9 December 2024

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Dear Tribunal Members

Prices for WaterNSW regional and rural bulk water from 1 July 2025 – Issues Paper – 1 November 2024

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts across eastern Australia. We also own, operate and contract a diversified energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 5,000MW of generation capacity.

We appreciate the opportunity to provide feedback on WaterNSW's proposed pricing from 1 July 2025.

Across all of its customers, WaterNSW proposes bill increases of up to 37% per year, in real terms. The magnitude of these changes is significant and driven mostly by capital related costs, with WaterNSW increasing its combined asset value from $3.65 billion currently to $5.05 billion by 2030 (in real $2024-25 dollar terms). This step increase is unusual in the context of managing very long-lived assets that should have predictable condition, risk and other cost drivers. The investment profile outlined in WaterNSW's long-term capital plan raises the prospects of further price shocks beyond 2030. Other drivers for the proposed price increases include material increases in operating expenditure (opex) and higher depreciation, as WaterNSW proposes to introduce specific cost recovery for its shorter-lived assets.

Prices for the Fish River Scheme, where EnergyAustralia is a customer, would increase by between 44% to 89% in real terms by 2030, or 8% to 14% per year for the next five years. EnergyAustralia currently contributes around half of WaterNSW's revenues in relation to Fish River, amounting to $5.2 million in the current financial year. Our 2030 bill would be in the order of $9 million or an increase of 73%, in nominal terms i.e. what we would actually pay.

Customers have already given direct feedback that these price increases are unaffordable. WaterNSW has proposed alternative scenarios including where bulk water price increases are capped at 15% per year. We consider these increases would still be

unaffordable and have negative impacts on affected communities and dependent industries. A 15% limit on real price changes would also not curb the increases proposed for Fish River customers. The use of price caps generally would further shift costs onto taxpayers, who do not seem to have a voice in this consultation process. Doing so may also create a sense of complacency on WaterNSW and the Tribunal about the importance of ensuring approved cost and revenue allowances are as low as possible. Strong incentives should also apply to WaterNSW to seek out cost efficiencies on an ongoing basis.

The pricing proposal has not been sufficiently justified

We expected WaterNSW to have furnished the Tribunal and customers with strong and detailed justifications, commensurate with the very large price increases it has proposed. In our view, this is not the case and is a major concern. The proposal and associated attachments only provide very high-level explanations of cost drivers and how WaterNSW has prepared its proposal.

For example, WaterNSW proposes $2.2 billion in capital expenditure (capex), which is 2.6 times the $831.4 million it has spent in the previous pricing period. The bulk of this will be on infrastructure investment, which is the subject of a 61 page attachment. This document describes WaterNSW's governance processes, general cost drivers and categories of its expenditure. Data on these drivers and how they are changing over time are not presented, for example, measures of asset condition, risk and service quality, and how these are presumably not in line with existing or new compliance obligations. Almost half of the proposed spending is attributable to Warragamba Dam Resilience ($609 million) and E-flows ($302 million). These and other large projects should have been the subject of their own dedicated appendices, including independent assurance reviews. We have similar views on the extent to which WaterNSW justifies its proposed opex, which would increase by 25% on an annual average basis in real terms. For example, there should be more detailed justifications on the selection of its base year, and why various additions to this amount reflect necessary or new activities.

We understand that the Tribunal and its expert consultant will now engage in further information requests with WaterNSW on its expenditure proposals. However from a stakeholder perspective, we cannot provide meaningful feedback. Question 19 of the Tribunal's issues paper asks whether the proposal represents a reasonable and efficient balance of costs and service levels. Based on the information before us, we do not consider the significant increases in bills reflect value for money, nor understand why they are necessary.

Also reflecting this limited starting basis of information, there is a very high risk that the Tribunal will be unable to reasonably scrutinise the proposal. The Tribunal indicates it will issue a draft determination by March, leaving it approximately 3 months from now to mobilise resources (including its consultant and from WaterNSW) to request, receive and analyse further detailed information. The intervening summer holiday period places further time pressures on this process.

