesser of \$15 million or 5% of the value of the RAB in the WCIR to 3% of the aggregate revenue requirement in the new WCR.

WaterNSW considers that the reasoning behind the ACCC's advice regarding the introduction of regulatory and taxation events in the regulation of water utilities (ultimately incorporated in the new legislation) is sound. WaterNSW proposes a substantially similar regulatory change event methodology (that includes a taxation event) for inclusion in IPART's regulatory framework.

### Essential Services Commission, Victoria – Water pricing framework

On 1 January 2004, the Essential Services Commission of Victoria (ESCV) commenced its role as the economic regulator of the Victorian water sector. The ESCV's role involves regulating the prices and service standards of the businesses supplying water, sewerage and related services to residential, industrial and commercial, and irrigation customers throughout the state.

The ESCV's pricing powers and functions in Victoria's water sector are informed by the Water Industry Regulatory Order (WIRO), which sits within the broader context of the Water Industry Act 1994 (Vic) and the Essential Services Commission Act 2001 (Vic).<sup>12</sup>

In 2014, the Victorian Government reviewed and revised the WIRO, providing the ESCV with greater flexibility in the manner, approach and method used to deliver efficient pricing and service outcomes for Victorian water and sewerage customers.

Following extensive consultation, the ESCV has made a number of changes to the water pricing framework and approach. These changes include a greater focus on customer engagement in price setting. The ESCV has also introduced a new incentive mechanism called PREMO, which links reputation and financial outcomes for businesses to the value water businesses deliver to their customers.

An important issue associated with setting prices is how businesses propose to deal with uncertain or unforeseen events that may have significant implications for the revenue required over the regulatory pricing period.

Typically, once a price determination is made by the ESCV, the price path for the pricing period does not diverge from the determination. The business effectively manages any differences between actual and forecast costs and demand during the regulatory period. This provides incentives for the business to ensure forecasts are accurate and well founded.

However, during the regulatory period, a business may face a significant increase or decrease in costs or demand over which it has little or no control, particularly with regard to changes in regulatory obligations. This may have implications for the financial viability of the business.

The ESCV's framework provides a number of options to deal with uncertainty in a regulatory period, including:

<sup>&</sup>lt;sup>11</sup> ACCC Review of the Water Charge Rules Final Advice, September 2016. Page 179.

<sup>&</sup>lt;sup>12</sup> The prices for rural infrastructure operators in the Murray Darling Basin are regulated under the Commonwealth Water Infrastructure Charge Rules. This affects the approach to setting prices for rural infrastructure operated by Goulburn-Murray Water and Lower Murray Water.

- Annual updating of financial parameters, such as inflation and the cost of debt;
- Reflecting approved cost pass through events (such as tax changes discussed below);
- Accommodating significant changes in circumstances (as discussed in our response to Question 37); and
- Reflecting substantial deviations in performance relative to the approved outcomes and targets.

The following paragraphs identify how the ESCV addresses 'annual price adjustments' relating to cost pass through arrangements.<sup>13</sup>

The ESCV indicates that it will consider proposals addressing other events that may require a pass through to adjust prices **during** the regulatory period, provided a clearly articulated justification is included in the submission. Where there is a potential policy or regulatory change that is known but uncertain in its impact on a business's costs, the change may be nominated in a business's price submission as a potential pass through, or uncertain or unforeseen event.<sup>14</sup>

In approving proposed pass through or uncertain or unforeseen events nominated in price submissions, the ESCV will consider:

- The extent to which the event is outside the business's control and poses significant risk of cost changes during the period;
- The extent to which the nominated event is uncertain in its impacts and timing;
- Whether it is reasonable that customers should bear risk associated with the nominated event;
- The impact of the nominated event on efficiency incentives for the water business; and
- The ability for the business to otherwise manage the risk posed by the event for example, in its form of price control, tariff structures or approach to contracting.

### Can IPART administer the cost pass through framework we are seeking?

WaterNSW considers that there are directly comparable examples of where IPART has exercised discretion within a regulatory period in a manner that has enabled the pass through of costs that were uncertain at the time of the determination. Two examples are provided below.

### Sydney Water 2016 determination for uncertain SDP costs

In its 2016 determination for Sydney Water, IPART incorporated a mechanism that provided for SDP costs that were uncertain at the time of the determination to be passed through to Sydney Water customers with a one-year lag. In this example, IPART incorporated a mechanism into the Sydney Water determination to enable the SDP costs, once determined by IPART at a future point in time, to be passed through to customers as noted below:

"Sydney Water included a forecast reduction in SDP's regulated prices from 2017-18. We have based forecasts on SDP's prices to Sydney Water remaining constant in real terms at 2016-17 prices. Any change in prices arising from the 2017 SDP determination will be passed through to Sydney Water's customers. Customers' water service charges will be increased/reduced to account for the difference between what SDP actually charges Sydney Water and the SDP-related costs we have included in the bulk water-related operating expenditure (emphasis added)"<sup>15</sup>

<sup>&</sup>lt;sup>13</sup> See ESCV's Water Pricing Framework and Approach Implementing PREMO from 2018, October 2016. Page 41.

