Independent Pricing and Regulatory Tribunal | NSW

Review of prices for Sydney Desalination Plant Pty Ltd

Public Hearing Transcript

Tuesday, 21 February 2023

Sydney Masonic Centre (SMC)
66 Goulburn Street Sydney and Zoom online

Water

Tribunal Members

The Tribunal members for this review are:

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The Independent Pricing and Regulatory Tribunal

IPART's independence is underpinned by an Act of Parliament. Further information on IPART can be obtained from IPART's website.

Acknowledgment of Country

IPART acknowledges the Traditional Custodians of the lands where we work and live. We pay respect to Elders both past and present.

We recognise the unique cultural and spiritual relationship and celebrate the contributions of First Nations peoples.

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1.1 Welcome

Ms Donnelly: Good morning everyone. Let's make a start. My name's Carmel Donnelly. I'm the Chair of IPART and I'll be managing this hearing this morning.

I'd like to start by acknowledging the Traditional Custodians of the land from wherever people are joining us this morning. We are on the lands of the Gadigal people of the Eora Nation here in Sydney and we acknowledge the traditional custodians from wherever you're joining us. I'd like to pay our respects to Elder's past and present and also extend that respect to all Aboriginal colleagues, customers, and stakeholders.

I'm joined this morning by fellow Tribunal members, Sandra Gamble and Deborah Cope and also by a number of members of the IPART Secretariat including Andrew Nicholls, our new CEO who you may not have met before. Also Matt Mansell, Greg McLennan, Maricar Horbino, Rhea Rachel, Simba Kanyongo, and Sachin Singh in particular in the room. And we do have a number of other IPART people making the virtual space work for this hybrid meeting, so they'll be joining us as well in that way.

Let me start by thanking you very much for making the time and joining us this morning. We value your input and we really appreciate you making the time. And we're looking forward to a very constructive public hearing.

I want to turn first to a few housekeeping items. For those who are attending in the room here in Sydney, if you want to speak we'll be doing the traditional thing of put your hand up. Please wait for the mic, so that it can be heard by all the people online.

If you are online, please mute your microphone if you're not speaking and we do encourage you to keep your camera on if your internet settings are up to it, and you're comfortable doing that. It just helps us feel more connected throughout the discussion because we're running this in a hybrid way.

You may have noticed online but we are recording the discussion today, as we always do for public hearings. It is being recorded to YouTube, but it isn't being broadcast live, it will be made publicly available later on, and we will place both a link to the recording and a copy of the transcript on the IPART website in a few days.

Now being a public hearing the media and others present today are free to publish and refer to what is said during the event. We do want to create an environment where everyone feels comfortable to speak. So we ask that you be respectful of others time in the length of your comments, and also in the way that we speak with each other. So with that I might now move on to giving you a little bit of an outline of the agenda for today and I'll just ask for the next slide.

We will have 4 sessions today. We'll begin with an overview of the review, including a presentation from Philip Narezzi from SDP. I'm going to say SDP, Sydney Desalination Plant Pty Ltd, but we're so into acronyms at IPART that I won't be able to help myself, hopefully you'll forgive me.

So with Session A will have that overview. After Philip has spoken I will open it up for questions and discussion, and it is an opportunity for you if you have any upfront comments that you would like to make right at the beginning of the public hearing.

Then we will move to Session B which my colleague Sandra will facilitate and that will be about service levels and costs, with a short presentation from IPART and then a question and answer session as well.

We'll have a short break and come back, and you can see the times on the screen. We will come back and have a similar short presentation from IPART on incentives and risks and a further Q&A session facilitated by Sandra Gamble and then we'll move back to Session D and myself and the IPART team will give a little presentation on pricing arrangements our last Q & A session, and then we will close the public hearing. So that's what you can expect.

Now I would just want to say for those online. You are able to raise questions throughout and we'd like you to do this in one of 2 ways. Either put your question into the chat online or put your hand up through Zoom in that sort of digital hand reaction. If you can find that. And the IPART team who are monitoring the session will let me know that there are questions, and I'll also attempt to follow online as well. So we will hopefully oscillate between the room and the people online and make sure everyone gets an opportunity to speak and ask questions.

1.2 Overview

Ms Donnelly: So let's just move on to Session A and a little bit of an overview and let me just make a few opening remarks around the review. So we are reviewing the maximum prices that SDP can charge for effectively 2 services, making its plant available to supply non rainfall dependent water and actually supplying that water. So that's a way of looking at it. And concurrent to this review we are also reviewing the Methodology Paper on SDP's energy adjustment and efficiency carry over mechanisms. So there's another aspect to it.

Now our goal is to ensure that you pay a fair price for safe good quality and reliable services and it's worth just talking about that for a few minutes. At present Sydney Water is SDP's only direct customer. However, Sydney Water of course passes on its costs to the customers of Sydney Water to its end-use customers. Therefore, end-use water customers are indirectly customers of SDP, and we are mindful of that through the review. Now we do have separate pricing reviews for Sydney Water but because of that relationship we will be very mindful in our review about impacts on end-use water customers.

So it's important that the prices that we set for SDP are not only meeting that goal that you can see on the screen. That they're not too low or too high. If they are too low for instance, SDP will have difficulty actually spending what's required, and delivering its services. So that's very important. But if the prices are too high, Sydney Water and ultimately end-use customers would be paying a higher charge, and potentially more than is required. So that is really at the hub of the review.

And another consideration is giving the right incentives to SDP to manage its business efficiently. So therefore we aim to set prices by considering, in particular, and you'll hear this morning SDP's new role decided by Government under the Greater Sydney Water Strategy; regulatory obligations as part of this review, and I'll expand on that in a moment; incentives for the water businesses to deliver good value outcomes for their customers; risks and who is best placed to manage those risks; climate change and the environment, and; the impact on water customers.

And it just gives you a sense of all of the things that we will be considering.

I might move on now just to look at the context. This is our third water price review for SDP. If you have a look at that timeline on your screen. Many of you will know the desalination plant and pipeline were constructed in the 2007-2010 period. The plant and pipeline were originally part of Sydney Water before they were leased to SDP. And in 2017 we set the SDP's efficient costs and prices in line with what was at the time the Metropolitan Water Plan. And under the previous plans SDP's role was to increase water security in the Sydney region particularly during drought periods.

Now in August 2022 the Greater Sydney Water Strategy was released by NSW Government and under that strategy it has already been decided that SDP will be required to operate flexibly and as part of the Greater Sydney Water System providing non-rainfall dependent water on a much more flexible basis so that, IPART acknowledges is a significant change and it is also a decision of Government that's already been made. But it has also now been reflected in changes in the Network Operator's Licence, Decision Framework, and also reflected in the Terms of Reference for this review. And I'll talk about that a little more in a moment.

So we're now working on setting SDP's prices from 1 July 2023. The review process will take into account a number of factors that context that I was just talking about of the Greater Sydney Water Strategy and SDP's changed roles; SDP's proposal, which is available on the IPART website, which we will obviously be taking careful consideration; we've identified questions, released an Issue's Paper, and obviously in a process of consultation, and that is very important; so stakeholder input and also engaging expert advice.

We will develop a package of draft decisions which we will release in April and those draft decisions will be based on everything that we're considering including everything that is said today, and the submissions, SDP's proposal, and expert advice.

We do have some unique requirements through this regulatory process. The price review for SDP is unique in that it has some clear procedural requirements that come out of the *Water Industry Competition (General) Regulation 2021*, and also there are specific Terms of Reference for this review that have requirements.

And so IPART is very clearly and diligently undertaking this review in line with those specific requirements. For example, our Issues Paper was required to set out any significant methodological changes from our 2017 review. In doing that, we found that what we needed to do was to describe the procedures, methodological approach from last time in order to explain the suggested changes for this time. So it doesn't imply that we're wedded to past approaches. It's really a response to the requirement for us to clearly explain where the methodology is shifting.