The Tribunal's decision-making framework should not default to accepting WaterNSW's proposal in the absence of proper justification. The burden of proof should rest with WaterNSW, given it has superior knowledge of its operating environment and costs. This information asymmetry and the associated incentive to submit insufficient data with regulatory proposals has been corrected in other regulatory regimes. For example, under chapters 6 and 6A of the National Electricity Rules, the AER is required to conduct a

preliminary examination of regulatory proposals and if found deficient, regulated entities must resubmit them with sufficient additional supporting information.

The lack of supporting information also applies to how cost drivers have translated into specific price increases for different valleys and customers. We raised these issues in the last price review. We again request the Tribunal to itself release, or compel WaterNSW to prepare, detailed modelling which illustrates how specific costs for each valley are changing over time and how these translate into price increases. This would include, for example, how the beneficiaries of major projects now contributing to large price increases have been identified. The Tribunal has not published WaterNSW's revenue modelling (i.e. Appendix 6) which assesses alternative pricing scenarios. Customers need visibility of this information to understand their own price outcomes, and to answer questions 22 and 23 in the Tribunal's issues paper.

WaterNSW's approach to volume risk and cost recovery

We have raised concerns with WaterNSW and Tribunal staff that much of our water entitlement is unutilised and we therefore derive limited benefits in return for $5 million per year in charges. As the Tribunal might expect, the prospect of now paying up to $9 million by 2030 for a mostly unused water entitlement has elevated our concerns.

We appreciate WaterNSW's comments that its costs are 90 to 95% fixed in nature[1] and this is reflected in its cost allocation and pricing approach. However this is not consistent across all valleys, with some instances of variable cost recovery as high as 40%. In discussions with WaterNSW, it noted these outcomes to some extent reflect customer preferences in different valleys. Yet when we and other Fish River customers have expressed a preference for higher variable cost recovery, this has not been adopted. We have also pointed out to WaterNSW and the Tribunal that the current pricing structure (which is proposed to be retained) also encourages inefficient use of water resources. We appreciate that shifting more costs into variable charging would create a revenue adequacy issue for WaterNSW but question why this is also not the case across all of its pricing regions, and how inconsistencies have arisen under Tribunal's regulatory framework. The Tribunal needs to closely scrutinise instances where WaterNSW says it has developed its proposal in direct reflection of customer feedback, and others where it has applied its own judgement using principles of revenue adequacy, affordability etc.

In meetings with WaterNSW, we and other customers sought to explore solutions involving short term temporary water trades to other parties, who would actually draw down water rights. This would potentially alleviate WaterNSW's volume risk, as well as release critical water resources for customers and communities in need. Depending on how prices are structured, this could also increase WaterNSW's revenue base and thereby lower charges for other customers. We encourage the Tribunal to help us and others explore the viability of this. Notably, in the context of Mt Piper Power Station's ongoing operation and contribution to reliability in the national electricity market, we are engaging with various stakeholders on our water management issues, while also seeking to move to more flexible operation to meet EnergyAustralia's emission reduction commitments. Mt Piper's role is discussed further in our latest Climate Action Transition Plan.[2]

[1] WaterNSW, *Pricing Proposal to the NSW Independent Pricing and Regulatory Tribunal*, 30 September 2024, pp. 102-3.
[2] Climate Transition Action Plan.pdf

Should a major customer exit the Fish River Scheme, it would push a very large revenue recovery burden (50% of total scheme revenues, in the event we exited) onto remaining customers, many of which would be unable to bear. We understand WaterNSW has presented these pricing scenarios to the NSW Government. Steps to address this type of scenario should be taken now, principally the alignment of costs incurred by each major customer to the charges they face. Our assessment of WaterNSW's scenario modelling is that there is a material misalignment between costs and charges in our case, i.e. EnergyAustralia is being materially overcharged while the reverse is true for other major users. This would be apparent where sufficient detail on cost allocation and drivers is published, but as noted above, this has not been the case and we urge the Tribunal to act on this.

