

Submission to the Independent Pricing and Regulatory Tribunal

**Response to the IPART Issues Paper on the review of
regulated charges for the Wentworth to Broken Hill Pipeline**



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1. Introduction

WaterNSW is pleased to respond to the IPART's Issues Paper on its review of regulated charges for the Murray River to Broken Hill Pipeline (the "**Issues Paper**") published on 25 September 2018.

WaterNSW continues to support the pricing proposal we submitted to IPART in late June 2018 for the pipeline. This submission does not seek to repeat the contents of our pricing proposal. Accordingly, we have only answered the questions in the Issues Paper on an exceptions basis.

By way of update, installation of the pipeline is tracking on schedule, with the last mainline pipe having been laid in Broken Hill on 12 October 2018¹.

2. Response to Specific Questions

2.1 Establishing appropriate cost shares

2.1.1 Question 1

What matters should we take into account when considering the appropriate notional sharing of the efficient costs of the Pipeline?

WaterNSW understands that:

- IPART intends to pass on the efficient cost of the pipeline to Essential Water through WaterNSW charges to Essential Water (to be included as part of Essential Water's operating expenditures and revenue requirement); and
- IPART will then split the cost of the pipeline between the Government and customers in determining the maximum price Essential Water can charge its customers (potentially also through the mechanism of a community service obligation where the costs are beyond customers' capacity to pay).

WaterNSW believes this approach is consistent with the 16A direction of the Independent Pricing and Regulatory Tribunal Act 1992 (NSW). The 16A direction requires IPART to **include** an amount or factor in its methodology representing the efficient cost of complying with the Pipeline directions in determining the **maximum price** for pipeline monopoly services. The IPART Act defines a price as including any rate, fee, levy and charge and any other valuable consideration. WaterNSW submits that the 16A direction requires IPART to specify in its determination a price which can be levied by WaterNSW onto its customers for pipeline monopoly services (e.g. Essential Water and offtake customers).

2.2 Length of determination, building block approach and form of regulation

2.2.1 Question 2

How long should we set prices for in the 2019 Determination?

WaterNSW agrees with IPART's preliminary view that a 4 year determination period is reasonable.

¹ Noting that pipeline beyond the bulk water storage and into Broken Hill, although part of the broader project, does not comprise that part of the pipeline subject to the WaterNSW pricing proposal.

2.2.2 Question 4

Do WaterNSW's proposed energy costs for the 4-year period to 2022-23 represent prudent and efficient energy costs?

WaterNSW's proposal on energy prices is contained in section 16.4 of the pricing proposal.

WaterNSW has structured its proposal on energy costs to mimic the outcomes of a competitive market environment. For example:

- **Customer charges reflect market rates:** Actual retail electricity rates have been incorporated into the energy forecast for the variable charge up to 2021. WaterNSW has also proposed annual updates to the fixed and variable electricity charges to ensure all energy rates for the pipeline correspond to actual market rates (see sections 17.09 to 17.13 of the pricing proposal)
- **Market rates are determined through a competitive tender process:** The pipeline operator is **contractually obliged** to demonstrate to WaterNSW that the electricity retailer it intends to contract with for a Power Supply Agreement provides the **best value for money** having regard to the price quoted in the prevailing market conditions and the experience, capability, financial and regulatory standing of the electricity retailer in the context of the pipeline (see section 16.4 of the pricing proposal)
- **Network Costs are reviewed for prudence and efficiency:** Actual network rates are reviewed by the Australian Energy Regulator (AER) under the National Electricity Rules (NER). This review is comprehensive and transparent and includes a price review and an annual review process. The annual review process involves an assessment of the proposed network tariffs in accordance with the AER tariff principles (see section 17.13 of the pricing proposal)
- **Efficiencies are passed on:** If annual updates of the electricity charges are permitted, then WaterNSW proposes to pass on 100% of its share of the energy efficiencies, under the O&M contract between WaterNSW and the pipeline operator, to Essential Water and offtake customers in the following year (see section 17.14 of the pricing proposal)
- **Volumes risk has been allocated to the pipeline contractor:** Under the O&M contract, electricity volumes risk has been allocated to the pipeline contractor, as the most efficient party to manage this risk, instead of WaterNSW or end users. This allocation of risk incentivises the pipeline contractor to become more operationally efficient.