Another specific requirement is that we are only to consider oral submissions that are made at a public hearing. So we're considering written submissions so this is in the regulation and oral submissions at this public hearing. And so I just want to emphasise how important it is for you to have your say at this oral hearing, and that we will consider everything that's said today. So do encourage you to provide your feedback.

I might just move on to the review timeframe. I do want to emphasise that no draft decisions have been made at this point. We are very much in the exploring phase if I can use that word. As most of you know just looking at that timeframe we received pricing proposal in September and made it public. That's SDP's pricing proposal.

We released an Issues Paper in November. We had submissions open until the 31st of January. We now have this important public hearing. The draft report, as I mentioned in April, and we will consult again for more feedback, inviting submissions on the draft report and then the final report at the end of June for new prices that will commence from 1 July.

So with that background, overview, and some opening remarks for me, let me just say again how pleased I am that you're joining us. Look forward to hearing from everybody. The role of the Tribunal here is very much to listen. We may ask questions. You may ask questions of us and for us to consider everything that's said today.

Now very pleased to be now able to introduce Philip Narezzi, who is going to give us SDP's presentation, and then I'll be back later for a question-and-answer session. So over to you, Philip thank you very much.

1.3 Presentation by SDP

Mr Narezzi: Firstly, I would just like to thank the Chair and the Tribunal for this opportunity to present key aspects of our pricing submission. We're approaching the next phase of the operating evolution of the plant with a sense of excitement and confidence we can successfully deliver on government policy to provide increased long-term value for customers through flexible operations that will improve Sydney's drinking water resilience. We are proud of our ongoing success in meeting all production requests by putting the customer first. This is a great foundation to set us up for success in the future. Next slide.

As Traditional Owners of the land that the hearings been held on has already been acknowledged. I would also like to acknowledge the Traditional Owners and Elders, past and present of the land the desalination plant sits on at Kurnell, next slide.

Our operating role is significantly changing. Historically, the plant has been responsive to drought only operating when storage dams were low. As Sydney's only major rainfall independent water supply, the new operating environment will provide greater value to customers by enabling the plant to operate flexibly in response to modal events that can impact the water supply, ultimately assisting Sydney Water in delivering high-quality drinking water to the people of Sydney. Next slide.

Our proposal has been shaped through significant engagement with the Department of Planning and Environment, Sydney Water and IPART and customer focus groups to ensure we are meeting the expectations of government policy through the Greater Sydney Water Strategy.

It provides a huge opportunity to deliver a better service for customers, and we want to grab it. We have put a lot of effort and consideration into our submission, and it's heavily backed by expert reports. We have actively engaged with IPART and its consultants in timely responses to all requests for information and extensive comments on IPART's consultant's draft report.

We asked the Tribunal to fully consider all aspects of our submission. Our expert reports and comments provided on IPART's consultant draft report. We're very proud of our achievements to date: restarting the plants, planning for an expansion, successfully meeting all of Sydney Water's 16 emergency requests. SDP is excited about the future where we can deliver a continuous service. So use the plant in a way that maximise benefits to customers. Next slide, please.

Our costs are a small component of customer bills about 8% at full operations. Due to significant changes in our operating environment our proposal does present some increases in elements of our cost base. Namely, associated with the cost of keeping the plant available to operate flexibly. But these increases are largely offset by other areas of saving.

We are proposing a modest minimum baseline production level to enable systems and processes to remain operational. So the plant is ready to respond to changing production requests. Our proposed prices are structured through a flexible, a fixed and variable charge to ensure the prices are reflective of the service we provide. Overall our proposal provides customers with significant increase in value and service, while keeping prices stable even at full production. Next slide, please.

This is a busy timeframe but it's important for the Tribunal and all stakeholders to understand the journey that SDP has been on since 2017 and the challenges and uncertainty that has impacted the evolution of our proposal.

As you can see at the bottom of this slide SDP has been dealing with multiple priorities and engaging with numerous parties through this period including Government, Sydney Water, IPART and our operator to better understand what the new operating rules meant for services and costs. The new operating service levels did not settle into mid-2022. So any costs before that time are not representative of costs required to deliver the new operating licence requirements. Next slide.

Things haven't unfolded as expected since 2017 Determination. The plant transitioned from water security mode to an operational restart in early 2019 in response to drought and declining storage dam levels. The plant was operational for about 14 months, and until the drought broke and storage dams recovered. At the same time, SDP was also asked by Government to start planning for an expansion. This process was put on hold once those storage dams had recovered, next slide.

Following the recovery of the storage dams in early 2020, instead of transitioning back to water security mode through a shutdown, SDP was asked to continue to operate through an emergency response provision. The emergency response for short durations in response to network risks, and once these risks reduced, the plant should return to water security mode. Thus a shutdown could happen at any time.

Throughout this period SDP has had to balance its service level of response. The commercial realities of the 2017 Determination that did not allow for full cost recovery of an emergency response mode, and the uncertainty of the scope and timing of the new operating environment.

Due to not having certainty and longevity of sustained operations SDP was unable to prudently invest in the plant. For example, decisions were made to defer major preventative maintenance and capital work through this period, as shutdown could occur at any time. And it was not prudent to invest in assets that may not be required to operate for a long period. But this deferral of expenditure is not sustainable and could ultimately impact the reliability of the plant. It's just one cost element that has been impacted.

SDP is concerned that there has been a misunderstanding that the operational regime during the emergency response phase is the same as the new operating environment and thus the costs incurred during this period would also be the same. And additionally that SDP can leverage off the operating experience through this period. Thus it could be more efficient.

This simplified assumption that the past equals the future is not correct. Until some clarity was provided on what the new operating regime was likely to be in mid-2022, the costs incurred, and the operational activities undertaken up to that point were not reflective of the costs and activities required to deliver the new levels of service under the new operating environment.

Once confirmation of the new operating environment was received, SDP was able to invest in the plant and truly reflect the cost of the service. This occurred from FY23 which effectively provides a bridge of prices we are proposing to be in place from FY24-27. If this misunderstanding is not addressed it is difficult to see how government policy objectives can be achieved to the detriment of customers. Next slide, please.

As mentioned clarity about SDP's future required levels of service started to merge with the draft Greater Sydney Water Strategy, followed by a draft of the SDP's new operating licence in mid-2022. In response SDP was able to review the costs and activities required to maintain the plant in a state availability and continuous operation; and this was reflected in our proposal.

To enable SDP to deliver its new operating role SDP's proposal has focused on a step change in committed fixed operating costs in FY23. As these should be considered revealed efficient costs and a further step change in the first year of the 2023 determination period to fully meet the new operating environment which comes into effect from the first of July this year. Next slide, please.

The new operating regime is codified in an amended SDP operating licence. Effectively Sydney Water will set an annual production figure based on a decision framework taking to account multiple factors such as dam levels, system constraints, risks, and major networks maintenance.

Sydney Water and SDP will work together to sequence the daily production volumes based on this annual production request to meet the needs of customers, and at all times have the plant available to quickly respond to any emergency request and ramp up production.

The annual production request can be amended at any time to enable to be responsive to the ever-changing conditions such as drought and heavy rainfall. While untested, the new framework will provide customers and Sydney Water additional value from the plant by providing a high level of flexibility on how we operate.

SDP has reflected the requirements of this new framework in our proposal that also acknowledges the need for a step up in activities such as response to Sydney Water's production changes, routine asset maintenance, proactive asset replacements and active management of membrane performance efficiency.

For example, our current emergency response regime is very restrictive with maximum daily volume set for a short period of time based on risk assessments. The new operating environment will allow for complete flexibility with daily production requirements and ongoing changes aligned to the needs of the network, which is a better outcome for customers. Next slide, please.

The movement in costs in our proposal can be broken down in a few key areas. There's moderate increases in operations and maintenance costs and capital expenditure driven by the constant operational state of the plant and the fact the plant is aging. Even in an increasing unstable energy market, energy costs will stay stable if our Greenhouse Gas Reduction Plan energy contracts are recognised. There are significant reductions in our financing costs due to changes in global markets since the last determination. And modest increases in corporate costs, mostly driven by pressures of the global insurance market. Overall there is significant increase in service will provide. But the cost will remain stable for customers, which is a great outcome. Next slide, please.