More generally, the Tribunal should seek to validate the extent to which the proposed price increases would force already financially exposed users out of business, leaving remaining customers to fund the fixed cost of water infrastructure, potentially forcing further exits. Sustained real price increases in water charges of up to 37% per year will almost certainly affect the viability of marginal irrigators and their ability to withstand years of below average profitability. We note that Deliotte's analysis on affordability (attachment 30) relies on pricing scenarios with assumed fixed and variable allocations, rather than WaterNSW's actual pricing structures, further underlining our point on the lack of transparency on whether WaterNSW's prices are cost reflective.

Further detailed comments on WaterNSW's proposal are attached.

If you would like to discuss this submission, please contact me on [redacted]

Regards

Lawrence Irlam
Regulatory Affairs Leader

Proposed operating expenditure

WaterNSW adopts a 'base-step-trend' approach for its opex proposal. This relies on an effective incentive regime such that historic expenditure "reveals" efficient cost.

The profile of WaterNSW's historic opex illustrates an overall overspend relative to its allowance. Most of this overspend is estimated for the current year (2024-25), at $52 million or 27% above IPART's allowance, which is substantial. WaterNSW does not explain this variance.

WaterNSW has generally not explained why any of its historic expenditure should be regarded as efficient. It has not been subject to an Efficiency Benefit Sharing Scheme (EBSS) and is proposing this scheme does not apply for the forthcoming period. The Tribunal should carefully consider how WaterNSW has behaved in the absence of an EBSS. Without it, it is not clear to us whether a 'base-step-trend' is a valid approach and it may be more appropriate to adopt a 'bottom up' assessment approach. WaterNSW appears to, in part, rely on bottom up forecasts.[3] However there is now limited opportunity to conduct this type of assessment given the Tribunal's timing constraints and the lack of necessary data submitted with WaterNSW's proposal.

Under its base-step-trend approach, WaterNSW has not substantiated why 2022-23 is an appropriate base year. Spending in this year is the highest of the three it could have chosen from (i.e. $215 million, compared to $200 million and $186 million in 2021-22 and 2023-24 respectively).[4]

WaterNSW makes several adjustments to reduce its 2022-23 value down to $201 million. It states it has excluded costs associated with the Wentworth to Broken Hill Pipeline, MDBA, Unregulated Weirs and non-core (core plus) projects.[5] We were not able to find any descriptions of these projects or the nature of their costs.

WaterNSW then makes a series of further adjustments which add back $33.6 million. Various factors that add to cost are described however it is not clear whether these are uncontrollable or else if WaterNSW has attempted to minimise costs. For example, its software contract with Microsoft was renewed at a 50% ($2 million per year) increase but no process to scrutinise this or seek alternative suppliers is described.[6] Generally there is little evidence of WaterNSW seeking competitive tenders, or validating its costs via its own benchmarking or external review. In the two instances where benchmarking is mentioned, WaterNSW refers to (but does not reference) a NSW Government benchmark for digital costs, and a government-managed process for insurance costs.[7] In the case of Land Tax, WaterNSW refers to analysis from JLL[8] however this was not published with its proposal.

WaterNSW's descriptions of its base year adjustments appear to include instances of 'scope' changes as well as 'price' items like labour costs. Land tax is counted as both a base year and a trend adjustment. The nature of digital costs and its proposed value

[3] WaterNSW, *Attachment 8: Base-Trend-Step operating expenditure*, p. 7.
[4] ibid.
[5] ibid. p. 9.
[6] ibid. p. 11.
[7] ibid. p. 18.
[8] ibid.

does not appear to reflect a typical trend opex item. The Tribunal should obtain detailed breakdowns of these items and ensure there are no inconsistencies in how WaterNSW separately applies adjustments for step and trend factors in deriving its overall opex allowance.