The framework proposed by WaterNSW ensures that both WaterNSW and the pipeline contractor is provided with the right incentives to manage their energy cost efficiently over the 20 year term of the O&M agreement.

2.3 Allowance for operating expenditure

2.3.1 Question 5

How could an efficiency carryover mechanism apply to any savings generated by the Pipeline contractor?

Please see WaterNSW's response to question 4 above.

If IPART permits annual updates to the fixed and variable electricity charges to account for changes in actual electricity rates, then WaterNSW proposes to pass on to its customers 100% of its share of the energy efficiencies under the O&M contract between WaterNSW and the pipeline operator in the following year.

WaterNSW's proposal is part of an overall package (see response question 4) designed to mimic the outcomes of a competitive market environment and to ensure that the electricity prices to operate the pipeline match the efficient costs of the service in each year of the regulatory period.

2.3.2 Question 6

Is there a case to manage WaterNSW's proposed energy costs through a cost pass-through mechanism?

In our view the most effective approach to manage energy costs is outlined in our response to questions 4 and 5.

WaterNSW submits that IPART should not consider its proposal in piecemeal. The pricing proposal should be assessed as part of an overall package designed to ensure that maximum prices for the pipeline match the efficient costs of the service in each year of the regulatory period. IPART's review mechanism should be flexible to determine the overall best outcome for customers rather than aligning to prescriptive and formulaic criteria in determining how to assess a proposed cost pass through mechanism.

2.4 Prudent and efficient capital expenditure

2.4.1 Question 18

Do you agree with our preliminary position that a regulatory true-up in the following period is the appropriate method to account for changes in the cost of debt over the 2019 determination period?

WaterNSW acknowledges IPART's preliminary view to implement a regulatory true-up mechanism to account for changes to the cost of debt allowances within a regulatory period. According to IPART, a regulatory true-up mechanism is more likely to promote price certainty for customers than the annual adjustments mechanism.

The Government, as per the 16A direction, has mandated that WaterNSW should receive an allowance which corresponds to the efficient cost of capital. WaterNSW submits that IPART should decide which method provides a more accurate measure of the efficient cost of capital.

WaterNSW outlined several benefits in favour of the annual adjustments mechanism, including customers 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. as soon as possible). See section 12 of the WaterNSW proposal. This is the most accurate method of calculating the cost of debt.

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 have to be inflated by a discount rate to ensure an NPV neutral outcome for WaterNSW. This issue would not arise under the annual adjustment approach.

2.5 Return on assets, depreciation and tax liabilities

2.5.1 Question 19

What comparable industries should we consider to establish the proxy companies we use to estimate the beta in this review?

Page 64 of IPART's Final Report on its "Review of our WACC Method" (Final Report) published February 2018, states:

Our final decision is to maintain our draft decision to use a broad selection of proxy companies, excluding thinly traded stocks. We consider that this is consistent with stakeholders' feedback and an improvement on our existing process. However, we will also amend our proxy selection process to make it more transparent, predictable and replicable for stakeholders. In particular, we will:

- publish our criteria for proxy selection, and our list of comparator companies that meet our criteria at the start of the relevant review, and*
- give stakeholders the opportunity to propose additional comparable industries that meet our criteria, but not individual stocks.*

We consider that this is an improvement to our existing process as it gives stakeholders the same information as we use to make our equity beta decisions, and gives them an opportunity to put forward their views on comparable industries, while limiting debate about individual firms.

However, IPART has not yet published its criteria for proxy selection and its list of comparator companies that meet that criteria at the start of this review. Instead, IPART has requested views on comparable industries without that information.