Although only a small component of our overall cost base, our operations and maintenance expenditure is extremely important to enable us to successfully deliver under the new operating environment.

We are proposing a step up in cost to enable the plant to be continuously available to respond to varying production requests. The key drivers for this step up are: additional staff are needed to proactively manage safety and operations of a continuously operational plant, the cost of keeping the plant available and complying with our EPA licence that increases non-productive water production, and we were required to have increased asset rotation.

For example, just to explain the unproductive water, the plant will remain fully operational. And for the plant to remain fully operational and available and a quick response to increased production, the pre-treatment system is effectively fully operational. The membranes will need to be regularly flushed, and additional water is needed to maintain an outfall velocity for our EPA licence compliance. All these activities do not produce drinking water but they are costly and contribute to non-productive water.

Another key driver is the fact that the plant is aging. Thus cyclical refurbishment and replacement of assets are required and will occur during this regulatory period. For example, a large group of assets that have a 10-to-15-year life will be required to be replaced for the first time during this regulatory period.

So while there are pressures to increase operational costs, we are confident that our proposed operations and maintenance costs reflect the prudent and efficient cost to deliver the service in a new operating environment. We rigorously challenged our operator proposal and had them benchmarked and tested through independent experts. This is fully demonstrated in our proposal. Next slide, please.

The desalination process does use large volumes of energy to produce high-quality drinking water. Hence it is extremely important for customers that the cost allowances for energy are set in a consistent stable manner especially in a volatile Australian energy market. which is affected by global issues and unpredictable government intervention.

We are required to source 100% renewable power and demonstrate this through a Greenhouse Gas Reduction Plan. This plan nominated long-term energy contracts that are underpinning legal requirement connected to our project approval, and so SDP is required to source energy through these contracts. The requirement to source energy via this contract is also effectively integrated in SDP's operating licence. Our lease and implementation deed agreed with Government at the time of sale and the Water Supply Agreement we have with Sydney Water.

Our proposal includes detailed legal advice to confirm this point. These legal requirements are very unique to SDP. This obligation has been recognised by Government through amendments to SDP's Terms of Reference, and is supported by Sydney Water.

Our proposal requests IPART recognise the obligation and sets prices as per the Greenhouse Gas Reduction Plan contracts which currently sit below the market prices. Thus this would be a saving to customers and provide a stable cost-based for energy. Next slide.

SDP has developed a new Service Level Incentive Scheme (SLIS) that aligns financial incentives with requirements of SDP's new operating licence and is designed around flexibility of operations required by Government and Sydney Water. SDP is moving away from providing limited services outside critical drought response, which attracted a high-powered abatement mechanism for underperformance during drought to a continuously operating component of Sydney Water's water supply system.

We are proposing a symmetrical reward and penalty regime with a cap of 2.5%. There appears to be a misunderstanding on the structure of our proposed incentive scheme. Although we are proposing a scheme to be symmetrical in principle, we cannot obtain additional reward for producing above 110% of production request. We are capped at 110% through our licence thus unable to obtain reward if production exceeds this 110%.

SDP is also concerned that there is a misunderstanding that due to the last few years of operation under the emergency response regime SDP should be able to reduce costs. As has been previously discussed the operations under a short-term stop/start unknown regime such as the emergency response is not a good starting base. Focusing on a stock standard cost cutting approach to the determination will not provide suitable cost allowances for SDP to deliver the new service and will ultimately impact customers.

We have been as efficient as possible in providing the emergency response services today. However, we need to provide a higher level of service, be constantly available and flexible in our operations over the next regulatory period.

Even though we have included learnings in our costs proposals, it's not sustainable nor efficient to provide this high level of availability at a lower cost than today. Last slides.

In summary we are confident that our proposal provides an efficient basis of costs to deliver high-quality drinking water under the new flexible operating regime. If adopted, our proposal will benefit long-term interests of customers by allowing us best possible opportunity to successfully deliver our new exciting operating environment for the people of Sydney. Thank you.

1.4 Discussion and Q&A

Ms Donnelly: Thank you, Philip. That's better. Thank you very much. Now I am going to open up a discussion and Q&A session. What I'm going to do is go to the room first, then online and then Tribunal questions.

Now, if you're online, I'll just remind you that you can record that you have a question by either putting something into the chat or raising your Zoom hand in the reactions on Zoom and I will ask that everybody, wherever you're asking a question from please give us your name, and organisation, and introduce yourself before your question. So with that, who would like to start off with questions and comments.

We've got a couple of people with microphones roving. We might be able to leave one over there, Simba. We've got another one here. Oh, Simba, you'll stay there. Yeah. Okay, because there might be questions of anybody in the room really. So alright, please start.

Mr El-Sherbini: Thanks very much. I'm Ashraf El-Sherbini Director of Urban Water Strategy, Policy and Programs, Department of Planning and Environment. And I'm joined by my colleague, David Gough. I just wanted to start off by acknowledging, by firstly thanking IPART for the opportunity and just expanding on some of the context setting pieces.

So my team led the Greater Sydney Water Strategy together with Sydney Water colleagues and WaterNSW. So the Greater Sydney Water Strategy was a significant step change in terms of Government's risk appetite for metropolitan water planning and there are a number of key features that are worth highlighting there.

At a high-level one of the things that it does is it adopts a different approach to water security planning which has us (a) maximising use of our existing assets, conserving more water at all times, and planning ahead for the next augmentation rather than using drought triggers.

Specific to SDP obviously the concept of maximising the use of our existing assets is key. And hence the shift from a drought response operating mode to an always on flexible operating mode. And the resilience that we're looking to get from that is both during times of drought but also as we've learned during at any other incident that may be impacting on the waters network.

So that is a key driver for what Government is hoping the new operating regime looks like whilst also recognising that that needs to be optimised in such a way that it is in the best interest of customers. And hence the role of the decision framework, and in establishing an annual flow request that is looking at the current and known future needs of the system and climatic conditions, but also able to be adaptable throughout the year to respond to emerging issues. So that's just the opening remark that I just wanted to share. And I'm happy to take any questions.

Ms Donnelly: Thank you Ash. Who would like to go next.

Mr Hollamby: Hi thanks for having us. Jamie Hollamby, Sydney Water. We've put in a comprehensive written submission. So I wasn't going to make any other verbal comments to start off with. But we're obviously here happy to participate and answer any questions that may come up. So thanks for the opportunity.

Ms Donnelly: Thank you Jamie and I'm not sure whether yes if we need people to stand up so that the camera can find us. Thank you for doing that. I will just take the liberty of asking whether, I know Ash mentioned the decision framework, whether you have anything you want to say about the role of Sydney Water in that?

Mr Blayney: Good morning, Ben Blayney Sydney Water, Head of Water Supply and Production. Sydney Water's role we are the water supply manager for Greater Sydney. So we work with all sources of water and including WaterNSW and the dams and recycled water, which is growing, as people know.

Our role is to ensure that we optimise both product cost and risk and at an acceptable risk, and our role is to do that every day. The decision framework was based on the planning that was supported for the Greater Sydney Water Strategy, get the right words, and what it does, is it actually clarifies, in my view SDP's role as a rainfall independent supply. Rainfall is not just about when we have it, but also when we don't have it. But when we have it and what we've learned over the last 3 to 4 years is that we can get some time periods of a lot of rain which requires us to operate the desal.

Our water filtration plants are designed for a situation where you have a lot less population, and it means that the dams were like a buffer. With the higher population you no longer have that buffer to balance out quality impacts, so rainfall independent supply I just want to add it means also when it rains. That's the big change, does that explain it?

Ms Donnelly: Thank you. I think that's helpful just to sort of set the scene. Okay, let me just see if anyone else in the room would like to make a comment or ask a question. I don't think so. Anybody online. It's a bit hard for me to see if there are any hands up but I can't see any in which case I might see whether at this point Tribunal members have a question. Sandra.