A major factor affecting WaterNSW's proposed opex allowance is its 'new operating model' which it says will add $24.7 million relative to base year costs. The description of these costs refers to organisational restructuring, changes to governance and other processes. It is not clear why these changes and costs are justified, for example, what would occur in their absence, or if looking historically, how organisational performance and customer outcomes have suffered under the previous operational model. Some of these costs reflect scope changes e.g. obligations under the Security of Critical Infrastructure Act and communications functions under IPART's 3Cs framework. WaterNSW engaged an advisory firm (Partners in Performance) in developing its operating model[9] however this analysis has not been submitted with its proposal. Elsewhere, WaterNSW states it has been able to achieve $19.7 million in opex savings via its revised operating model over the past two years.[10] It is difficult to understand the need for increased spending (or indeed any adjustments) on a forecast basis as presumably the net effect of its operating model is already reflected in its base year 2022-23 opex. Overall, this $24.7 million base year adjustment, equating to around 10% of its proposed allowance, has not been justified and should not be accepted by the Tribunal. The presence of this item, in addition to the large number of other base year adjustments (both positive and negative), warrants a bottom-up assessment of the entire opex allowance.

Proposed capital expenditure

WaterNSW's historic capex profile reflects a very significant ($128.6 million) underspend relative to IPART's allowance in 2021-22 for the Rural Valleys.[11] Actual capex for greater Sydney was within 1% of IPARTs allowance.[12] WaterNSW notes that actual spending overall was materially reduced because large projects were cancelled or deferred.[13] This includes:

- $103.3 million saving for three large Rural Valleys projects that were transferred to WaterNSW, then cancelled (Mole River Dam, Wyangala Dam Wall Raising and Dungowan Dam)
- Warragamba Dam Raising being cancelled by the NSW Government and Warragamba E-Flow now being delivered as a separate (deferred) project. This resulted in capex savings of $90.3 million
- Sydney Drought response was cancelled due to wetter weather conditions and recovering storage volumes
- several unnamed projects being delayed due to bushfires, flood events, and COVID-19, resulting in capex savings of $85.9 million (greater Sydney) and $21.8 million Rural Valleys).

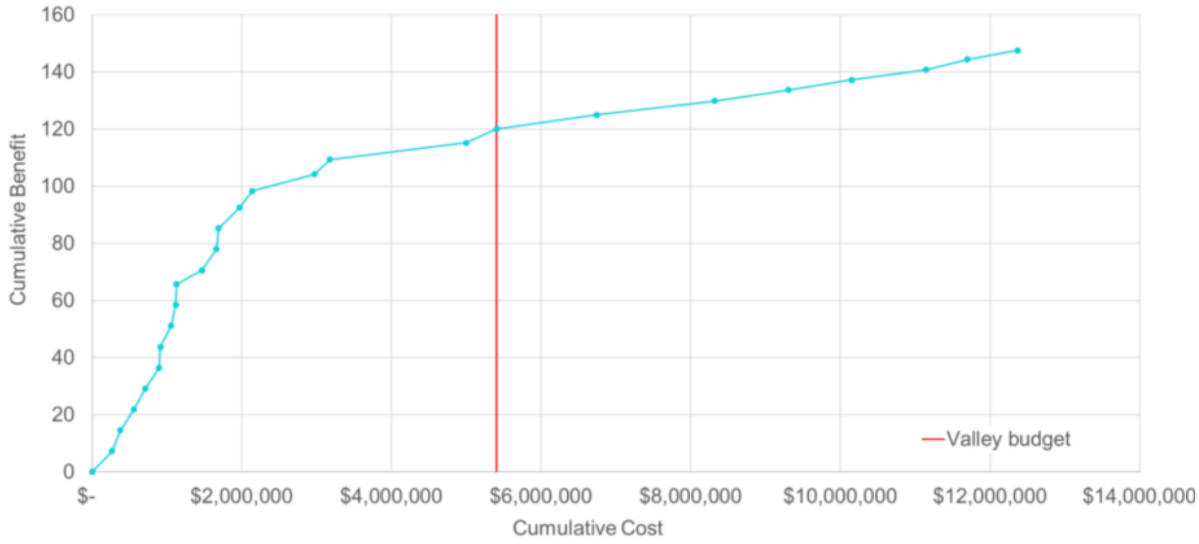
[9] ibid. p. 11.
[10] *Attachment 9: Efficiency program*, p. 4.
[11] *Pricing Proposal*, figure 14.
[12] *Pricing Proposal*, figure 13.
[13] *Attachment 6: Capital expenditure*, pp. 11-12.