WaterNSW suggests that this request is unreasonable given the analysis required to determine the broader proxy grouping. To be done properly it would require WaterNSW to consider a complete selection criteria for proxy companies and industries from a bottom-up perspective, rather than reviewing and commenting on an existing selection criteria. This is a completely different task which would require the dedication of significant resource and effort, while we suspect that IPART has a well-developed criteria and list of industries and companies to hand.

In line with the principles of transparency, predictability and replicability outlined in IPART's Final Report, WaterNSW asks that IPART publish its criteria and list of comparator companies in line with the decision in the Final Report that meet the criteria for WaterNSW's comment as soon as possible.

2.5.2 Question 21

Should we take the variable corporate tax rates into consideration in our review of the Pipeline's tax allowance?

WaterNSW's pricing proposal uses a statutory corporate tax rate of 30% to calculate the regulatory tax allowance for the pipeline. WaterNSW's proposal is consistent with IPART's December 2011 decision on *the incorporation of company tax in pricing determinations*, the IPART determinations for WaterNSW's Greater Sydney and Rural Valley bulk water customers and the Water Administration and Ministerial Corporation (WAMC) determination and our actual tax costs per Income Tax Legislation (i.e. Tax Consolidation/Grouping Provisions).

In March 2017, the Commonwealth enacted legislation that introduced different rates of corporate income tax for businesses of different sizes. IPART, in both its Broken Hill Pipeline Issues Paper and the Essential Water Issues Paper, suggests that it should apply the corporate tax rate using the aggregated turnover of *the business unit*, rather than the corporation. IPART proposes to apply a lower corporate tax rate of 27.5% to the pipeline business of WaterNSW. This lower tax rate typically applies to small to medium sized corporate entities who derive an aggregated turnover of less than \$50M.

Australian businesses pay tax on their taxable income using a corporate statutory rate determined under Commonwealth tax law. WaterNSW is subject to the National Tax Equivalents

Regime (NTER) regime, which apply the same tax provisions to government owned corporations to promote competitive neutrality principles across both public and private sectors.

Under tax law, the corporate tax rate is determined using the aggregated turnover of the corporation. From the 2017/18 income year, the reduced 27.5% corporate tax rate applies to companies that are “base rate entities” (Income Tax Rates Act 1986 s 23(2)(a)). An entity is a base rate entity for a year of income if no more than 80% of its assessable income for the year of income is base rate entity passive income and its “aggregated turnover” for the year of income is less than \$50 million (Income Tax Rates Act 1986 s 23AA). “Aggregated turnover” is calculated as the sum of the company’s annual turnover **and the annual turnover of any entity connected with the company or that is affiliated with the company** (Income Tax Assessment Act 1997 s 328-115).

As such, it is not clear from the Issues Paper why the aggregate turnover of the *business unit* would be the most appropriate criteria by which to determine the corporate tax rate in an IPART determination. The logic applied by IPART assumes that a regulated *business unit* earning an aggregate turnover of less than \$50M would be eligible for a tax rate of 27.5%. This is not the case. For example, the WAMC business segment of WaterNSW would not be eligible for the lower tax rate of 27.5%, even though its revenue is less than \$50 million, as WaterNSW as a total corporate entity derives an aggregate turnover of more than \$50M.

WaterNSW notes that the NTER applies the tax consolidation rules contained in Part 3-90 of the *Income Tax Assessment Act, 1997*. Under these rules, WaterNSW would form a tax consolidated group with the SPV where the pipeline assets are being transferred and held.

Per income tax legislation the statutory tax rate of 30% would apply to the tax consolidated group of WaterNSW and its subsidiaries (including the SPV), as the aggregated turnover from the combined entities would exceed \$50M. WaterNSW would be underfunded by the IPART allowances should it adopt 27.5% corporate tax rate to calculate the regulatory tax allowance for the pipeline. This would also result in WaterNSW not being funded to meet a legislative compliance obligation.

WaterNSW notes that the Australian Energy Regulatory (AER) is conducting an industry wide review of the regulatory approach to estimating the notional tax allowance for electricity business which are regulated by the AER.