<sup>&</sup>lt;sup>14</sup> See ESCV's 2018 Water Price Review – Guidance Paper, November 2016. Page 60.

<sup>&</sup>lt;sup>15</sup> See *IPART Review of prices for Sydney Water Corporation from 1 July 2016 to 30 June 2020 Final Report*, Footnote 119, Pager 72.

and

"[we] have decided to:

- continue to enable Sydney Water to pass through into water service charges (after a 1-year lag) the difference between its actual and forecast SDP-related bulk water costs over the 2016 determination period
- apply the current cost pass-through mechanism in the first year of the 2016 Determination period and pass through \$0.43 million into 2016-17 water service charges, being the actual 2015-16 SDP costs incurred by Sydney Water above those included in 2015-16 prices, and
- introduce a pass through of the annual actual Shoalhaven transfer costs that Sydney Water incurs into the water service charges at a 1-year lag." <sup>16</sup>

The change in the service charge to reflect the charges paid by Sydney Water to SDP under the SDP are provided in Section 9 of Schedule 1 of the 2016 Sydney Water determination and is not reproduced in full here. The relevant consideration is that service charges reflect the difference between:

- The charges paid, and reasonably forecast to be paid, by Sydney Water to SDP under the SDP Determination for the relevant year of the determination; and
- The revenue raised, and reasonably forecast to be raised, by Sydney Water as a result of Sydney Water levying the Sydney Desalination Plant Uplift Charge for the same year.

### Sydney Desalination Plant determination (2012 and 2017) - electricity network charges

In its 2012 determination for SDP (and maintained in the 2017 SDP determination), IPART decided to establish an annual methodology for the cost pass through of fixed and variable electricity network charges.

In explaining the reasoning for the cost pass through of electricity network charges, IPART stated that:

"We note that while these costs are uncertain, they are subject to review by an independent price regulator. As such, we have decided to establish a methodology to pass through fixed and variable network charges determined by the AER to SDP's prices. We note that this approach reduces SDP's risks as it does not have to bear the risk associated with changes in network costs (thereby allocating this risk efficiently and lowering its risk profile), which in turn ensures that the charges paid by water customers ultimately reflect the actual network costs".<sup>17</sup>

### Discussion

The above examples of cost pass throughs for SDP costs (one for Sydney Water passing through SDP costs and one for SDP passing through updated electricity network costs) clearly highlight that IPART is able to pass through costs within the regulatory period that are uncertain at the time of the determination.

- In the case of the Sydney Water determination, SDP costs are passed through during the determination period following determination of the costs by IPART; and
- In the case of the SDP determination, electricity network costs are passed through during determination period following determination of the prices by the AER.

<sup>&</sup>lt;sup>16</sup> Ibid, Page 90.

<sup>&</sup>lt;sup>17</sup> See IPART *Review of water prices for Sydney Desalination Plant Pty Limited From 1 July 2012, Final Report*. Page 67

We are seeking a similar approach to cost pass throughs for the 2020 determination.

While both of the above examples are instructive, we consider that IPART's approach to the passing through of SDP costs in the Sydney Water determination is directly relevant and provides a precedent for the introduction of regulatory events, catastrophic events and contingent projects for the 2020 determination.

Similar to IPART passing through a (yet to be determined) SDP cost in the Sydney Water 2016 determination<sup>18</sup>, WaterNSW is requesting IPART to establish a cost pass through methodology for regulatory change events and catastrophic events that:

- Is symmetric in that WaterNSW is able to apply for the recovery of the costs of positive change events (i.e. where costs have increased) but is obliged to seek to reduce prices for a negative change event (i.e. where costs have decreased);
- Incorporates a materiality threshold;
- Requires IPART to approve the efficient cost of complying with an eligible event; and
- Adjusts fixed service charges based on a 1-year lag after the event (e.g. T-1).

We note that, while IPART has provided a cost pass through for Sydney Water for SDP costs where it exercised discretion during the SDP determination, IPART has indicated that it is limited (but not precluded) in its ability to exercise discretion within a regulatory period, as stated below:

"While the IPART Act does limit our ability to exercise discretion during a regulatory period, this is not the reason we have decided to retain our current approach to cost pass-throughs".<sup>19</sup>

It is clear from the cost pass through examples provided above, IPART is able to pass through uncertain costs within a determination and it would appear open to IPART to establish a methodology to pass through regulatory events, catastrophic events and contingent projects based on separately determined charges by IPART. A suggested methodology to be included in the determination is provided below:

IPART has based forecasts on WaterNSW's prices to Sydney Water including an assumption of \$0 for regulatory events, catastrophic events and contingent projects remaining constant in real terms at 2019-20 prices. Any change in prices arising from the determination by IPART of the efficient costs for any or all of these events from time-to-time will be passed through to WaterNSW's customers. Customers' water service charges will be increased/reduced to account for the difference between what IPART separately determines to be the efficient costs for regulatory events, catastrophic events and or contingent projects and the WaterNSW-related costs IPART has included in the bulk water-related operating expenditure in the 2020 determination.

