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22 July 2011

Mr James Cox  
Chief Executive Officer and Full Time Member  
Independent Pricing and Regulatory Tribunal of NSW  
PO Box Q290  
QUEEN VICTORIA BUILDING NSW 1230

(Submitted by email to [ipart@ipart.nsw.gov.au](mailto:ipart@ipart.nsw.gov.au))

Dear Mr Cox

### **Sydney Desalination Plant Pty Limited Price Determination 2011**

The Sydney Catchment Authority (SCA) welcomes the opportunity to provide input to the review of prices for the Sydney Desalination Plant Pty Ltd (SDP). The supply of bulk water in Sydney is the primary business of the SCA. SDP Ltd, although a declared monopoly supplier for desalinated water, in concert with the SCA's raw water supply, makes up the total water supply for Sydney.

In order to support sustainable service through efficient asset investment, it is essential that the risk of underinvestment is mitigated by providing bulk water businesses the confidence that their efficient cost will be recovered. One key aspect for achieving this is that bulk water suppliers are treated on a competitively neutral basis. That is, no bulk water supplier faces market rules that either prevent them from including efficient costs in their required revenue, or lose sales to a competitor for reasons other than allocative efficiency. In this context, the SCA is providing the attached submission on some key issues around these elements in relation to the SDP Price Determination.

I have also attached a letter that the SCA sent to IPART in June 2010 in response to Sydney Water's application on behalf of the SDP for a network and retail licence under the Water Industry Competition Act. The SCA considers the issues raised in this letter are pertinent to this review and urges IPART to consider them as part of SDP's Price Determination.

Should you wish to discuss these matters in further detail, please do not hesitate to contact me on

Yours sincerely

Michael Bullen  
**Chief Executive**

**Sydney Catchment Authority**  
**Submission to IPART's Review of Prices for Sydney Desalination Plant Pty Ltd.**

**WACC**

The SCA recognises that SDP has certain risks that are specific to its business in producing desalinated water. However, the SDP's business specific risks are low as a large portion of its costs are covered irrespective of water sales. Further, it would be the SCA's view that a majority of risks listed by SDP in Chapter 4 of its submission are operational risks that can be wholly or mostly mitigated by management action or by insurance, and therefore should already be included in its proposed efficient operational costs.

**Stakeholder's views of SDP's fixed costs not classified as allowance for return on assets, allowance for return of assets or fixed operating costs**

IPART should ensure that SDP's Interest During Construction is offset by any tax benefit that it received.

**Allocating fixed and variable cost**

The SCA argues that the cost of Renewal Energy Certificates (RECs) should be classified as variable cost. While SDP is contracted to purchase a fixed minimum amount of RECs at a fixed real price, the final amount of RECs required is ultimately dependent on the total energy used, which in turn is determined by the volume of water produced.

**Payment of SDP charges by other retail customers**

The SCA supports SDP's proposal that new retailers should pay for SDP's charges (both fixed and variable) in proportion to their share of the metropolitan demand. IPART should ensure that the same arrangement is applied to customers who are not retailers or 'small retail customers' but elect to take supply directly from SDP. Arrangements between SDP and direct connection customers where they pay proportionally lower charges would result in Sydney Water (and other retailers) bearing a higher cost for the alternate water supply in Sydney.

**Who should bear the cost of renewal energy certificates?**

The SCA supports SDP's position that the cost of RECs should be included in its charges and that the cost of RECs is a legitimate cost in providing an alternate source of water supply in Sydney Water's operation area and such cost should not be borne by tax payers in general. If tax payers were to subsidise the cost of RECs, it would be a breach of the competitive neutrality principles. The SCA argues that based on allocative efficiency, the cost of green power should be reflected in the volumetric component of SDP's price.



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Ref: D2010/02193

Mr James Cox  
Acting Chairman and Chief Executive Officer  
Independent Pricing and Regulatory Tribunal of NSW  
PO Box Q290  
QUEEN VICTORIA BUILDING NSW 1230

Dear Mr Cox

I am writing regarding Sydney Water's application on behalf of Sydney Desalination Plant (SDP) for a network licence and retail licence under the Water Industry Competition Act (WICA), for the desalination plant.

Under the existing institutional arrangements the SCA is currently the only supplier of raw water. The SCA is committed to delivering an uninterrupted supply of the best quality raw water. The SCA strives to achieve this at the lowest sustainable price whilst also meeting its obligation to generate a commercial return to government. The SCA is keen to ensure that its current and future infrastructure is fully utilised given the community's investment in it.

The SCA acknowledges that the desalination plant is an important initiative under the Metropolitan Water Plan. It diversifies water supply sources by providing non-rainfall dependent volumes of water and additional security of supply. The introduction of the desalination plant however, has the potential to substantially impact on the SCA's operations and financial position and the SCA is seeking consideration of the issues in the attached submission in light of this potential impact. Should there be a future expansion of the plant there will need to be a further review of the impacts on the sector to assess whether this would trigger any changes to structural or institutional arrangements.

I would appreciate the opportunity to discuss these matters with you. Please contact me on \_\_\_\_\_ if you wish to explore them further.