During this review, the AER received preliminary advice from the Australian Taxation Office (ATO), which indicated that:

The aggregate AER tax allowance provided to NTER entities consistently understated the ‘notional’ tax payable by those entities²

Given this preliminary advice, the legislative requirement to pay tax at 30% (as out lined above), and the potential flow on effect to other determinations (i.e. WAMC), WaterNSW cautions against the introduction of any determination specific and ad-hoc changes to the corporate tax rate. WaterNSW submits that any change to the corporate tax rate should be driven by an industry wide review on the appropriate method of estimating the regulatory tax allowances for IPART regulated entities, including a review of all the inputs and computational elements of the regulatory tax allowance.

WaterNSW would be underfunded for its actual income tax costs should IPART adopt a corporate tax rate of 27.5% to calculate the regulatory tax allowance for the pipeline.

² <https://www.aer.gov.au/system/files/ATO%20note%20to%20AER%20-%20Comparison%20of%20regulatory%20tax%20allowances%20and%20tax%20paid%20-%2010%20April%202018.PDF>

2.5.3 Question 22

For the Pipeline, should we use the same business unit level for determining the tax rate as we do for determining the WACC (ie, the NRR of the Pipeline rather than the NRR of the broader WaterNSW business), or are there reasons to move away from applying this approach?

Please see our response to Question 21.

2.5.4 Question 23

Should we use 30% as the default tax rate, and if the Pipeline's NRR is, on average over the determination period, below the threshold then use the lower tax rate in recalculating the tax allowance for the whole of the review period?

Please see our response to Question 21.

2.5.5 Question 24

Is WaterNSW's proposed allowance for tax, including the assumptions (e.g. asset values, depreciation method and gearing ratio) underpinning this allowance, reasonable?

The approach proposed by WaterNSW is consistent with IPART's December 2011 decision on *the incorporation of company tax in pricing determinations*.

2.5.6 Question 25

What would account for differences in demand forecasts between WaterNSW for its Pipeline and Essential Water to its customers in Broken Hill and surrounding townships?

Essential Water's demand forecasts at the **Essential Water determination level** should be relevant and consistent with an operating scenario where Essential Water uses the pipeline asset as much as possible. The demand figures should assume raw water will be extracted from the bulk water storage incorporating potential evaporation losses at the storage. The demand figures should then be adjusted to account for potential system losses from the extraction point to the end user.

Whilst Essential Water will balance its supplies to its customers using its own raw water storages (including at Mica Street, Block 10 and Stephens Creek Reservoir), these merely provide Essential Water further operational flexibility on a single day to week timeframe, and are not expected to result in material variability in demand over the medium to long term.

WaterNSW's pricing proposal includes a demand forecast to *illustrate* the potential revenue requirement over the determination period. The demand forecast was compiled by consultants GHD, on behalf of WaterNSW, and in consultation with Essential Water, using a regression of past observed demand data. WaterNSW did not have further information to form a view on the future trend of expected demand from Essential Water.

Essential Water is the only party that can advise IPART on its future expected demand.

For the avoidance of doubt, WaterNSW has proposed a cost reflective charging structure for the pipeline, where variable charges recover variable cost and fixed charges recover fixed costs. This means WaterNSW is not subject to demand forecasting risk under its proposal. For this reason, WaterNSW is indifferent to the demand forecast applied by IPART for its determination of prices for Essential Water customers. WaterNSW believes demand forecasting risk should be borne by Essential Water, as the party who has control of this risk, and is capable of actively managing this risk.

2.6 Forecast water sales and customer numbers

2.6.1 Question 26

Is WaterNSW's approach to forecasting water demand reasonable?

Please see our response to Question 25.

2.6.2 Question 27

Is WaterNSW's projection of increasing water demand in Broken Hill over the 2019 determination period reasonable?

Please see our response to Question 25.

2.6.3 Question 28

Is the number of offtake customers likely to change significantly over the 2019 determination period?