These capex savings appear to reflect a windfall gain to WaterNSW, that is, they seem to be in response to external events, rather than a result of its efforts to optimise or reprioritise spending. If so, the associated excess revenues paid for by customers (in terms of depreciation and returns on capital) should be refunded as a 'true up' in the forthcoming period. WaterNSW's forecast capex is again dominated by several very large projects and the associated likelihood of further windfall gains (or losses) should be factored into any incentive regime on a prospective basis, noting that WaterNSW does not propose to apply a capital expenditure sharing scheme.

As mentioned in our overview, we consider WaterNSW's capex proposal generally to be inadequately justified. We expect it to have submitted rigorous cost benefit assessment to the Tribunal and placed these in the public domain for wider scrutiny. WaterNSW presents the chart below as an example of how it developed its proposal. This chart reflects the only quantitative cost benefit assessment that we could find for its proposed $2.2 billion of capex (assuming it reflects 'real' numbers for the Border Valley and not numbers for illustrative purposes). In presenting this chart, WaterNSW describes its general approach:

- it developed a full list of potential capex projects for each valley with associated costs for each
- projects were assigned some value of expected benefit (in this case, avoided risk, however the dimension of this is not explained)
- projects were then ranked according to a cost benefit ratio
- WaterNSW imposed a 'budget' (the vertical red line) reflecting several factors, namely long-term capex modelling, customer feedback, bill impact modelling and whether any risk associated with deferred projects can be managed by its operations function.[14]

Figure 4 – Border cumulative cost versus cumulative benefit (avoided risk)



[14] *Attachment 18: Capital expenditure for infrastructure*, p. 12.

We assume further information is being retained by WaterNSW and will be requested by the Tribunal. However as part of its published proposal, we expected to see this actual chart for all valleys, alongside a range of supporting information and further analysis, including:

- benefits expressed in dollar terms, such that stakeholders can see that prospective projects all delivered net benefits
- how benefits such as risk reduction and legal compliance were quantified and compared to project costs, and in such a way that allowed meaningful ranking across its entire portfolio
- how spending budgets were set for each valley, for example:
    - how WaterNSW has defined its risk tolerance for projects that are deferred
    - how this risk tolerance relates to the quantification of benefits (where this reflects avoided risk)
    - what factors are captured in 'long term capex modelling'
    - an explanation of why this general approach has resulted in a proposal that customers deem to be unaffordable, that is, how other factors have been weighted in setting budgets and whether this has been transparent and consistently applied
    - confirmation that any projects with acceptable deferral risk have not formed part of its proposal
- evidence of a robust process to determine the prudent scope and efficient cost of prospective projects, including instances where these have been grouped and optimised in terms of scope and timing
- interactions between project spending and opex.

EnergyAustralia has repeatedly requested via our Consumer Advisory Group further insights into capex (as well as opex) specifically for the Fish River Scheme, as well as future planned projects. We have stressed throughout WaterNSW's consultation process to consider any measures to optimise the system, remove redundant sections and outline potential productivity gains in its submission. We cannot see any evidence of these types of considerations.

The supporting information we expect to now see should have been readily available for publishing by WaterNSW. Without it, we can only speculate on whether the proposal has been robustly prepared. More importantly, we expect the Tribunal is similarly unable to determine whether the proposed $2.2 billion in capex reflects prudent and efficient costs. If the Tribunal still finds itself in this situation after having to request and analyse further information in the coming months, it should not default to accepting WaterNSW's proposal.

The significant step change in capex highlights more fundamental issues in managing WaterNSW's cost drivers and potential price shocks into the future. Charts from WaterNSW's long term capital plans below highlight that its proposed capex levels will

persist at high levels out to 2032 (for Greater Sydney) or significantly increase (Rural Valleys).[15] As noted in our covering letter, this compounds issues of affordability and the need to align prices with costs now, to avoid issues over the medium to long term.

