

23 April 2020

**Western Sydney Leadership Dialogue submission to
Independent Pricing and Regulatory Tribunal NSW
Review of Prices for Sydney Water from 1 July 2020
Draft Report**

Introduction

The Western Sydney Leadership Dialogue is pleased to present the following submission to the Independent Pricing and Regulatory Tribunal (IPART) Draft Determination ('Draft') regarding its ongoing Review of Prices for Sydney Water Corporation (SWC) from 1 July 2020.

Current Proposal and Draft

Differences between the SWC Proposal and the IPART Draft of interest to our submission are:

- SWC proposed that the pricing mechanism remained structurally unchanged, to include substantial fixed service charges, non-variable usage charges, and a Sydney Desalination Plant operational 'pass-on' levy. The Draft instead includes key structural changes, including a substantial reduction in fixed service charges, the introduction of partial 'scarcity' pricing ('normal' and 'drought' variation), and changes to the SDP operational pass on levy.
- SWC sought approximately \$5.5 billion in CAPEX and \$5.9 billion in OPEX. The Draft approves around \$4.55 CAPEX and \$5.4 billion OPEX.
- Key CAPEX reductions of interest are deferral of \$488 million for the proposed Prospect-Macarthur link, a net reduction of \$160 million for growth infrastructure in GWS, and significant expenditure cuts in EPA compliance, wastewater upgrade and maintenance measures.

Submission principles

We respond to the differences in the Proposal and the Draft with a regional focus on GWS, and the following principles in mind. These are imperatives which we would embrace in any case but submit that in the current disrupted and uncertain economic circumstances, doing so becomes essential.

- **Operational stability:** SWC's obligations under the Act entitle it to expect determinations which guarantee operational stability and certitude, especially regarding supply resilience and budget stress and shock buffering. This is of particular relevance to GWS in the coming determination period, which will be defined by recovery from deep economic shock.
- **Infrastructure planning certainty:** Servicing growth in water provision has long lead times. GWS was rapidly expanding prior to this health crisis and the economic pause it has

necessitated. The region's role in 'building us out of the shutdown' will now be vital. Infrastructure expansion must not be destabilized or decelerated.

- **Revenue prudence:** Prior revenue assumptions are now far less assured. The same applies to government, private sector and household fiscal metrics. The dominant instinct in budget management in a period of disruptive uncertainty must be prudence. There is a strong case for erring towards caution when weighing customer savings against revenue needs.
- **Budgeting flexibility:** Budgeting in a time of disruptive uncertainty also demands as much built-in flexibility as is viable. This is especially so given a determination period of four years.

General points

Some general points regarding the Draft are set out below.

Pricing mechanism changes: partial 'scarcity' pricing

- We acknowledge that the Draft sets out to provide more flexibility and responsiveness in the pricing model, as rainfall becomes more unpredictable. We endorse the ambition of giving customers more control over their water bills while safeguarding SWC's ability to re-invest revenue in infrastructure improvement and expansion. We have concerns about the Draft's ability to deliver both aspects across a four-year period of potential rainfall uncertainty, with revenue volatility now likely to be exacerbated by economic shock and recovery.
- We are particularly concerned about whether the partial 'scarcity pricing' embedded in the Draft will deliver those twin ambitions in a way that is not regressive, both in socioeconomic and regional terms. We think the proposed higher 'drought price' based on dam levels (an externality beyond all SWC customers' control) will struggle to avoid becoming, de-facto, unfair water restrictions applied regressively on the basis of household wealth.
- We observe that the existing mechanisms for influencing water use behaviour in times of supply shortage, namely the staged imposition of regulatory water restrictions in conjunction with consumer information campaigns, appeared to function very effectively during the recent supply squeeze. Water use per capita decreased at an appropriately quickening pace as the squeeze threatened to become a crisis. We note that regulatory water restrictions impose 'equality of outcome' on all SWC customers, regardless of wealth.
- We think the Draft's 'drought price' concept risks becoming regressive across SWC's customer base in three ways: 1) households with less budget headroom will be compelled to reduce their water consumption more than households with the capacity to absorb higher water prices 2) households in SWC's operating area where maintaining equivalent amenity already demands higher water consumption than in other areas will face an exacerbated regressive choice, i.e. between relatively even higher water bills or lower amenity; and 3) business customers whose normal commercial activities use more water than others will be disproportionately impacted.
- Those impacted in the manner of 1) and 2) are significantly over-represented in GWS. On average, SWC customers in GWS have less capacity to absorb higher water usage costs into