WaterNSW is unable to forecast the number of extra offtake customers over the next determination period.

2.6.4 Question 29

Do you agree that we should set maximum prices in line with the principles of cost reflective pricing? Are there any other factors we should consider?

WaterNSW's proposal for cost reflective tariffs can be found in section 17 of WaterNSW's pricing proposal.

2.7 Prices

2.7.1 Question 30

Are WaterNSW's proposed prices for Essential Water reasonable?

WaterNSW's rationale for proposed prices can be found in section 17 of the WaterNSW pricing proposal.

2.7.2 Question 31

Should WaterNSW be exposed to some of the costs of shutdown and standby events, if it can influence the duration (and hence cost) of those events?

As mentioned in section 17.4 of the pricing proposal, WaterNSW only proposes to pass onto Essential Water the cost of shutdown and standby events triggered or caused by Essential Water. The trigger events will be defined in the supply contract between WaterNSW and Essential Water.

WaterNSW's objective is to pass on the efficient cost of the pipeline. To this end, WaterNSW also proposes to reimburse Essential Water a proportion of the fixed operational maintenance charges based on the number of days the pipeline was in shutdown/standby mode. The net impact is a reduction in Essential Water's bill for the period in which the pipeline is in shutdown/standby mode. WaterNSW should be reimbursed for shut down/standby events when it is prudent and efficient to do so. See section 17.6 of the pricing proposal.

2.7.3 Question 32

Should prices to Essential Water recover all of the fixed operating and maintenance costs that WaterNSW will be exposed to over the determination period?

The 16A direction requires IPART to include in its methodology for determining maximum prices a factor for passing on the efficient cost of complying with the Pipeline direction.

As mentioned in section 17.4 of the pricing proposal, the Pipeline was built to supply water to the township of Broken Hill.³ The installation of the additional offtake assets has not triggered a noticeable increase in the fixed operating and maintenance costs of the Pipeline. For instance, the O&M contract specifies a payment schedule for operating and maintenance charges which is fixed over the 20-year term of the agreement, irrespective of the number of offtake assets installed. Therefore, all of the fixed operating and maintenance cost should be passed onto Essential Water.

2.7.4 Question 33

Could setting variable charges to encourage use of the Pipeline have any unintended consequences?

WaterNSW's proposal on variable charges is described in section 17 of its pricing proposal.

WaterNSW has proposed charging Essential Water according to a variable charge scale based on weekly demand. Offtake customers would be charged at a single point on the scale. In contrast, the O&M contract assigns a variable charge based on total weekly demand from both offtake customers and Essential Water.

In the Issues Paper, IPART commented that this charging structure may not match the cost that WaterNSW would incur under the O&M contract. WaterNSW assumes that IPART is concerned that any misalignment may encourage WaterNSW to generate extra revenue over and above the regulatory allowances.

WaterNSW has been transparent to IPART and customers about this potential risk. WaterNSW disclosed this risk in section 17, figure 15 and attachment A of its pricing proposal as well the pricing model attached to WaterNSW's pricing proposal to IPART.

Under the scenario of 3,000ML p.a of demand from Essential Water, WaterNSW may extract up to \$17,000 p.a in excess revenue. However, if Essential Water orders 6,000 ML of water p.a, WaterNSW may extract up to \$91 in excess revenue.

WaterNSW submits that the risk of over recovery is immaterial and hence the proposed charging structure is generally cost reflective. However, to alleviate IPART's concerns, WaterNSW proposes to pass on any excess revenue amounts (e.g. \$17,000 or \$91) in the following year. This approach ensures that the maximum prices for the pipeline match the efficient costs of the service in each year of the regulatory period.

This proposal also aligns with WaterNSW's request for IPART to implement an annual updates mechanism for the pipeline charges to account for changes in actual energy rates. See section 17.8 to 17.13 of WaterNSW's pricing proposal for more information. This mechanism would ensure that WaterNSW can pass on any operational efficiencies, as soon as possible, as reflected in a competitive market environment.