### Summary

The discussion above – and the pass throughs in place for Sydney Water and SDP - illustrates that IPART is able to develop a methodology that allows for the passing through of the costs of regulatory events, catastrophic events and contingent projects costs within the 2020 determination period.

<sup>&</sup>lt;sup>18</sup> See <u>https://www.ipart.nsw.gov.au/files/sharedassets/website/shared-files/investigation-legislative-requirements-water-metropolitan-water-sydney-water-corporation-pricing-investigation-commencing-from-1-july-2016/determination - sydney water corporation -</u>

<sup>&</sup>lt;u>maximum\_prices\_for\_water\_sewerage\_stormwater\_drainage\_and\_other\_services\_from\_1\_july\_2016.pdf</u>. Page 12.

<sup>&</sup>lt;sup>19</sup> See IPART *Review of prices for Sydney Water Corporation from 1 July 2016 to 30 June 2020 Final Report*. Page 62.

We note that, irrespective of whether IPART considers that providing additional cost pass throughs is appropriate on its merits, there is some contradiction as to whether IPART is able to exercise judgement during a regulatory period (as it has done for Sydney Water and SDP cost pass throughs as highlighted above) and whether IPART considers this *ultra vires*. We seek IPART's views on this matter in the draft determination.

If there is any doubt as to whether the legislation enables the introduction of effective cost pass through arrangements during a determination period, IPART should seek legislative change to address this uncertainty.

### 2.7.5 Question 31

#### What other criteria should we consider when assessing cost pass through mechanisms?

IPART should consider the need for infrastructure businesses to have the reasonable opportunity to recover the efficient costs they incur as a result of unexpected events. The inability to recover the costs of uncertain events may have a significant financial effect on the ability of water networks to invest in and operate their networks. This is not in customers' long term interests as it may impact future service delivery.

### 2.7.6 Question 32

### Is there a case for WaterNSW to pass any cost under-recovery for the Shoalhaven Transfer Scheme in this current determination period into future prices?

Yes. As outlined in the WaterNSW Pricing Proposal, WaterNSW is seeking to recover the estimated revenue shortfall from the operation of the Shoalhaven Transfer cost pass through event from the 2016 determination period. IPART indicated on Page 75 of the Issues Paper that its preliminary position is to not allow WaterNSW to claw back any under-recovery from future customer prices, because:

"On balance, we typically do not make retrospective adjustments for any under- or overrecovery between determination periods unless in exceptional circumstances. This is because we set efficient operating and capital expenditure allowances for the regulatory period with an expectation that costs can fluctuate, some new costs will rise, and some expected costs will not occur. If there is no bias in the forecasts, we would expect the gains from underspends to offset the losses from overspends over the long term (emphasis added)."

As indicated in our response to Question 23, we consider that this is an exceptional circumstance and there is unintended bias in the forecasts whereby there is no potential for revenue increases in the Shoalhaven Transfers formula to offset the revenue shortfall. We do not consider it to be reasonable or appropriate that WaterNSW should bear the costs of the revenue shortfall on the basis that any "under-recovery associated with this Shoalhaven Transfer Scheme is more than offset by WaterNSW's operating expenditure savings over the 2016 determination period" (Issues Paper, Page 75).

As noted by IPART but stated in the counterfactual, when there is bias in the forecasts, as is the case for the Shoalhaven transfers, the benefit arising from any other savings should not be used to address the bias.

WaterNSW considers that it would be inconsistent with good regulatory practice to claw back the current period operating efficiencies to offset an activity cost which was not contemplated by the allowance and when bias is evident. On Page 21 of the 2016 Final Decision on Greater Sydney Bulk Water Prices, IPART outlined the intended effect of implementing the pass through mechanism:

The pass through mechanism should ensure that WaterNSW recovers <u>the efficient costs</u> of Shoalhaven transfers (**no more or less**), and that these costs are passed through to its customers (emphasis added).

WaterNSW is unable to recover all of the efficient costs resulting from the transfers, including the cost of greenhouse gas abatements schemes imposed by legislation and network and other ancillary charges typically paid for by energy users. WaterNSW believes that it is not an efficient outcome for WaterNSW to bear the revenue risk associated with these costs and schemes, particularly given that WaterNSW has no, or limited, ability to control the cost in terms of the unit cost, the type of cost and the projected energy volumes used to calculate the final energy bill<sup>20</sup>

WaterNSW reiterates that it is a mandatory requirement as a drought security measure for WaterNSW to implement the Shoalhaven transfers and incur the associated pumping costs. We work diligently to manage the impacts of drought and, as a result, it was necessary for WaterNSW to incur the actual pumping cost and the associated revenue shortfall in the interests of Sydney residents. WaterNSW therefore had no ability to avoid its current revenue shortfall position.