Ms Gamble: Yes, I do. So I'm Sandra Gamble a Tribunal member. I've got 2 questions for Sydney Water and 2 questions for SDP.

So I'll start with Sydney Water. In your submission Sydney Water, Ben or Jamie, you've indicated that SDP was originally built for flexible operating capability. Would you like to expand on that and what it means for our consideration of costs and prices for SDP?

Mr Blayney: Yeah, that's correct. It was originally built for that. And design and construction is quite different to an operations and maintenance period, as you'd appreciate, and some of the things that probably Phil was talking about today is talking about operations and maintenance period, where you're investing in not just maintenance and operations, but renewals and capital all those things.

While the plant was designed to be flexible, designed initially to be flexible when the new rules where the existing rules at this present time, which is around water security and drought response were established that set the new operations and maintenance regime going forward and the level of investment going forward.

Ms Gamble: So Ben, that's a different type of flexibility isn't it?

Mr Blayney: Yeah, that's right. It's a well, I guess if you went back in time you, had your time machine, you would go back, and you would say, well, what level of maintenance and operational staffing and operational response would you need under these rules.

Those things were set under the existing rules, under the new rules they're quite, quite different. So while the plant was designed so largely, you know, you've got a pumping station with multiple pumps. You've got a large reservoir. You've got big intake structure. Those sorts of things are big physical capital investments. It was also designed to optimise the investment in the future. So that's the change.

Mr Hollamby: Sandra. If I could just add to that just philosophically, there's a few things that are worth putting on the table from us. The first is that we're expecting, as Carmel mentioned, that any costs of running SDP are passed through to end-use customers and so obviously that's an important concept.

So we do need the SDP to operate when we need it, in order to maintain that customer service outcomes and we also need that to be done efficiently. And so there is a balance between risk and operation of the plant.

In our submission we have acknowledged that operating under the new decision framework is different and we obviously don't have access to all of the confidential cost information. But conceptually we acknowledge that some of the investments that are put forward in the proposal are needed to manage risk under that new operating regime and that's prudent to do so in order to make sure it is available. So that's in our written submission.

Ms Gamble: Thanks, Jamie.

So SDP, we understand that you're saying there are significant differences in the way the plant operated previously and what will be needed going forward more specifically having the plant continuously available in a reliable way requires expenditure on personnel and maintenance that it's not was not undertaken when SDP was in emergency response mode which were a short term. Can you tell me if that's an accurate reflection of SDP's position and if so, can you describe a little bit more detail what those costs are, and I have a follow-up question. But I'll let you answer that first.

Mr Narezzi: I can touch on that I think you also need to go to take a step back from just the emergency response. So obviously has been mentioned the current operating rules are we're effectively an on/off plant. So we will either be off and then be in a water security mode effectively a mothball mode, or will be 100% on, depending on where dam levels are.

The emergency response provisions were an additional thing that weren't necessarily envisaged in the 2017 determination. The key assumption in the 2017 Determination was that we would effectively not operate for the 5-year period of that determination, because that was the key assumption back then, obviously, as we demonstrate in our presentation things did change and unexpectedly.

So if you look at the evolution of that period, and we entered into an emergency response period. Our number one focus was responding to those requests from Sydney Water in the best interest of the customers. It wasn't the commercial realities of what that actually meant necessarily because you really got to appreciate at the time that their first emergency response notice actually arrived we were expecting that to be of short duration and they would enter straight back into water security mode.

We've had 16 of those emergency response notices, and we would've had it a lot more. We probably would have had about 30 if it hadn't been for the last 12 months. We've reduced that administrative burden with assistance from IPART in relation to that. So from a cost perspective, the cost that we have been incurring through that period up until we had a lot more confidence that we weren't going to enter it back into water security mode and we did have a path forward are more reflective of the costs that we are actually occurring for that service under emergency response.

So as we highlight in our presentation the cost that we're incurring for this financial year because once we understood and had confidence that the new rules were going to occur and what they actually look like, and that will continue on in an emergency response phase for the next 12 months most likely.

We still have only got an emergency response to the end of February. So technically we could enter shut down from the first of March right now. So until we actually knew that we couldn't actually invest in the plant. So some of those cost elements that we mentioned in the presentation. Staff is a good example, where, as soon as we went back into restart we identified that there were some areas that required additional staff than what was presented back in 2017 in our proposal to IPART, and what was determined by IPART and required for operations.

So we did fund those staff during that restart period that wasn't sustainable, and once we entered into emergency response mode those staff weren't continually funded. But our operator chose to keep those staff on at their cost through that period because they were important. Because there was a belief that that was going to be a short duration, short period, and we'll end up back in the shutdown. That period has continued on for 2 to 3 years. And each time we nearly go into shutdown, then we start again. And each notice usually turns up at the last minute for us to continue on operations.

So got to understand that context of why that has occurred. Those costs are reflected in this financial year. Some of those costs that we will require for the new service. So, as we mentioned the cost of staff, the cost of the availability of the plant and non-productive water. We mentioned the cost of investing in the assets and doing the preventative maintenance that we had been deferring, and some capital replacements we had been deferring.

We have started investing that in this financial year as a bit of a stepping stone into the cost we proposed for next year. Because, the costs from 2020-21 and 2021-22 aren't reflective of the service we were actually delivering, because we weren't 100% confident that we were going to continue that service. At any time we could have shut down. So hopefully that answers the question.

Ms Gamble: It does, thank you, but I have a follow-up question to that, that occurred to me while you were giving your presentation. So what you're saying is that there's a new cost structure that SDP will apply under this new Greater Sydney Water Strategy mode, if we call it that. And previously you've been either underwater security mode or emergency response mode. That the costs you incurred during those previous modes though, are they completely irrelevant to the costs that you're going to incur in the future. Or is there some useful information we should be able to glean from your previous operation modes?

Mr Narezzi: Look, I think all of those things are the lessons learned, I think even IPART highlighted in their Issues Paper that the next 4 years is a learning experience for all of us. I'm sure Sydney Water acknowledged that.

We're not sure how this new process and annual requests, and in theory it looks quite simple and should work well. But there'll be lots of lots of challenges, lots of issues that we'll have issues on the plan, how the plant responds and so forth. So it's a bit of a learning experience for the next 4 years of this determination period.

The experiences definitely we've had, not necessarily in the water security mode, but more in the restart there was definitely lessons learned from the restart that showed that certain decisions made and costs allocations that we proposed in our last determination were probably not appropriate in a lot of areas.

For example, the costs we propose for a shutdown. If we had to enter the shutdown was definitely undervalued. And there we would have not been able to shut down the plan appropriately. And that was the lessons learned. So this definitely lessons learned for that period.

In the emergency response, definitely learnings through that period. We have learnt a lot, and our operators learnt a lot of on how to operate the plant efficiently at a low production to keep it available, that's effectively what we have to do.

The key piece of that is, if you just look from an efficiency perspective and energy is a great example, is that we have ran we've got 13 RO trains. So bulk of RO membranes. We run our 3 most efficient trains to keep the plant available. We don't rotate all those trains because we do have 3 trains that are more efficient than the others. That's due to the way we've got 3 pumping impellers that have been trimmed on those 3 pumps as a historical thing before our time why that was done. So that's an example where we've run the most efficient trains because we're trying to be the most efficient, because we didn't have suitable cost recovery that was reflected in the determination.

So we've learned a lot from that process of how to run the plant, what is required, what is required in our EPA licence requirements, all those things that we have factored into our submission. And we are continuing on right now in our operations for this financial year, and that will lead into the next financial year. So definitely there's lots to be learned from that. But it's also that's that balance of yes, there's lots to learn, but it's also not a good starting point to say that we should take all those learnings and we should be a lot more efficient already and we should have a lower cost base moving forward, because it's the stop/start nature and not having that longevity of operations. You could not really necessarily focus on that.

Ms Gamble: I'll move on. I've got some fairly straightforward questions this time so hopefully that we'll have some precise answers because I can see my colleagues here getting sort of aware of the time.