Yours sincerely



**MICHAEL BULLEN**  
**Chief Executive**

## **SCA comments**

The SCA provides a secure high quality water supply to the people of Sydney from its catchments and dams. At all times, the SCA endeavours to achieve this at the lowest possible cost to customers whilst generating an appropriate return to government. The SCA's response to Sydney Water's application on behalf of Sydney Desalination Plant (SDP) for a network licence and retail licence under the Water Industry Competition Act (WICA), for the desalination plant, is based on the same principles.

The application by Sydney Water for a network licence and retail licence for SDP raises a number of issues regarding Sydney's water supply that need to be considered as part of the licence approval process. If, in the future, there is an expansion of the current plant, there may need to be a full review of the matters discussed below.

### **1. Financial viability**

The SCA is well placed to continue to provide its essential services to Sydney, with the approach taken by the SCA in its most recent pricing review of managing its costs and revenues in this new environment. Nevertheless, appropriate pricing (and supply arrangements as detailed below) will be needed if the SCA is to remain financially viable and operate efficiently over the longer term.

The SCA is dependent on Sydney Water taking its notified annual quantity of raw water over the price determination period. The SCA's concern is that its financial position not be jeopardised by variations to those quantities.

Overestimation of future demand in pricing determinations can lead to substantial adverse impacts on the SCA's financial outcomes. Currently, the base demand in Sydney is around 500GL per annum. The desalination plant is capable of producing 90 GL per annum. In order to manage the SCA's exposure to the high level of variability in Sydney Water's demand and consequent revenue reductions that could result from access to this alternative water service, careful consideration must be given to suitable tariff structures. One way to address the revenue variability would be to increase the fixed component of bulk water prices. Another way is to introduce a take or pay element to the tariff structure whereby there is a sharing of the risk associated with demand estimation.

Accordingly, it may be necessary to re-open or re-assess the current price determination which runs until June 2012. Structurally, the supply arrangements between the SCA and Sydney Water may change in some manner as a result of the application. This may trigger a re-evaluation of the Sydney Water and the SCA's price determinations. It may also be desirable to align the pricing determinations of Sydney Water, the SDP and the SCA.

### **2. Metropolitan Water Plan**

Modelling indicates that Sydney's water supply needs can be met in the short and medium term. For the longer term, the Metropolitan Water Plan uses an adaptive process for achieving a secure water supply. The operating rules developed as part of

the Metropolitan Water Plan demonstrate how desalination water could best be used to complement surface water supplies. That is, to provide additional supply without causing the dams to unnecessarily spill over time.

The Metropolitan Water Plan suggests that the desalination plant should be switched on when water supply levels in the SCA's dams fall to 70% full, and should be switched off when supply levels rise back up to 80%. It should, however, be pointed out that this is a broad guideline to be achieved on average over the longer term.

The actual day to day operating rules for the desalination plant will be guided by this approach, but in practice, to balance supply and demand they will need to be far more sophisticated and take in to account operational factors such as the start-up and shut-down (or ramp-up and ramp-down) response times of the plant. It is understood that these times can take some months. Also, there may be opportunities to access greater volumes of desalinated water, say, ahead of a predicted hot dry summer.

### **3. Balancing supply and demand - transparency**

It follows that for this to be implemented is essential to correctly capture the supply/demand balance information, especially in the event of SDP selling water to third party customers. Thus, there needs to be complete transparency of demand volumes and supply arrangements. Transparency will help to ensure efficient operation of the water supply system and engender appropriate short and long term planning so that the community's investment in costly water supply assets are efficient, and the assets are fully utilised (ie there is no stranding of assets).

### **4. Supply arrangements and co-ordination**

From the application it would appear that the primary Water Supply Agreement will be between Sydney Water and the Sydney Desalination Plant (SDP) with no direct relationship between the SCA and SDP. The application refers to circumstances where SDP may not be able to provide continuity of supply and outlines that an agreement will be necessary between SDP and Sydney Water to underwrite supply. In practice surface water from the dams would be used to underwrite and supply the shortfall. It is essential for the SCA to be a party to such arrangements and its obligations in order to plan its operations.

Given the planning and operational considerations highlighted above, the SCA considers it imperative that there should be close direct co-ordination between the SCA and the SDP.

It is important that contractual arrangements be made between the appropriate counter parties. Given that SDP will be able to make future supplies available to third parties, and will be backed up by supplies from the SCA it is imperative that the SCA be a party to SDP's underlying water supply agreements and pricing of supplies. Thus it may be appropriate that the supply contract and the water security deed, be between the SDP and SCA rather than with Sydney Water as currently envisaged.

## **5. Dispatch**

To minimise the cost of water to customers it is imperative that Sydney's water supply balances the cost of water with the security of supply. Therefore, raw water for Sydney should be sourced so that supply/demand outcomes are optimised. This is analogous with the dispatch order of generators in the supply of electricity, whereby progressively more expensive sources of electricity are dispatched starting with the base load sources first. This will require careful consideration in future pricing outcomes, in conjunction with the operating rules as discussed above.

The above issues highlight the need for integrated planning of the wholesale supply. How these arrangements can provide enhanced opportunity in the future to open up a competitive retail market for consumers and greater certainty to the wholesale suppliers regarding their security of supply, demands and operations, are important considerations for IPART.