As indicated in Section 4.4.2 of our Pricing Proposal (and as discussed in Appendix D, where we provide detailed workings of our proposed amendments to the formula for the cost of Scheme transfers relating to the electricity charge) the impact of the above charges being excluded from the current formula is not trivial. In one month alone (December 2018) when transfers occurred, WaterNSW's costs for Shoalhaven transfers exceeded IPART's allowance by over 31%, or \$0.7 million.

Assuming the same price differential observed in December 2018, WaterNSW could incur a revenue shortfall of up to \$1,372,000 per month (for 35,000 MLs pumped) in times when the Scheme is activated. This would have significant financial implications for WaterNSW and would promote perverse incentives for the operation of the scheme if not corrected as discussed in our response to Question 33.

Given that the revenue shortfall has been the result of an unintended bias in the transfer formula, and the amounts are not immaterial, WaterNSW proposes that the revenue shortfall is recovered during the 2020 determination period.

To minimise bill impact, WaterNSW notes that the shortfall levy would only be applied to Sydney Water bills as a variable component and only for each month that the Shoalhaven transfers are triggered in the future regulatory period, and the shortfall recovered over time.

### 2.7.7 Question 33

## Should we adopt WaterNSW's proposed changes to the Shoalhaven cost pass through mechanism? Are there any alternative approach that we should consider, eg a benchmark cost approach?

In our Pricing Proposal (Section 4.4 and Appendix D), WaterNSW provided a detailed assessment of the changes that are required to the Shoalhaven cost pass through mechanism to address the current bias in the forecasts. WaterNSW suggests that our proposal reflects the most appropriate approach to ensuring the formula is cost reflective.

<sup>&</sup>lt;sup>20</sup> WaterNSW cannot control the volumes it pumps given that the Shoalhaven transfers are a regulatory requirement. However, WaterNSW does pump in the cheaper off-peak pricing period to reduce the cost for the end user.

Alternatively, a trueing up of the forecast and actual costs arising from the application of the transfer formula during each year of the 2020 determination period (similar to the electricity cost pass through in the SDP determination and WaterNSW's proposal to pass on the current period revenue shortfall for the Shoalhaven Transfers) may provide a more accurate and straightforward approach to passing through the costs of the transfer.

### 2.7.8 Question 34

### Do you agree with WaterNSW that a separate mechanism should be established to deal with contingent project risks?

As outlined in our Pricing Proposal (Section 4.5), WaterNSW has identified a number of large uncertain major projects (or contingent projects) that are not included in our proposed capital expenditure program other than for some minor preliminary planning costs or early investigation works.

Any of these projects may need to commence during the 2020 determination period for reasons outside of WaterNSW's control, such as to ensure water security should dam levels continue to fall at unprecedented rates. If one or more of these projects proceed, WaterNSW may face significant financial risk if the costs are not included in prices during the 2020 determination period.

Importantly, WaterNSW did not consider it reasonable to include these contingent projects in its capital expenditure program. This is because the uncertainty around if or when these projects will take place and how much these projects will cost would result in prices that that are significantly higher than efficient costs if the costs were included in the determination and the projects did not go ahead.

WaterNSW therefore proposes to include a separate mechanism in the determination that would allow the costs of a contingent project to be assessed within the determination period only once the need for the project and the costs have been established with more certainty.

As outlined in our response to Question 37, a mechanism to address contingent projects is a common feature of many well-functioning regulatory frameworks in the water and energy sectors.

### 2.7.9 Question 35

If so, what should a regulatory mechanism for contingent project look like? How should we design it? How should it be applied? Should it affect prices during the determination period or only provide assurance to the business that these costs will be recognised and reflected in prices in the future (ie, from the next scheduled price determination)?

WaterNSW has identified in detail our preferred approach to a contingent projects mechanism (see Section 4.5 of our Pricing Proposal) and has identified other jurisdictional and industry approaches to contingent projects that form a sound basis for IPART to adopt.

Our preferred approach to contingent projects necessarily requires that prices are subject to review during the determination period.

WaterNSW has also identified that if IPART does not accept our proposal for contingent projects, then a second (or third) best option is to provide assurance to the business that these costs will be recognised and reflected in the future RAB (i.e. at the 2024 determination).

As outlined in our response to Question 30, WaterNSW would only consider seeking an early price determination once all other remedies have been exhausted. Seeking an early determination is considered a last resort in addressing the investment uncertainty, only after

options of a specific contingent projects mechanism and roll-forward adjustments to the RAB have been exhausted. We note that this latter option of rolling-forward the RAB, as discussed in our response to Question 38, would not compensate WaterNSW for the return on capital for the period between when the additional costs are incurred and when the next price determination occurs for a contingent project if the current 'as incurred' approach to calculating the RAB is in place.

### 2.7.10 Question 36

## Relative to the current framework, will a new mechanism likely complement or confound the existing mechanisms and incentives? What incremental benefits would this provide and what are the potential unintended consequences?