their household budgets. On average, in GWS urban heat island effect and relatively less public 'green and blue infrastructure' means that - household budget capacity being equal - maintaining equity of household amenity requires more water use than elsewhere. A shady green back yard and a filled swimming pool are – so we would argue – objectively 'more essential' for daily living amenity in a household far away from public recreational water and green parks, than they are in one five minutes' walk from public beaches and lush parks. Add to such a comparison the much higher temperatures now typical in GWS households, and we are concerned that the Draft's 'drought price' will, in periods of extended drought, exert a comparative 'amenity penalty' even more unfair than currently obtains.

- We also query the impact of partial scarcity pricing on commercial activities in GWS, noting our concern that SME's and sole traders may be disproportionately subject to regressive unintended consequences. The role of water in different 'non-residential' sub-sectors varies vastly. So does the degree of behavioral control commercial users have over usage. Some sectors and SME's can reduce it in response to 'drought pricing' and remain viable. Others may have no viable way of reducing usage (other than to shut down altogether). This variation also applies within sectors. Business A may be able to pass on higher water costs to consumers. Competitor B may realistically not. There is also the complicated water use calculus of downstream economic impact. Price signaling that reduces water use in one part of a supply chain may lead to increased wastage in others. As on households, the non-residential impact of scarcity pricing may not be evenly and fairly distributed to commercial customers - particularly those ineligible to seek unregulated pricing agreements with SWC.

Pricing mechanism changes: bills v. revenue v. investment

- Overall, we support pricing innovations that aim to keep household bills as low as is operationally viable for SWC. However, we are concerned that proposing to effect this by significantly reducing fixed water costs and seeking to compensate revenue loss via a differential pricing mechanism based on an unpredictable externality unnecessarily imperils the 'bill savings v. investment savings' cost-benefit balance. Bill shock arising from an unexpectedly high usage tariff can easily trigger consumption over-reduction. Subsequent revenue 'choke' can translate into reactive operating inefficiencies, maintenance corner-cutting, even investment starvation. Ultimately 'bill savings' can foster longer-term bill *pain* for customers. We accept in good faith the structural econometrics of the Draft but again note that the risk arising from the inherent uncertainties implicit in *any* pricing mechanism change is, in this instance, amplified by the current broader economic tumult.
- In general, we submit that the current crisis will further impact the econometrics of the Draft beyond the untried pricing mechanism, such as in cost of capital assumptions, fixed and variable tariff settings, depreciation, tax, cash contributions and Regulatory Asset Base values. The Draft's many technical moving parts are beyond our expertise, and we will default-support to any expressed IPART/SWC view that major audit/redraft is advisable.
- Similarly, we also regard it as responsible to recognise that the shut-down of large segments of the Sydney economy will be having an unpredictable impact on SWC revenue already, particularly in hospitality, retail, CBD and education sectors. Work from home imperatives

will meanwhile be multiplying typical residential usage and infrastructure pressures. The net impact on revenue and operational costs remains unknown but will surely be large.

Government revenue more generally will also be hit. Add in the crisis debt and deficits now being projected and the otherwise-admirable IPART choice to place reducing water bills at the heart of its 2020-24 SWC pricing determination may, in retrospect, seem untimely.

- Finally, we make the point that any pricing/revenue/investment misjudgement that does lead to investment starvation or budgetary stress, in what is now a pivotal determination period, will be felt most keenly in GWS, given that much of SWC's proposed CAPEX for growth focuses here. Even prior to economic shut-down, we regarded the region's expansion to be of importance to the wider Sydney and NSW economy, especially that relating to 'greenfield' residential growth and the Western Sydney Airport and Aerotropolis. Given current crisis and future recovery circumstances, any uncertainty imposed now on SWC's projected budgetary freedom to meet maximum growth demands in GWS over the next half decade will, we respectfully but forcefully submit, be economically adverse far beyond the region itself. In our view now is simply not the time to pare SWC's operational and investment capacity right down to the bone, and beyond.

