



Colin Reid



Mr James Cox
Chief Executive Officer and
Full Time Member
Independent Pricing and Regulatory Tribunal of NSW
Level 8, 1 Market Street
SYDNEY NSW 2000

Dear Mr Cox Jim

Thank you for the opportunity to comment on the Independent Pricing and Regulatory Tribunal's (IPART) Review of prices for the Sydney Catchment Authority (SCA) - Draft determination and report. Sydney Water has particularly focussed its comments on three aspects of the draft determination:

- 1. the under-recovery of SCA's costs
2. the proposal for wholesale scarcity pricing based on dam levels
3. the pass-through mechanism from SCA prices to Sydney Water prices.

For prices to take effect from 1 July 2009, advertisements will need to be placed in major newspapers as required in Sydney Water's Customer Contract, no later than 24 June. For this to happen, Sydney Water needs final price adjustments by 15 June. If this timeframe is unachievable, IPART should advise how it proposes to pass through these costs. Sydney Water should not face a revenue loss as a result of the timing of IPART's determination.

1. Under-recovery on costs

In the draft determination, IPART has set prices to under-recover on SCA's efficient costs by around \$23 million over 2009-10 and 2010-11. The majority of this under-recovery (\$14.6 million) occurs in 2009-10 when SCA's operating costs are higher due to the \$17 million contribution to the Accelerated Sewerage Program.

As a regulatory principle, Sydney Water does not support IPART setting prices to recover less than efficiently determined costs. IPART should set prices so that the present value of expected revenues equals the expected value of efficient costs.

The revenue shortfall directly reduces SCA's returns and shareholder value. In particular, SCA may need to write down the value of its assets because prices are set below that necessary to support the cost of capital.

IPART has acknowledged that under the draft determination household water bills will increase by a relatively small amount. The price increases necessary for full cost recovery are also small. The decision by IPART to under-price services directly reduces the value of SCA while providing only minor price reductions across the 4.5 million people in the greater Sydney area.

2. Pricing that depends on dam levels

IPART seeks stakeholder views on a scarcity pricing regime to be introduced at the 2012 SCA determination. IPART is considering whether or not to vary SCA's prices, charged to Sydney Water, with dam levels. Under this approach bulk water customers, mainly Sydney Water, would pay a higher price for SCA water when dam levels are low and vice versa. The regime would only apply to wholesale prices, meaning Sydney Water would not pass through the cost variations to its customers.

The introduction of new water sources through recycling and desalination, and the potential entry of new players, may make it worthwhile to investigate the scope to develop a market for bulk water. Efficient bulk water pricing may be a step in this direction.

Regarding possible scarcity pricing, it is important to recognise that work done since 2004 on recycling, desalination and water efficiency means that Sydney does not currently have a scarcity of water and there are substantial potential new supply sources to address any future scarcity. Desalination will be on line in 2009-10 providing 15% of supply if needed. Recycling volumes will be about 12% of supply by 2015 and water efficiency measures save about 24% of supply without drought restrictions. Additional supply if needed is also readily available from an extension of the desalination plant, and piping to enable more Shoalhaven transfers.

If the price of water is set at its appropriate long run marginal cost then additional supply should be financially viable and should be implemented to the extent required to address any scarcity. In these circumstances, it is not clear what wholesale scarcity pricing is intended to achieve and nor is it clear why it is needed.

The current Metropolitan Water Plan review is considering the most efficient combination of sources to meet the needs of Sydney, the Blue Mountains and the Illawarra, both within and out of drought. As part of this it will determine the most appropriate regime of Shoalhaven transfers, desalination operating rules and environmental flows. Any approach to price dam water depending on dam levels will need to complement this process.

IPART's proposal also has an interaction with Sydney Water's Operating Licence. Any scarcity pricing regime would necessitate substantial changes to the Operating Licence. This would need to be completed before the next term of the Operating Licence, from 1 July 2010 to 2015. It may be ambitious to amend the Operating Licence to take proper account of scarcity pricing by 1 July 2010.

3. SCA pass-through mechanism

A pass-through mechanism was incorporated into Sydney Water's 2008 Determination. The pass-through mechanism was designed to increase Sydney Water's water service charge to capture any increase in SCA's fixed and variable charges that were not captured in Sydney Water's 2008 Determination. This mechanism was required because Sydney Water's

determination was one year ahead of schedule, resulting in Sydney Water's and SCA's price paths being one year out of step.

The pass-through mechanism compares the bulk water purchase costs incorporated into the 2008 Determination with the bulk water purchase costs resulting from SCA's revised prices and revised bulk water purchase forecasts. The aggregate resulting difference is then allocated on an equivalent meter basis. That is, the increase to be applied to each meter size is calculated.

Sydney Water considers the pass-through mechanism to be appropriate. Achieving full pass-through of increased SCA costs depends on the accuracy of the parameters used to calculate the pass through. In particular, IPART has prescribed the 20mm meter equivalent estimate in the 2008 Determination, and the revised demand profile in the SCA draft determination. These variables are out of Sydney Water's control. Sydney Water considers these variables should be re-estimated each year prior to calculating the SCA pass-through to ensure the appropriate amount is passed through to Sydney Water's prices.

We would be happy to work with IPART on these technical issues to ensure the full pass-through of additional costs.

Yours sincerely



Kerry Schott
Managing Director

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