As discussed in our Pricing Proposal (Section 4.5) and our responses to Questions 34, 35, 37 and 38, if the regulator does not factor forecast expenditure for uncertain projects into the revenue requirement and the expenditure proves necessary, the infrastructure operator will be undercompensated for its provision of water infrastructure services. This may lead to reduced quality of services for customers and underinvestment in the infrastructure operator's infrastructure. This outcome is not in the long term interests of customers.

As the contingent projects identified by WaterNSW are large capital works largely outside of our control that are required to ensure water security for Greater Sydney customers, and there is currently no specific capital expenditure incentive mechanism, we do not consider there to be negative unintended consequences created by including a contingent projects mechanism in the regulatory framework.

### 2.7.11 Question 37

### What can we learn from the experience of other jurisdictions and regulated industries on addressing contingent projects?

The application of a contingent projects regime is a common feature of many well-functioning regulatory frameworks. As outlined in detail in the WaterNSW Pricing Proposal (Section 4.5) and as summarised by IPART in the Issues Paper (Section 10.2.3) the National Electricity Rules applies a robust framework for contingent project and 'reopener' provisions for Australian electricity distribution and transmission network service providers. References in WaterNSW's Pricing Proposal to the contingent projects mechanism by the AER for the energy sector were intended to highlight how that sector addressed investment uncertainty in a holistic manner. It was not intended to be suggest that this approach was unique or somehow specific to the energy sector.

WaterNSW provides the following analysis of how uncertain projects are addressed in other jurisdictions and industries (primarily water) in Australia and overseas and cites examples of effective contingent projects regimes in place for:

- The Australian Energy Regulator's regulation of energy networks;
- The Australian Competition and Consumer Commission's regulation of water utilities;
- The Essential Services Commission of Victoria's regulation of water utilities;
- The Essential Services Commission of South Australia's regulation of SA Water; and
- The Office of Gas and Electricity Markets' regulation of gas and electricity networks in the United Kingdom.

### Australian Energy Regulator

As outlined in our Pricing Proposal (Section 4.5), the Australian Energy Regulator (AER) is required by the NER to assess applications by network service providers (NSPs) to amend their

revenue determination to include the revenue required for a contingent project. The NER sets out the requirements for businesses to lodge applications and the obligations on the AER in assessing those applications.

The contingent project mechanism allows the AER to exclude a project which is uncertain, but which has a clearly defined trigger event, from the forecast expenditure established in the determination but to include it later if it is required.

A contingent project is a project assessed by the AER as reasonably required to be undertaken, but which is excluded from the *ex ante* capital expenditure allowance in a revenue determination because of uncertainty about its requirement, timing or costs. A revenue determination also identifies associated trigger events.

Should the trigger event occur, a network service provider may apply to the AER during the regulatory period to amend the revenue determination to include forecast capital expenditure and incremental operating expenditure for the project.

For contingent projects, the materiality threshold is the greater of \$30 million or 5 percent of the annual revenue requirement in the first year. WaterNSW proposes that IPART adopt a similar methodology for addressing contingent projects.

### Australian Competition and Consumer Commission – Water Charge Rules 2010

As outlined in our response to Question 30, the ACCC undertook a review of the water charge rules in 2016. Based on the ACCC's advice, the Minister for Agriculture and Water Resources amended the water charge rules through the Water Charge Amendment Rules 2019 and incorporated the three sets of rules into the Water Charge Rules 2010. The rule changes were intended to streamline requirements and provide greater transparency for customers. The new Water Charge Rules 2010 (WCR) apply from 1 July 2020.

The WCR retained the ability for an operator to apply for a variation of approval or determination in certain circumstances. However a number of fundamental changes to the approach to detailing with uncertainty and variations to determinations are included in the WCR. These changes included the addition of mechanisms to address a **taxation event** and a **regulatory event** (discussed in our response to Question 30) and **contingent projects** (discussed below).

Under the current WCIR, a regulator must approve or determine infrastructure charges based on the forecast prudent and efficient cost of providing infrastructure services. This requires the regulator to form a view about whether the expenditure proposed by the infrastructure operator is prudent and efficient. For some 'business as usual' costs, there will be a high degree of certainty that the infrastructure operator will incur the costs. However, for other projects (such as certain capital expenditure items), there will be a degree of uncertainty about:

- Whether the infrastructure operator will go ahead with the project;
- Whether the scope of the project will differ from that proposed;
- The timing of the expenditure of the project; and / or
- Whether the cost of the project has been forecast accurately.

In its Final Advice on the proposed legislative changes, the ACCC stated that:

"Where the regulator factors the forecast expenditure into the infrastructure operator's revenue requirement (and therefore into approved or determined charges), but the expenditure does not occur, customers will face higher than necessary charges. However, where the regulator does not factor this forecast expenditure into the revenue requirement and the expenditure proves necessary; this means that **the infrastructure** 

# operator will be undercompensated for its provision of water infrastructure services. This may lead to reduced quality of services for customers and underinvestment in the infrastructure operator's infrastructure (emphasis added).<sup>#21</sup>

The ACCC recommended in its Draft Advice (that was reflected in the amended legislation) that the rules allow the regulator to specify a specific project or particular portion of capital expenditure related to a specific project as a '**contingent project**' during the initial determination process, along with the criteria that must be met before the infrastructure operator can apply for the cost of the project to be factored into the calculation of the infrastructure operator's charges for the remainder of the regulatory period.