Sydney Water, the foundation instruments for this new mode of operation the Greater Sydney Water Strategy, the Network Operator Licence, the Water Services Agreement and the decision framework. Can you please describe for the record what drives your positions/Sydney Water's positions, as you've been contributing and developing and negotiating these agreements? What is your principal position that you've been taking? What's driving that position?

Mr Blayney: I guess we need the outcomes of the Greater Sydney Water Strategy. So we need water security which we had, but it wasn't tuned to the current conditions within Sydney in terms of drought and floods.

We needed to ensure that we could maximise yield which was, with growing Sydney, we needed to do that. We also needed the ability to respond to system shocks. And as we looked at the situation from a planning perspective, we appreciated that desal isn't just a plug and play for the system. It is part of a whole entire network that balances multiple sources and that impacts all sorts of programs like not only flood response, also major capital upgrades up and downstream of the desal plant.

And then I guess how do we do that at a scale. That at a time scale that could be daily, monthly, yearly. So as we did that it took a number of months to approach that. We are always interested in cluster customer. We always interested in reducing that cost and the lowest cost of water to serve. And so that's in the back of our mind as we implement those rules. How do we get that flexible enough to do that, but also manage the risks that are associated with a large water supply system like Sydney. I think that answers your question.

Ms Gamble: Yes. Okay, last one for SDP, it's possibly a yes or no question. Let's see. Do you agree that IPART should allocate the risks to SDP or to customers on the basis of the party best able to manage them?

Mr Omar: Yes. But can I, if you would indulge me just a few points to try and answer your earlier question, or expand on Phil's response in terms of the additional costs of delivering the service in the future. So both to answer your question, are historical costs any guide or is historical experience any guide? Absolutely.

So we've got the plant manager here as well Amid Akhyani from Veolia, which is fantastic. So please, if you have questions, he's available. Our GM of operations, Matt Blaikie is here as well.

But what we found, additional staff is needed for health, safety, environmental quality, additional staff to monitor the plant operations. So we are ensuring that we're available safely and readily available as well 24/7. So those are some of the staff and costs which you know 2 additional staff. I think there's more detail in the submission.

But also what Phil mentioned about 3 trains being preferentially run. One of the key costs going forward is asset rotation. So using all the assets, that point about impellers being trimmed, that's not sustainable under our licence conditions, EPA licence that is. The water quality envelope we need to manage requires that those impeller stay as is, not trimmed. So that's a learning from the past, but also additional costs that we know is needed for the future.

And just the last point I wanted to make about this what Phil referred to as non-productive water. I tend to refer to it as process water because it's providing an important, I guess you think about it like lubricating the wheels, you make sure that the membranes stay moisturised so that they can remain operational and don't degrade. So that point about process water is another additional cost.

Ms Gamble: Okay, thanks Ifty, back to you.

Ms Donnelly: Thank you. Look, I have been monitoring online and it doesn't look like there's any questions online, and we're due to move on to the next session. So I propose that we might do that if you have anything that you want to ask later on that refers back to this discussion. You'll be able to do that in our next Q&A session. So I will hand back to Sandra to facilitate the next session.

2 Session B – Service levels and costs

Ms Gamble: We're in Session B. Now, as you all know I'm Sandra Gamble. I'm one of the Tribunal members. So one of our members of the Tribunal Secretariat will be taking you through a presentation on SDP's pricing proposals specifically about service levels and costs as well as the summary of submissions to our Issues Paper. We'll then have another Q&A session, and an opportunity to ask questions of SDP, IPART or anybody else in the room.

A key consideration for this review is ensuring SDP's costs appropriately reflect the level of service that's provided to end-use customers. Ensuring the right balance of service level and costs is especially important for this review given SDP will now be operating in a new flexible, full-time manner.

The following presentation will outline SDP's new operating environment under the water strategy, and I think that will give you some comfort that we can see that, as well as the costs of that it's proposed in meeting the new operational requirements. We'll also outline the views we've heard, as I said from stakeholders. So now I'd like to hand to Matt Mansell, who'll present on behalf of IPART.

2.1 IPART presentation

Mr Mansell: Thank you very much, Sandra.

The decision to build the Sydney Desalination Plant was made in 2007 in response to drought conditions that had seen Sydney's dam levels fall to 34% capacity.

Until recently SDP's primary role has been drought response and its secondary role has been emergency response. This primary drought response role was reflected in the NSW Government's metropolitan water plans that were in place from 2006 through to 2022 and in SDP's Network Operator's licence. Our 2011 and 2017 pricing determinations reflected SDP's primary role as a drought response asset.

As mentioned in Carmel's overview, in August 2022, the NSW Government released its Greater Sydney Water Strategy which defines a new role for SDP. Rather than operating primarily as a drought-response asset, SDP will now operate on a flexible and continuous basis to increase our water supply and improve our drought resilience.

Understanding SDP's new role and the levels of service SDP is expected to deliver in this new operating environment is critical to setting new prices that reflect the efficient costs of SDP's regulated services going forward.

In our Issues Paper, we outlined the importance of setting SDP's efficient costs in a way that is informed by and consistent with its new operating role. And we emphasise the importance of supporting flexibility by ensuring that prices remain reflective of efficient costs across all levels of production.

We discussed the importance of designing incentive schemes that deliver value to customers in a way that is consistent with SDP's new network operator's licence. We sought feedback to understand stakeholders' views on how we should set prices that accurately reflect SDP's new role . And within this context whether SDP's pricing proposal reflects a fair balance between service levels, costs and risks.

We have also engaged engineering and desalination experts who are advising us on setting cost allowances that recognise the flexible full-time nature of SDP's new role and operating environment.

I will now outline the key operating and capital expenditure elements of SDP's pricing proposal. Under full production, SDP proposed on average $113 million per year in operating expenditure. Before inflation, this represents an approximate 7.5% increase from the average yearly allowance in the current price Determination.

SDP attributed this increase in operating expenditure to higher operational and maintenance costs to keep the plant in a state of readiness so that it can quickly ramp up and ramp down production when requested. SDP also noted the need for increased corporate costs in order to manage oversight of the plant under the new flexible operating regime.

Desalination is an energy-intensive process and energy costs make up a large share of SDP's total operating expenditure. SDP has a legal obligation under its Greenhouse Gas Reduction Plan to procure energy from 100% renewable sources. In accordance with its Greenhouse Gas Reduction Plan, SDP has contracts with Iberdola Australia to supply electricity and renewable energy certificates.

SDP has proposed to set the energy cost allowance based on the prices contained in its existing electricity and renewable energy contracts. SDP argues that this would be in customer's long-run interests, would be consistent with its legal requirements, would be in line with regulatory best practice, and would comply with IPARTs terms of reference for this review.

Our Issues Paper sets out that in our 2011 and 2017 pricing determinations we used a market-based benchmark to set the efficient energy cost allowance. Our Issues Paper asked whether SDP's energy allowance should continue to reflect a market-based benchmark unit cost, or should instead be based on SDP's existing energy contracts. We note Sydney Water's response to our Issues Paper expressed support for SDP's proposal to set the energy cost allowance based on SDP's contracts.

In coming to our draft decision we will assess the arguments put forward by SDP. We will consider feedback from stakeholders, and will also consider any other relevant factors including how SDP's incentive to procure and manage energy may be impacted as a result of our decision. What impacts this may have on SDP's prices into the future. And whether this is in customer's long-run interests.

For capital costs, SDP proposed to spend $81 million over the 4-year determination period. This is approximately 90% higher than the average annual allowance under the current determination.

The key project driving SDP's capital costs is the membrane replacement program which involves the progressive replacement of aging membranes over the 4-year determination period. Ongoing membrane replacement is important for desalination plants, like SDP, and benefits customers by ensuring ongoing operational efficiency of the plant.

Other key drivers for SDP's proposed capital expenditure include periodic asset maintenance projects, as well as other large capital works to improve plant redundancy and reliability, including a second 132 kV high voltage feeder to provide greater resilience to the plant.