2.7.5 Question 34

Are WaterNSW's proposed prices for offtake customers reasonable?

As noted in our pricing proposal, WaterNSW consulted with landholders adjacent to the Silver City highway to determine the demand for offtakes along the pipeline. These consultations culminated in three landholders entering into a letter of intent to procure pipeline services from WaterNSW at a maximum IPART determined price of \$14,000 per annum (inclusive of an

³ This policy intent is also set out in the Pipeline Direction (i.e. to deliver low salinity raw water to Broken Hill).

assumed 10ML of variable water usage costs for the purposes of modelling a price). The voluntary nature of these agreements suggests that WaterNSW's proposed prices for offtake customers are reasonable.

2.7.6 Question 35

In particular, is WaterNSW's proposed annuity approach for recovering the incremental capital expenditure associated with offtakes reasonable? Are there other approaches we should consider? Should offtake customers contribute more to the fixed capacity costs of the Pipeline?

IPART has asked, in its Issues Paper, whether the annuities approach is consistent with its pricing principles. The benefits of WaterNSW's proposed annuities approach was discussed in section 10.4 of the pricing proposal. They include:

- the annuities approach produces the same fixed charge irrespective of the timing of the commissioning of each offtake asset. This charging level is consistent with the letter of intent entered into between the offtake customer and WaterNSW
- WaterNSW observed that the capital cost of additional offtakes will remain the same in real terms over the term (20 year) of the O&M agreement. Hence the annuities approach was considered better suited to pricing the capital allowances of a minor asset, such as an offtake, with a stable cost base for renewals
- the annuities approach produces an NPV neutral outcome for WaterNSW, while maintaining price stability for offtake customers via a flat fixed charge (as per the letter of intent).

For these reasons, WaterNSW considers the annuities approach to be both cost reflective and consistent with IPART's pricing principles in pricing the capital cost of the offtakes.

IPART has stated that WaterNSW has applied a WACC of 4.3% to calculate the annuity for offtake assets. WaterNSW would like to point that it has used a real **pre-tax** WACC of 5.28% which is consistent with the **post-tax** WACC of 4.3% quoted by IPART. This approach is set out explicitly in the formulas in page 56 of the WaterNSW pricing proposal. The WACC rate is also disclosed in the pricing model which accompanied the WaterNSW pricing proposal submitted to IPART.

WaterNSW has applied the pre-tax WACC to calculate the annuity in lieu of a regulatory tax allowance under the RAB approach. See footnote 28 of the WaterNSW submission. The approach of using a pre-tax WACC is consistent with the annuity payments which were incorporated in the meter service charge under the IPART 2017 Rural Valley Bulk Water Determination.

2.7.7 Question 36

Should we allow unregulated pricing agreements between WaterNSW and offtake customers? Why or why not?

As previously mentioned, three landholders entered into a letter of intent with WaterNSW to procure pipeline services from WaterNSW at a maximum IPART determined price of \$14,000 per annum (inclusive of an assumed 10ML of variable water charges). All of WaterNSW's consultations with the landholders was on the basis that IPART would set the final price. This was the expectation of the landholders and WaterNSW cautions against an assumption that the same outcome could have been achieved without landholders having comfort that IPART would review WaterNSW's proposed prices.

The letter of intent with the landholders will not bind the parties if IPART deems the service to be unregulated. These customers could back out of the service all together, triggering a write down event for WaterNSW up to value of the offtake assets in question.

WaterNSW is generally supportive of a pricing framework which promotes unregulated pricing agreements between 'sophisticated' parties, WaterNSW also supports the determination of an IPART regulated charge that could apply in the event that the parties do not agree to an unregulated pricing arrangement. A similar mechanism was approved by IPART in its Hunter Water and Sydney Water determinations for large customers.

2.7.8 Question 37

If we do allow unregulated pricing agreements should there be any restrictions on these agreements?

Unregulated pricing agreements are struck on a voluntary basis between the parties. As such, WaterNSW sees no benefit in adding restrictions on these agreements.