The ACCC considered that rules allowing the regulator to specify a project as a contingent project in a determination should have the following elements:

- The regulator should have the discretion to specify a project as a 'contingent project' (either in response to a Part 6 operator's request, or on the regulator's initiative), taking into account the cost / likelihood / timing / necessity / feasibility of the project;
- The regulator may specify the criteria (or 'trigger event') that must be met before the infrastructure operator can apply for the contingent project to be included in the revenue requirement for the remainder of the regulatory period; the criteria set would depend upon the circumstances;
- Where the regulator is satisfied that the contingent project meets the criteria, the regulator can review whether the contingent project is included in the revenue requirement for the remainder of the regulatory period, taking into account information that was not available at the time of the original determination; and
- As a result of including the contingent project in the revenue requirement for the remainder of the regulatory period, the regulator can decide which infrastructure charges should be varied, by how much and when, subject to the decision rules.<sup>22</sup>

The relevant changes to the Water Charge Rules 2010 are provided below:

Amendment to Rule 31(1)

(1A)If the circumstances in subrule 29(3A) apply, **the notice may also specify a capital expenditure project as a contingent project** and set out the conditions that the operator must satisfy in relation to the contingent project before the operator may apply for a variation of a determination or approval of its infrastructure charges under Division 4 (emphasis added).

Amendment to Rule 40

- (3) A Part 6 operator may also apply in writing to the ACCC for a variation of the determination or approval made under Division 2 or 3 (or, if previously varied under this Division, as so varied) if the infrastructure operator is of the view that the conditions specified under subrule 31(1A) in relation to a **contingent project** have been satisfied (emphasis added).
- (4) An application made under subrule (3) must set out:
  - (a) the reasons for the operator's view that the conditions in subrule 31(1A) have been satisfied; and
  - (b) the total amount that the operator anticipates will be required during the remainder of the regulatory period to meet the prudent and efficient costs of delivering the contingent project; and

<sup>&</sup>lt;sup>21</sup> ACCC Review of the Water Charge Rules Final Advice, September 2016. Page 178.

<sup>&</sup>lt;sup>22</sup> ACCC Review of the Water Charge Rules Final Advice, September 2016. Page 178.

- (c) the proportion of the costs of the contingent project that the operator seeks to recover through infrastructure charges; and
- (d) the infrastructure charges the operator is seeking to vary and the amount of that variation.

In its Final Advice, the ACCC stated that, when considering whether to incorporate a materiality threshold for contingent projects:

"Specifically, the ACCC must be satisfied that the inclusion of the proposed capital expenditure project would have a material impact on the operator's infrastructure charges to be approved or determined. The ACCC considers that the inclusion of this criterion will promote regulatory certainty and make the operation of variations relating to contingent projects simpler and less costly."<sup>23</sup>

WaterNSW is seeking a similar approach to addressing uncertainty in the 2020 determination as outlined by the ACCC (and as reflected in the new Water Charge Rules 2010) relating to cost pass throughs and contingent projects that we consider reflects a more contemporary approach to addressing regulatory investment uncertainty.

### **Essential Services Commission, Victoria – Water pricing framework**

As discussed in our response to Question 30, on 1 January 2004, the Essential Services Commission of Victoria (ESCV) commenced its role as the economic regulator of the Victorian water sector. The ESCV's role involves regulating the prices and service standards of the businesses supplying water, sewerage and related services to residential, industrial and commercial, and irrigation customers throughout Victoria.

The ESCV's framework provides a number of options to deal with uncertainty in a regulatory period, including:

- Annual updating of financial parameters, such as inflation and the cost of debt;
- Reflecting approved cost pass through events (such as tax changes) as discussed in our response to Question 30;
- Accommodating significant changes in circumstances (discussed below); and
- Reflecting substantial deviations in performance relative to the approved outcomes and targets.

This section identifies how the ESCV addresses 'significant changes in circumstances'. WaterNSW notes that the mechanism to address significant changes in circumstances has similarities to the contingent projects mechanism we have proposed that is also a feature of the regulatory regimes of the AER and the ACCC as discussed above.

The 'uncertain or unforeseen events' mechanism allows businesses to apply for a price adjustment to account for events that were *significant and uncertain or unforeseen at the time of the original determinations*. Application of this mechanism involves:

- A water business promptly notifying the ESCV upon becoming aware of an event which could form part or the entire basis of an application;
- A water business applying to the ESCV for amendment of its determination and/or adjustment of the scheduled prices to reflect increased or decreased costs incurred, or increased or decreased revenue received, as a result of events which were uncertain or unforeseen at the time the determination was made; and

- The ESCV potentially taking action to adjust forecast revenues and prices in respect of an uncertain events application where the ESCV is satisfied that such action:
  - Is necessary or desirable to take account of events that were uncertain or unforeseen at the time of making the determination, and
  - Takes into account the interests of customers.