In addition to these capital projects, SDP also proposed changes to some of its asset lives which affect the rate of regulatory depreciation. Specifically, SDP proposed we move from the current 120-year asset life for its pipeline to 100 years, which would increase SDP's annual depreciation allowance.

SDP argued that since a proportion of the pipeline is under seawater, it is exposed to more deterioration that would reduce the useful life of the entire pipeline asset. Not just the portion that is under seawater.

SDP also argues that, based on advice from its engineering consultant, the physical and design characteristics indicate that the pipeline should have an overall 100-year asset life. We are consulting on this proposal, and we will consider all relevant information, including information presented by SDP as well as feedback from other stakeholders.

Overall, SDP's proposed increases in operating and capital expenditure would place upward pressure on prices for end-use customers. For this reason it is important that we carefully review SDP's proposed costs, and ensure that prices reflect efficient costs both now and into the future.

In the shorter term, we note this upward pressure on prices is likely to be partially or fully offset by a reduction in the required rate of return on assets, which has fallen since we last set SDP's prices in 2017. SDP's pricing proposal is the weighted average cost of capital or WACC of 3.6% which is 1.1% or 110 basis points less than the WACC of 4.7% used to set prices in our 2017 determination.

It's important to note the final WACC is subject to change. So this analysis is only indicative at this stage but based on SDP's pricing proposal under full production and before factoring in recent inflation data, the proposed revenue requirement is approximately 7% lower than the level used to set prices in the 2017 determination period. After factoring inflation the proposed revenue requirement is very close to the level used to set prices in the 2017 determination period.

In our Issues Paper we sought feedback from stakeholders on whether SDP's proposal represented a fair balance of service levels, costs and risks that both are consistent with Greater Sydney Water Strategy, and in the long run interests of customers.

In response, Government stakeholders recognised SDP's new role and added operational flexibility warranted by the Greater Sydney Water Strategy. There was support for setting a minimum level of production. However, there were mixed views regarding what this minimum level should be.

When asked if SDP's energy cost allowance should be determined based on actual contract costs or an efficient market-based benchmark, SDP and Sydney Water expressed support for using SDP's existing contracts to set the energy cost allowance.

Lastly, there were mixed feedback on the level of SDP's Business Interruption Insurance costs that should be passed through to end-use customers. Some stakeholders also questioned whether customers should continue paying a service charge during business interruption events, or when SDP is not delivering its required services.

I'd like to thank stakeholders for their submissions, and we look forward to discussing these issues with you today. I'll now hand back to Sandra for the discussion and Q&A.

2.2 Discussion and Q&A

Ms Gamble: Okay, thanks, Matt. So we'll go through the same process that we did for the previous Q&A which is to call from questions in the room first, and then we'll ask the online community if they have any questions. Is there any from people in the room? Carmel and Maricar, are their anybody with their hands up online? Okay, that means I get to ask some questions.

So I have a question for SDP, one for DPE and 2 for Sydney Water. So start with SDP. Your submission states that the expected levels of service under the Network Operator's Licence were agreed between Sydney Water and DPE following extensive consultation. Could you clarify the input that Sydney Water and DPE have had to your proposed minimum production level of 23 gigalitres per year?

Mr Narezzi: Thank you, Sandra. Yep. So the 23 gigalitres minimum production was something that we worked with Sydney Water to determine. So we said to ourselves from experiences from the emergency response period of what we believe the minimum baseline is required to meet the level of service.

So if you look at those 2 stakeholders that you mentioned Department of Planning was really the engagement there was to understand what level service is required, because at the time we were trying to determine what that volume of that minimum baseline should be, the Greater Sydney Water Strategy was still in draft and was still being developed.

Additionally our operating licence hadn't been finalised, and we hadn't even seen it after that operating licence, because our submission was submitted in September, the months leading up, as you can imagine it's a big job to put these submissions together.

All that didn't get finalised until about June 2022 only a few months before our submission. So leading up to there, we engaged heavily with DPE to make sure that we understood what the levels of service and what was the strategy side from the Greater Sydney Water Strategy.

We worked closely with Sydney Water to understand what the level service they're going to have to require. There were quite a few interactions and discussions on what those levels service should be, and that went on for quite a few months to understand it, and that's where we settled on the 23, once we had settled on the 23 ourselves, we reengaged with Sydney Water to understand, to make them understand how we've determined that figure, to make them comfortable with that figure, and they have actually put in their submission as part of the Issues Paper response that they are supportive of that figure.

So from a technical perspective we're comfortable that we feel like we've got the right figure moving forward, but and from a DPE perspective their submissions seem to support the idea of that baseline. But didn't comment on the actual volume.

Ms Gamble: Ash, in your submission you actually did indicate a preference for IPART to specify the minimum. Are you comfortable with where things have ended up between SDP and Sydney Water on that matter?

Mr El-Sherbini: Thank you. Yeah. So in the strategy I think we relied on advice from SDP and Sydney Water as to what an appropriate baseline figure might be, and noting that it hadn't been fully settled at that point in time and we use the figure in the strategy of, you know, under a range of assumptions, we assume that SDP can contribute an additional 20 gigalitres of yield per annum.

So to answer your question directly. Everything that Phil said reflects the conversations that we had, and yes, we are comfortable with where things have ended up. The reason our submission called on IPART to form a view as to whether that's appropriate or not is because we thought that it was really important for the transparency of how SDP arrived at that figure to ensure that it met Sydney Water's needs and to balance the needs of customers in doing that.

Ms Cope: So on the issue of whether we set a minimum level. It would be extremely unusual for IPART to set a service standard in a pricing determination. We will need to, we may need to make assumptions about it, depending on what methodology we end up using to set the prices but that in no way sets the minimum because we then just set the maximum prices. And what you guys do under that is really up to you.

So what that means is if this is a serious consideration about IPART being involved in that, we probably need to raise this in the context of the next licence that we're talking about rather than the pricing determination.

But and, as I said, we may or may not need to make assumptions about that minimum level. It depends on what methodology we end up using to set prices.

Ms Gamble: That's right. I guess, unless it's incorporated into the Water Services Agreement. You can indeed, Ifty. Thank you.

Mr Omar: Sorry. Yeah. I tend to agree with that. In our pricing structure, we've proposed something that is flexible to charge for water below 23 gigalitres as well as above, because, as you say, we're going into a new environment.

We could do it for less like we could maintain availability potentially at less than 23 gigalitres, or we may need to be higher. So the pricing we've proposed allows that flexibility and I agree 100% with Deborah's point that it's an input assumption to how you set the rest of the prices. If you are at a lower production, maybe you need to do additional services you know, or have longer lead time to produce.

Ms Gamble: And if there was a regulatory intervention hypothetically then that would be potentially manifest in the licence rather than the price determination.

Okay, I just ask Sydney Water to respond on that and the minimum service level. Did you have any other comments you wanted to make on that?

Mr Blayney: Yeah, we support the rationale for a minimum annual baseline volume. It's operationally needed for the system, but we do prefer that it's not specified, and do prefer to have a flexible approach.

Ms Gamble: A flexible approach, can you just explain what that means.

Mr Blayney: I would anticipate that over the life of the next price period, that we will learn more things about the system which means that while you might pick a number and you would optimise how you operate the system as a go forward. Having understood that we still got to try to achieve that 20 gigalitres that we planned for in terms of yield and the Greater Sydney Water Strategy.

Ms Gamble: And given that you are representing consumers and what's in the best long-term interests of consumers, you said that earlier, would you have any concerns with us assuming 23 gigalitres?

Mr Hollamby: In our written submission we have made a number of points in there that I'd reference, particularly in relation to some of the requirements are not required every year. And so it could set up a take or pay position, which is not potentially in the best interests of customers, which is why we've proposed the flexible minimal production mode.

Ms Gamble: And how do you think that might have an impact on costs?

Mr Blayney: Yeah. Well, it comes down to the volume order that you order on a particular year. We would normally work with desal quite closely, as we do with all our partners to optimise those arrangements. So a flexible arrangement would allow for that. Noting that there would be technical requirements to produce a baseline volume. There would always be under these new rules.