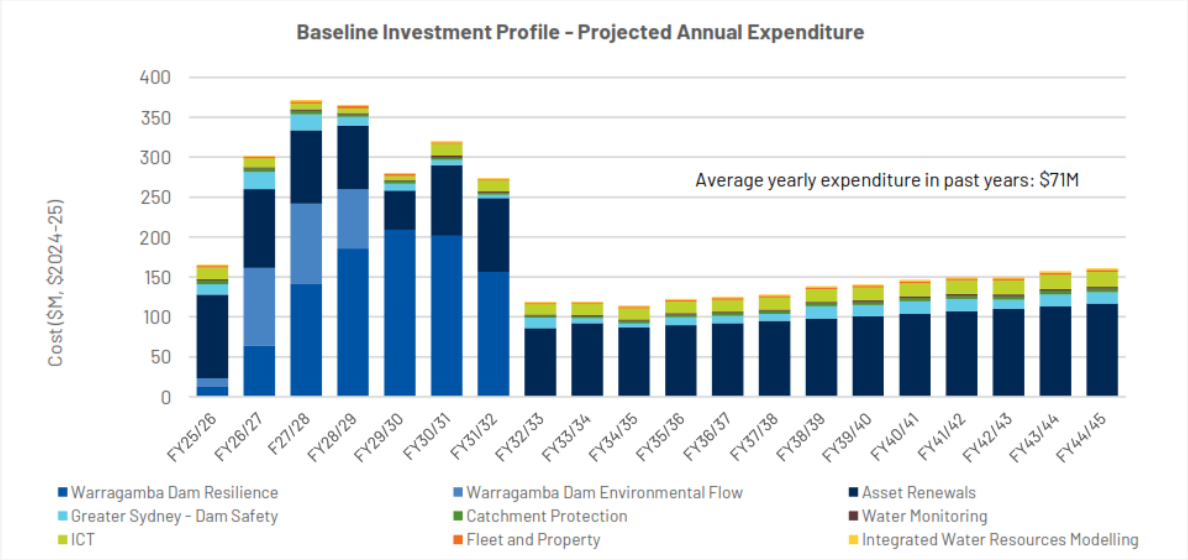
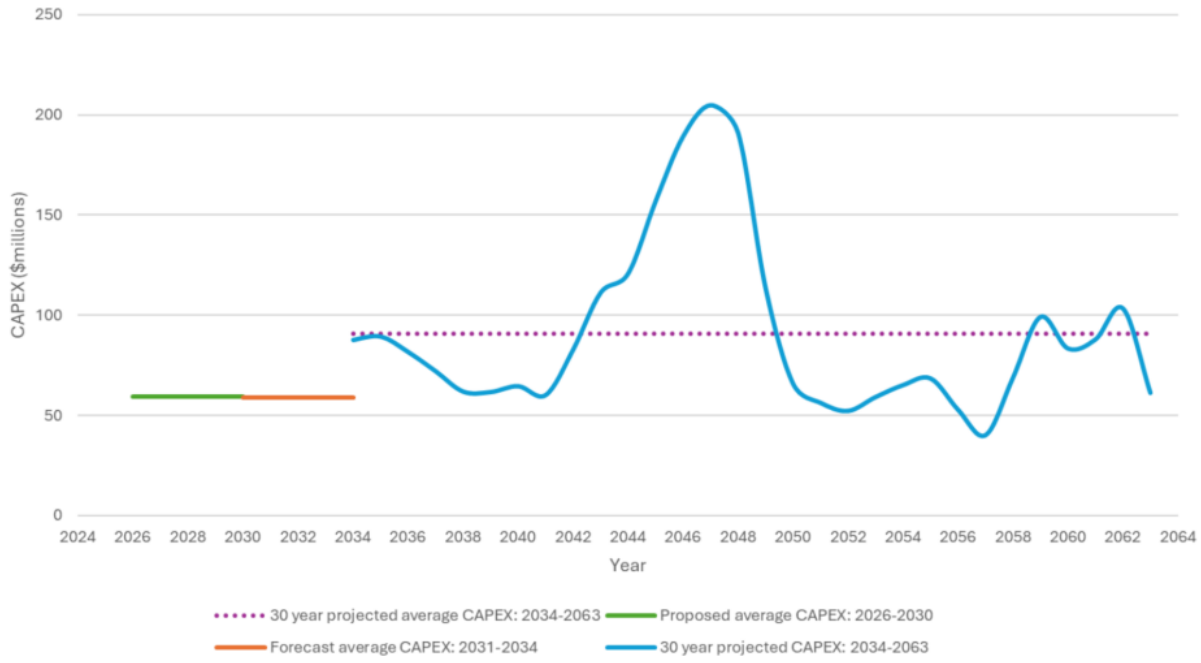