Price adjustments can occur **during** or at the end of the regulatory period, and be initiated by a business or by the ESCV. The ESCV will approve price adjustments when it is satisfied that:

- The event is clearly outside of the control of the business and not predictable with any confidence;
- Customers are not unduly exposed to risk or price fluctuations;
- The impact of the event is material, clearly observable and verifiable;
- The net impact on costs or revenue of all changes that have occurred during the period under consideration is significant; and
- The business has done everything within their control to mitigate against the circumstances in which they find themselves.

In its guidance to regulated water businesses in Victoria, the ESCV suggests that water businesses should consider this mechanism for major capital projects that are not fully scoped, costed or internally approved (an approved business case, for example) at the time of submitting a price submission.<sup>24</sup>

For these projects, the ESCV considers it **reasonable to include revenue to cover the costs associated with project development and design works, but not the full construction costs for an undefined or unapproved project**. In some circumstances, it may be appropriate for a water business to seek to recover a notional amount to partially cover anticipated construction costs that will be incurred during the period, with the balance to be rolled into the RAB at the end of the period.

WaterNSW notes that we adopted a similar approach in the development of our Pricing Proposal as that suggested by the ESCV, whereby we sought recovery of the preliminary planning costs of drought-related projects, but did not include the full construction costs for the undefined or unapproved projects.

WaterNSW suggests that when considering whether (or how) to incorporate a contingent projects regime, IPART notes the approach adopted by the ESCV for the 'uncertain and unforeseen events mechanism' as part of the ESCV's regulation of water utilities in Victoria.

### **Essential Services Commission of South Australia**

In July 2018, the Essential Services Commission of South Australia (ESCOSA) established the framework and approach for the SA Water Regulatory Determination 2020 (SAW RD20), which is intended to deliver the lowest sustainable prices for the services that SA Water's customers value.

In July 2019, ESCOSA released *Guidance Paper 8: Treatment of capital expenditure – addressing uncertainty*, the eighth of a series of Guidance Papers released by ESCOSA to explain the requirements, methodology and process that will apply to SAW RD20. Guidance Paper 8 sets out how the Commission proposes to address uncertain costs or benefits in SA Water's capital expenditure plan for the SAW RD20 period. Further, it provides specific guidance

<sup>&</sup>lt;sup>24</sup> See ESCV's Water Pricing Framework and Approach Implementing PREMO from 2018, October 2016. Page 42.

on matters that the Commission considers to be relevant in determining the prudent and efficient costs of SA Water's Zero Cost Energy Future (ZCEF) program of works.

For any new ZCEF projects developed after SAW RD20 is made, ESCOSA considers it important that a robust process for regulatory review, including stakeholder consultation, is undertaken (similar to the process for reviewing those projects incorporated into SA Water's regulatory business plan). ESCOSA states that:

"In the absence of any regulatory review of forecast costs, **SA Water faces the risk that new projects may not meet the Commission's test of prudent and efficient expenditure** when reviewing actual capital expenditure at the end of the period and may not be included in SA Water's regulated asset base. That uncertainty may encourage **SA Water to defer those projects to the following regulatory period, which may not be in consumers' interest** as the potential overall cost savings to consumers would also be deferred (emphasis added)".<sup>25</sup>

ESCOSA notes that under the current SAW RD16 determination, SA Water would have to rely on the cost pass through mechanism or a re-opening of the entire determination to allow revenues to be adjusted during the regulatory period to incorporate any new projects. Those processes exist for unforeseen and uncontrollable events that materially impact SA Water's costs and it is unlikely that ZCEF projects would meet those criteria as they are controllable. Consequently, ESCOSA intends to introduce a new type of expenditure review mechanism under SAW RD20 to address any new ZCEF projects, or other major SA Water expenditure initiatives, that were not incorporated into SAW RD20.

A review of SA Water's forecast capital expenditure plan for the SAW RD20 period will be carried out using the current approach. However, as a further measure, **an intra-period review mechanism will be introduced from 1 July 2020, similar to that used (in various forms) by other economic regulators, such as the Australian Energy Regulator**. Those mechanisms allow for any major unforeseen capital expenditures to be reviewed by the regulator, through a transparent process involving public consultation, and provide for revenues to be adjusted (including by removing previously approved operating expense allowances) in the event that the capital expenditure is found to be prudent and efficient (emphasis added).<sup>26</sup>

WaterNSW considers that ESCOSA's approach to addressing the uncertainty surrounding significant projects through an *intra-period* review mechanism is introduced represents sound regulatory practice that should be considered for the IPART 2020 determination.

### Office of Gas and Electricity Markets (United Kingdom)

The Office of Gas and Electricity Markets in the UK (Ofgem) regulates gas and electricity networks under an approach called 'RIIO', which stands for 'Revenue = Incentives + Innovation + Outputs'. The RIIO-T1 price control sets the outputs that the electricity and gas transmission network companies need to deliver for consumers and the associated revenues they are allowed to collect for the eight-year period from 1 April 2013 until 31 March 2021.