Ms Gamble: Okay, thank you. And finally Sydney Water, and perhaps anybody else in the room. What signal do we give to end-use customers if we set costs based on actual contracts in particular on energy.

Okay, what signal do we give to end-use customers if we set contracts based on actual costs, actual contracts. I think this is, excuse me, relevant to your submission where you supported the idea that energy costs should be based on actual contracts.

Mr Hollamby: Yeah, our position on that is around the choices that are made to invest at a particular point in time. And the analogy would be if as an example, SDP had actually built the wind farm that supplies energy that investment is then a fixed charge or a fixed cost. And which is compared to a market, and the market is variable, and it's been quite variable for quite some time. And our proposition is that was actually an efficient thing to do to enter into a long-term power purchase agreement with a wind farm over a long period of time to supply renewable energy. And we support the position that customers shouldn't have to bear the cost of market fluctuations when there's been a significant investment in the fixed price contract for energy.

Ms Gamble: Okay, thank you very much.

Ms Cope: Completely understand what you're saying when we're dealing with a past contract, the question for me is going forward. So if we set the price now based on actual contracts. How do we then deal with the next contract? Because you could imagine a situation where a business, obviously neither of yours would say, oh, the regulator is going to give us the actual price of the contract. Therefore we don't need to put so much effort in negotiating the next contract, or we can increase the price and put it put a bit more fat in it to manage risk, or something like that. So if we did go with actuals what do we need to do to make sure that we don't lose that important incentive in the system going forward?

Mr Hollamby: Great question. So I'm answering on the fly for that one. I think when those decisions are made a prudent and efficient business will look at the options, assess those options based on risks and cost and then make the best decision based on those risks and costs.

Now, obviously the regulatory regime needs to if there's no incentive for them to reasonably balance that, it's a great question about how an organisation could demonstrate prudence and prudent and efficient expenditure. But I think it is possible through analysis and obviously rational decision making.

Mr De Lorenzo: Thanks for the question. My name's Justin De Lorenzo, Chief Financial Officer of SDP. Just to pick up on your question, Deborah. I think the way we've presented our proposal is very much to talk about a very unique set of circumstances that came with the project approval back in the 2000s prior to 2010. I don't think necessarily what we're saying, and we certainly don't have a comment about the future or the next iteration of our energy evolution whether it's by contract or otherwise.

I think we would reach out to all of the stakeholders here in the room, and others probably, in addition to talk about how we might do that. But I think it's the proposal we're putting is very much specific to this contract and to this determination. So yeah, in that sense, I don't think it necessarily sets any precedent for the future.

Ms Cope: And I think that's a really important point that if we did decide to go with the actuals because of that we would nearly by definition be having to say explicitly that we are not setting a precedent for how we would deal with future contracts, because we would completely undermine that particular incentive.

Mr Hollamby: And, Deborah, if I may just add I think the review obviously you can't also commit a future Tribunal to a decision as well. And I think efficiency reviewers have always looked at the procurement methodology behind and in the decision making behind those types of decisions when they occur, and I think that's it's I agree with Justin that it's not a precedent, because we can't bind the future Tribunal decisions on that review.

Ms Donnelly: Thank you. And obviously for those that, unlike me, may not have the Terms of Reference right in front of them. We are very clear that the Terms of Reference specifically require us to consider SDP's ability to recover those costs in complying with its contracts.

Look that's been a good discussion. I'm aware that we've got some catering out there and a break that we're now running a little late for. I'm going to suggest, because I know that there are probably a few more questions that Deb has, that we actually have a break and a leg stretch.

And we're due back at in about 12 minutes, so I think I might give us a little bit of leeway because we're starting late. I'd like to be able to bring us back in by 11:45am. Probably go to any more questions, and then we'll move on to Session C if that's alright.

For those online I'm sorry that we're not able to cater for you. But please go on mute and turn your camera off, stay online. So you don't have to re-join and go and get a cup of tea, and we will see you again and we will be kicking off at 11:45am.

[SHORT BREAK]

Ms Donnelly: In a moment we're going to begin Session C, and I will in a moment hand back to Sandra to facilitate that session. But just before we do that, I'm going to ask Deb has a couple of questions, and we'll deal with them first. Thanks.

Ms Cope: Thanks very much. So this is a question for 2 people, SDP and Sydney Water, and it has kind of 2 bits to it. But I'll ask them together, and then let you sort of work out how you want to deal with the answer.

And it's about flexibility and it's sort of how flexible is flexible because Philip talked about complete flexibility. And I can't remember who it was that mentioned it from Sydney Water but it was around talking about sort of efficient level of flexibility.

So how flexible is flexible and how does flexibility affect cost? How does it drive cost? Is it how much you go up and down? Is it how frequently you go up and down? Or is it how quickly you go up and down? And how is that going to be managed to get the efficient level of cost?

Mr Narezzi: I can start then hand over to Sydney Water. I think from a flexibility perspective an annual production will be set for the year, call that a say 100 gigalitres or 90 gigalitres if we are at full production. But the sequencing of that production won't be the same every day. That will go up and down each day, and we will have a crack at that with Sydney Water at the start of that year. So this annual production question will be set on the first of May for the starting on the first of July.

So at that point in time everything we know at that point in time, there may be issues with its system that they require more water one month and less the next month, more water one week, less next week, more water one each day the next day.

Then that scheduling of that of that production will be adjusted on a monthly, weekly, daily basis. There are if you look in the decision framework there's concept of a monthly production request and a weekly production request, and they're all related to that each week Sydney Water assesses, and they can speak to this, but each week they assess what they need in the system, and they will adjust what we have targeted as our production.

So that's when I refer to full flexibility. It is for flexibility that even though we've set our target for the year, how that flow is sequenced each day will be will change, and morph. And issues will arise from both parties from Sydney Water and us. We will have constraints of the plant. We'll have issues at the plant that we need to manage. So we'll need to adjust those things as well, so maybe we can just talk about flexibility. Then we can talk about cost.

Mr Blayney: Can I take a step back, when we look at what source of water that we supply into the system, because that's what drives the costs of water largely at the bulk scale. We certainly look at an annual production request, and we're looking at things like the yield, and what's required according to those rules set out in the decision framework and the dam levels and those sorts of things. So we set that first on an annual basis.

The annual basis also has to look at what's going on in the system with the other sources of water. So Sydney Water is looking at its outages across the system. And how do we schedule those across the system with the sources of water that we've got.

That's where a little bit of flexibility occurs at the annual level. At the monthly level then it's about how do we implement those maintenance programs considering what's happened in the system with maybe rainfall events, or whether there's been a drought trigger when it gets to I think it's at that minimum level there I can't remember what, around 75%.

Once we get to that level that sets a different volume of water requirements. And certainly we're responding to the higher risk drought periods in that period. So at a month level you're looking at those things.

But you're also looking at the micro, again the micro stuff that's happening on the daily basis. And then you can actually see what is at the monthly production request. You can see what's happening at each of those plants. And then you're starting to balance public health risk really acutely, safety and cost because you're still trying to hit that annual yield target that's water security target but you're really trying to hit those costs at that point. That's why that's quite flexible within different parts of the levels within the dam to achieve those outcomes.

Ms Donnelly: And I think, Philip, you wanted to now move on to cost and efficiency but, Jamie, sorry did you want to add to Ben's comments?

Mr Hollamby: Yeah, just on a first principles basis. We would love to be able to turn the SDP on and off whenever we liked. And we know that's not practical. And we know there is work that is required in order to have it available to turn on in a reasonable period of time, and that is the to meet our levels of service, so water quality and of water security.

And we want to do it at the lowest cost. We know the SDP costs more to run than in our other facilities. And it's also a risk balance where if we can't turn it on when we need it that will also create a problem. And so I see this as a very micro balancing levels of service, risk, and cost on a daily basis, or on a much shorter timeframe than the whole regulatory cycle. And I think that's the balance of the engineering, the cost side and the levels of service that we need to manage.