Figure 6: LTCOP baseline capital expenditure profile

Figure 1 – Long term capital investment projection for Rural Valleys (forecast average capex from 2026 to 2034 excludes construction of new fishway and cold water pollution assets)



[15] *Attachment 24: Greater Sydney long-term capital and operational plan*, p. 29; *Attachment 18: Capital expenditure for infrastructure*, p. 9.

Depreciation and financing costs

The Tribunal appears to have already guided WaterNSW's approach to depreciation for Rural Valleys.[16] Introducing a separate asset class for shorter lived assets, and hence increasing charges for customers, is inopportune given cost of living pressures and other drivers within WaterNSW's proposal. WaterNSW however appears to consider that recovering the value of its assets over a longer period of time is not in the long-term interest of consumers as it 'artificially' places downward pressure on prices.[17]

As the Tribunal has noted, the regulated value of assets will not match 'actual' asset values and simply reflects how costs are recovered over time.[18] To the extent the proposal is unaffordable and the Tribunal considers alternative pricing mechanisms, depreciation appears to be a main area where cost pressures can be alleviated while still leaving the business revenue-neutral over the longer term. It should explore alternatives to the 'straight-line' depreciation method or mechanisms like loss-capitalisation.

We make the following WaterNSW's justifications for introducing new asset categories[19]:

- regulatory precedent and best practice regulation should include references to approaches adopted in the UK. For example Ofgem's RIIO approach adopts concepts of 'fast money' (opex) and slow money (capex) which is depreciated as a single category. This type of approach allows for prices to be set with explicit regard to customer preferences and the cash-flow needs of regulated entities.

- consideration of intergenerational equity should reflect capacity to pay. Trying to align what customers pay to notions of the physical condition of individual assets is an exercise in false precision. Using aggregated asset classes also creates gaming opportunities by introducing new or merging asset categories over time, hampering attempts to check if the cost of assets is only recovered once.

- It is unclear what WaterNSW suggest in terms of benchmarking of asset values. Benchmarking of standard asset lives might be possible if the same asset categories are strictly defined and enforced across multiple regulated businesses. WaterNSW does not appear to be proposing this.

- WaterNSW states that more accurate forecasting of cashflows to align with the economic life of the asset results in a pricing calculation that is more cost reflective.[20] The Tribunal should delve into this statement given our long-standing concerns that WaterNSW's prices are not aligned to its costs. Introducing new asset categories would not assist in this regard. More fundamental investigation by the Tribunal and publishing of WaterNSW cost information is necessary.

WaterNSW's alternative scenario 1 depreciates ICT assets over 10 years (compared to its proposed 7 years). It states 10 years better reflects the expected lives of its digital investments.[21] Notwithstanding our general comments on depreciation above, the Tribunal should adopt 10 years in its determination and it is not clear why WaterNSW has not done so in its proposal.

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[16] *Attachment 19: RAB, asset lives, regulatory depreciation and Return on Capital (WACC)*, p. 9.
[17] ibid., p. 9.
[18] Handbook-Water-regulation-July-2023-V2.PDF p. 62.
[19] *Attachment 19: RAB, asset lives, regulatory depreciation and Return on Capital (WACC)*, pp. 9-10.
[20] ibid.
[21] *Attachment 26: Proposed Rural Valley bulk water charges and bill impacts*, p. 29.