CAPEX reductions

Expanding on this we note specific concern at the following reductions to SWC's CAPEX requests.

Prospect-Macarthur Link (deferral of \$488 million)

- Most notable is the deferral of the Prospect-Macarthur bi-directional link, proposed as a systemic optionality and resilience measure targeting SWC's most rainfall-vulnerable customers. The Draft's key justification for deferral is that the easing of drought conditions '*...allows time for a comprehensive drought response and long-term supply-demand plan to be developed*'. We understand the thinking behind the Draft's decision and given such a deferral we would strongly support – indeed, urgently advocate – exactly that concomitant outcome: the priority development and delivery of an equally robust and time-realistic alternative fix for the identified supply vulnerability. However, that this project is the largest component of SWC's growth CAPEX request appears (to us) to reflect SWC's recognition of the speed with which sustained 'zero rainfall events' can nowadays see critical dam levels being reached. '*Comprehensive drought responses and long-term supply-demand plans*' take time to develop. We presume that the link as proposed represents, at this determination period 'gateway', the optimum realisable solution SWC is in a position to seek support for, if it is to pre-empt that supply vulnerability over the whole determination period. We are concerned that in deferring this CAPEX component, IPART risks leaving SWC vulnerable to being unable to meet its obligations under the Act.
- We are strong advocates for a bold recalibration of our approach to our water resources and endorse the Draft's ambition for a '*comprehensive drought response and long-term supply-demand plan*' for Macarthur system resilience. Our preference, too, is for a Sydney water 'marketplace' incorporating every element of systemic resilience: sustainable social licenses and consumer habits; competitive participation; world-best design and operational efficiencies; minimal ocean outfall wastage; optimum integration of recycling, stormwater

harvesting and desalination; catchment and storage diversification; and maximum systemic balancing and optionality. Water resilience is anything but a 'zero sum game', and it seems logical to us that the proposed link would form part of any credible '*comprehensive drought response and long-term supply-demand plan*' for the region, anyway.

- While conceding the Draft's reasoning that fuller southern dams have eased the immediate urgency of the Macarthur-Prospect link we note how quickly they emptied when last, they did. It's not inconceivable that they could again be dangerously low even within the first year of the determination period.
- We also note that the proposed link would in any case play a key servicing role for anticipated new growth in south-western parts of GWS - a justification entirely separate to systemic resilience and balancing arguments, and independent of rainfall and dam levels.
- For these reasons we urge IPART to be confident of its reasoning for this CAPEX deferral. We also think it's reasonable to assume, should it be retained, that IPART has shouldered a fair burden of responsibility alongside SWC in ensuring plausible alternatives for Macarthur system resilience are deliverable on a similar timescale. SWC must be extended realistic opportunity to meet its obligations under the Act for 2020-24, regardless of rainfall.

Greenfield new growth infrastructure (net reduction approx. \$160 million)

Following on from this, we are concerned at the substantial net reduction for other growth infrastructure, much of it slated for GWS's greenfield sites. As noted earlier, public infrastructure projects, population growth and vast potential for investment in next-generation energy, utilities, manufacturing, agriculture, transport, IT, education and health industries, will make this region the engine room of post-crisis economic activity. Any limitation on private sector growth imposed by unnecessarily stunted public infrastructure investment will be a disastrous recovery 'own goal'.

- **Upper South Creek Treatment Plant (approx. \$80 million increase):** We welcome the Draft's upscaling of the CAPEX request for the Upper South Creek Treatment Plant, to better accommodate the rising cost of land acquisition. This is a perspicacious acknowledgment by IPART of its central importance to SWC's intentions for water service provision more broadly in GWS. As the project's concept has evolved it is positioning to serve as the infrastructure spearhead of a major shift towards integration, efficiency, resilience and localised 'circular models' of utility servicing. SWC has played a leading role in developing small and mid-scale water recycling projects in GWS, and in recent years has focussed its accumulated technical, planning and delivery expertise increasingly on its crystalizing obligations towards Western Sydney Airport and Aerotropolis precinct. The aspiration, in both residential and commercial provision, is for new best-practice benchmarks in sustainable water service provisioning. The Upper South Creek Treatment Plant has the potential to lead a disruptive shift not only into more recycling efficiency, but as a fully integrated utilities centrepiece within a truly sustainable Aerotropolis circular economy. We gratefully acknowledge IPART's recognition, with this CAPEX increase, that this specific project is a potential 'climate change disruptor' and 'sustainable economy multiplier' for the future residents of GWS's greenfield sites.