The RIIO-T1 price control includes two reopener 'windows' for companies or Ofgem to propose adjustments to expenditure allowances for certain cost categories that were deemed to be too

 <sup>&</sup>lt;sup>25</sup> See ESCOSA's SA Water Regulatory Determination 2020: Guidance Paper 8, *Treatment of Capital Expenditure – Addressing uncertainty, July 2019.* Page 5.
<sup>26</sup> Ibid. Page 5.

uncertain to provide ex ante allowances at the time of the Ofgem Final Proposals.<sup>27</sup>

For cost categories where there was uncertainty about expenditure requirements at the time of setting allowances, the price controls include a 'reopener' mechanism. The mechanism allows network companies to propose adjustments to baseline expenditure allowances for these costs when there is more certainty. The reopener mechanism specifies two windows during which adjustments to allowances may be proposed – one in May 2015 and other in May 2018 (i.e. two 'windows' during the regulatory period).

While different in form to a contingent projects mechanism, Ofgem's approach to addressing the costs of large uncertain projects during a regulatory period through a reopener mechanism is relevant in the current circumstances.

### Summary from other jurisdictions

The preceding sections have identified that addressing the uncertainty of large capital projects through the introduction of a contingent projects (or similar) mechanism with *intra period* adjustments has been adopted by many regulators in Australia and overseas, including:

- The AER for electricity network businesses through explicit contingent projects provisions in the NER;
- The ACCC for water utilities through contingent projects provisions in the new Water Charge Rules;
- The ESCV for water utilities through the 'uncertain and unforeseen events mechanism';
- ESCOSA for SA Water through the introduction of the new 'intra-period review mechanism'; and
- Ofgem for UK gas and electricity networks through an intra-period reopener mechanism.

Our analysis highlights that the regulatory framework in NSW as administered by IPART for addressing large uncertain (or contingent) projects that does not feature an intra-period review mechanism has not kept pace with more recent regulatory developments in other jurisdictions and industries. WaterNSW encourages IPART to consider how to apply an intra-period adjustment for the 2020 determination. If there are any legislative obstacles to implementing an effective contingent projects regime in NSW, IPART should seek to have these removed.

### 2.7.12 Question 38

In terms of actual additional costs (or cost savings) incurred (or generated) by the business during a determination period, do you agree with our current approach to not compensate (or claw back from) for return on capital over the period when they incur those costs and when we review the prices?

As a general proposition, yes. Understanding the 'rules of the game' prior to investing is an important consideration before investors will commit capital. IPART's current 'as incurred' approach to calculating the RAB that does not provide additional compensation (or clawing back) of the return on capital over the period is an important consideration that underpins the integrity of the regulatory regime and that minimises regulatory risk.

However, in exceptional situations, such as those currently facing the State with the potential need for significant (but uncertain) investments to maintain water security resulting from the current drought conditions, alternative arrangements may be appropriate. This could take the form of an 'as commissioned' approach to rolling investments into the RAB that includes the return on capital during construction.

<sup>&</sup>lt;sup>27</sup> Ofgem Decision *RIIO-T1 reopener: One-off Asset Health Costs (Feeder 9), 28 September 2018.* <u>https://www.ofgem.gov.uk/system/files/docs/2018/09/one-off\_asset\_health\_costs\_decision.pdf</u>

For example, if WaterNSW is required to build new infrastructure during the 2020 determination period to provide water security during the current drought (and in the absence of other mechanisms to address this uncertainty), IPART's current 'as incurred' framework would require WaterNSW to roll the costs into the RAB at the time that the investment occurs, with WaterNSW foregoing the return on capital during the remaining years of the current regulatory period. This funding shortfall is likely to be material with any large project.

The effect is that the investment will be loss making (i.e. it will have a negative net present value) due to the return on capital foregone. This creates an incentive to defer projects that otherwise may be customers' interests to proceed as soon as possible. This impact was noted by ESCOSA in its consideration of uncertain projects for SA Water during a regulatory period as reproduced below:

"That uncertainty may encourage SA Water to defer those projects to the following regulatory period, which may not be in consumers' interest as the potential overall cost savings to consumers would also be deferred".<sup>28</sup>

We suggest that in exceptional circumstances for new assets, IPART provides pre-approval to roll into the RAB the full efficient costs of the investment, including any otherwise foregone return on capital, on an 'as commissioned' basis at the start of the subsequent determination period.

While not our preferred approach to addressing the uncertainty of certain major projects (see our response to Question 37), an 'as commissioned' approach to rolling investments into the RAB would be a positive development to ensure projects that are genuinely uncertain in terms of cost and or timing do not face a disincentive to proceed while enabling the business to meet its financeability requirements.

<sup>&</sup>lt;sup>28</sup> See ESCOSA's SA Water Regulatory Determination 2020: Guidance Paper 8, *Treatment of Capital Expenditure – Addressing uncertainty, July 2019*. Page 5.