- General new growth (approx. \$236 million decrease):** For precisely the same reason, however, we query the hefty *reduction* in CAPEX projection for other new growth infrastructure - since by far most of this is also intended for greenfield areas associated with the Upper South Creek project. SWC's 'general growth' CAPEX anticipated similar rates of new connection here as occurred over the previous determination period. In electing to reduce the allowance sought, apparently by basing per unit new connection costs likewise on the previous period, IPART may have failed to take into account the significantly higher per-unit costs SWC will now face. New connection growth in established infill areas – such as Canterbury-Bankstown and Parramatta, which have seen among the highest rates of population growth in GWS in the last five years – is markedly less costly than in the undeveloped areas of Liverpool, Penrith, Camden, Campbelltown and Wollondilly LGA's where the Airport/Aerotropolis expansion will demand SWC's general growth expenditure be focussed. The risk in increasing CAPEX for the project at the 'green heart' of the new Aerotropolis 'green corridor', while cutting thrice that increase from what's needed for the surrounding associated growth, is a counter-productive distribution of budget stresses and cost 'crimping' across *all* new growth over the entire determination period. Given the vastly changed external circumstances, stripping growth margins beyond the bone will at the very least impose cascading budgetary pressures elsewhere, such as on dividends and cash flow.
- For these reasons we welcome IPART seeking, as the Draft notes, more granular information from SWC. Being familiar with the significant variation in 'the cost of doing the same business' in different parts of GWS, we're confident SWC will provide a compelling case for IPART revisiting this net reduction.

Maintenance and environmental (reduction of approx. \$300 million)

Finally, there are CAPEX reductions in areas in which SWC in fact faces *increased* challenges in meeting efficiency, wastewater, wet weather and maintenance benchmarks, as a result of the prolonged impact of drought and dry ground on its assets.

- \$30 million reduction in wastewater assets maintenance (includes mitigation of 'sewer choke' issues significantly increased by drought).
- \$133 million reduction in sewer capital works (as above).
- \$40 million reduction to new EPA wet weather overflow compliance forecast (as above).

Since SWC places high priority on compliance with Environmental Protection Licences it will, given these reductions, almost certainly overspend the Draft's nominal allowances in these areas over the determination period - particularly (as is likely) in the event of sustained drought. Once again noting the wider economic circumstances, and in the context of other reductions, we suggest there is a prudent case for revisiting at some of these reductions, to reduce any need to do so and so avoid the risk of yet more budgetary pressures being distributed counter-productively elsewhere.

Concluding remarks

We are grateful for this opportunity to respond in considered good faith to IPART's Draft Determination for SWC Pricing in the period 2020-24. We are confident that regardless of the final

Determination, SWC will never fail to provide water and wastewater services to every customer in its operating area IAW its obligations under the Act.

However, we are concerned that the accumulated reductions in the Draft as it stands, particularly in requested growth CAPEX for our primary region of interest, impose a significant risk that SWC's finances in the 2020-24 period will become unsustainably stretched. We are concerned that this will result in distracting operational budget stresses, debilitating limitations on strategic infrastructure investment at a particularly pivotal moment in the region's economic evolution, and no spare capacity for SWC to respond coherently and independently to future external contingency or shock.

We would note these concerns even at an unremarkable economic juncture but submit that current circumstances legitimately amplify their urgency considerably. The reality is that we are entering a period of unprecedented economic instability, in which all established assumptions should be re-assessed, and every budgetary contingency pondered. However much we applaud the Draft's embrace of bold pricing innovation in pursuit of the ambitious goals of water use behavioral shift, lower household bills and record levels of strategic infrastructure investment, we respectfully ask whether this is really still the ideal moment to be seeking to juggle them all at once, and largely on the strength of an untested new revenue mechanism.

Naturally we would be happy to discuss this submission further, at your convenience.

With thanks and kind regards,



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Director