Mr Blayney: And I guess that's why we involve DPE and SDP in developing the decision frameworks as the guidance tool to how to make those decisions, so it's not up to the whim of an operator on either side. The decision framework guides those principles.

Mr Narezzi: I'll finalise on the flexibility. It was mentioned early today that the plant was originally conceived to have that flexibility in operations. That's somewhat correct, but also not quite correct.

To what Jamie was just alluding to was the plant is not designed to run a full production, drop to zero, run at full production, drop to zero on a daily basis. It's not designed to do that. And that's where you get a lot of inefficiencies and issues and problematic.

What the flexibility that was in the original design of the plant was for more longer term and modular operations of the plant. So the plant is split into 2 modules, and there's multiple modules, sub modules in those modules.

So it would be that if for 3 months you know that you're going to be a certain flow rate it's consistent that's what it'll be. The ramping up and ramping down of the plant is what causes a lot of grief from an efficiency perspective, and also issues and upsets of the plant. And that's what a lot of lessons learnt a lot of issues that we've had over the last few years in running in that flexible way.

Now to costs, I might hand over to Matt Blaikie, our GM of Operations you can also touch on, but just from a higher level we only get paid for the water we produce. The way we structure the prices we have a fixed charge and a variable charge. The variable charge will cover the dollars per litre of water we actually produce.

So when we do set that annual production request, when that is issued by Sydney Water to us, that is, effectively the maximum price that we can charge for water that year we can't overproduce. There is a threshold of plus or minus 10% on that to allow us a bit of flexibility, so we're not trying to hit one like the last litre on that. So we do, and we'll work with Sydney Water on producing, so that at least then sets that maximum cost base. And then Matt can allude to the actual details to Deborah's question about how the inefficiencies of their ramp up and ramp down.

Mr Blaikie: Thanks, thanks, Phil. My name is Matt Blaikie. I'm GM Operations with SDP. And look Phil made a very good point that yeah, we are indifferent about how much water we produce. So the cost of the variable water do we produce is reflected in the variable cost, and we've been sure to and to make sure that our proposal includes that.

So then we have what are the increases in our fixed cost of being available. It's probably 3 things that we should consider in that respect. Number one is, you know, being available to be able to respond. And that's probably the difference between now, when you know, when outside drought, the plants not operating. So we get rid of some of our operational staff, and it's just in the care and maintenance mode, where there's less people there ready to operate it and ramp it up when needs to be.

Whereas this time we just setting, you know we need that staff at all times. We need the experience, etc., etc., and we need to be able to respond to the drop of a hat. So that staffing level remains. And then we've got some lessons learned on a couple of extra staff that we need just to make sure we can do that efficiently, and Phil has touched on that before.

So number 2 is then being able to ramp up quickly operationally, and once again Phil has touched on that. The plant was sort of originally designed you had a request for a certain production volume over a period of time, and then you could manage the rest of the plant just to give that production response.

One example would be the membranes. So if one of our trains isn't running, one way you could maintain the rest of those membranes, is to put it in preservation for a long period of time. The problem with that is, then, it will take, you know, weeks to months to bring those trains out of preservation and then operate them and ramp it up.

So instead, we produce a little bit of extra permeate, so that's the water from the RO process, and use that to flush the trains, you know, every second day. So that rather than preserve them, they're available to run very quickly. So that cost is, you know a fixed cost that will be incurred, no matter what happens from now on. If we're in a flexible operation, we'll have those kind of costs, and there's some other examples similarly.

And then the third part is yes, on a case-by-case basis a ramp up is a little less efficient because you've got to get the plant to a steady state of operation, and so you do have a period of time where that water is not in going into the supply. So there are a few inefficiencies in doing that.

But equally we plan to implement asset rotation, where we're rotating through all of those trains on an ongoing basis so we know they're ready. And that's similarly if you're swapping from one train to the other for a period of time, you're ramping it down. You're still using a bit of energy. You're ramping another one up. You're using energy, but there's a period before that water then goes into supply. So that's probably the third one.

There is some effect on how much we're asked to go up and down. But even if we're not asked to go up and down, we'll be ramping our trains up and down so that's kind of you know set as well,. But that's probably something that's a little bit different than the current ERN process because we haven't really done that asset rotation. And we haven't got a lot of requests from Sydney Water to move our production around. And we anticipate that yes, we don't want that to change every day, but we want to respond as much as possible to Sydney Water's request, and maybe every day we will be adjusting production. So yeah, they're the 3 main, I suppose efficiency or cost drivers for flexibility.

Ms Cope: Does the way Sydney Water order that water on a daily basis affect the cost then?

Mr Blaikie: Not so much it does affect, I think planning. Obviously there's a lot of other tasks we need to do around maintenance, which you know some of those things will involve a shutdown of the plant for a period of time.

So if we want to set up something for a couple of weeks' time, and then Sydney Water rings us the day before and says, oh, look we've got an issue, we need you to ramp up. Then there may be some costs of delays and those sort of things. But as for the number of times we're asked to ramp up, only really that time it takes to get the plant stable and putting that water into supply that does affect it a little bit.

But there's not. Its swings and roundabouts I suppose, because we have got that asset rotation that does the same thing. But yeah, if we're asked every day to go from zero to 250 then there'll be long periods of time where we're getting the plant stable, when we may be having whole days operation where only half of the energy you're using is actually going into costs and water supplied to customers. So yes, it does have an effect. But our proposal aims to make some assumptions on how many times we'll be asked to ramp up, and then, you know, put that into the fixed cost forward.

Ms Cope: Did Sydney want to want to say anything around that response on cost?

Mr Blayney: I think you'll find that we're generally incentivised to maintain a stable production out of desal as it stabilises water quality in the network. And that is the biggest driver is the water quality for Sydney Water in the short term and supply of water, continuity of water to the customers.

So it does generally give you that response, and that is certainly a strong incentive for Sydney Water to stabilise production when we would be typically ordering water that's moving around is during emergencies and system shocks at that point. The operational protocols that support both organisations kick in, and there is strong communication to ensure that this efficiency is achieved.

So we will do what we can to avoid costs that we don't need to spend at any of our plants. We would always do that, and we do that with our (indistinct) partners as well as WaterNSW. That is a constant conversation.

And just to note the way the ordering system works is that largely Sydney Water is interested in the annual and monthly production. We're very interested in the daily, of course but the way it's set it's quite flexible for both parties to modify the daily production, to draw those efficiencies out. So it's not going to lock us in any specific way that we really want to hit our monthly and annual production targets.

Ms Donnelly: Okay, Thank you. Well we'll move on to Session C. And I will hand over to Sandra.

3 Session C – Incentives and risks

Ms Gamble: Hi welcome to Section C. So let's start that, in this session the IPART secretariat will provide a short presentation about issues raised in SDP's pricing proposal about incentives and risks and a summary of submissions on these issues. We then have a Q&A as we did before.

As Carmel indicated, one of the key considerations for our review, excuse me, is establishing a framework that provides incentives for SDP to pursue ongoing improvements in performance and reduce costs.

For this review, many of SDP's current incentive and risk mechanisms will need to be reshaped to better suit SDP's new operating environment. Our aims to consider SDP's incentive mechanisms in the light of the new operating environment to ensure there is a balance that provides risk management, and is in the long-term interest of consumers.

The following presentation will provide an overview of SDP's proposed incentive and risk mechanisms and we'll highlight the proposed incentive schemes, cost-pass throughs, and true-ups, before outlining what we've heard from stakeholders.

I'd like to hand over to Rhea Rachel who present on behalf of IPART. Thanks Rhea.

3.1 IPART presentation

Ms Rachel: Thank you, Sandra. So as Sandra mentioned this presentation will focus on SDP's incentives and risk mechanisms.

We'll begin with an overview of SDP's submission. So SDP has proposed several incentive and risk mechanisms to apply for the upcoming regulatory period. While the efficiency carryover mechanism and the energy adjustment mechanism are presently in force, SDP has proposed changes to these mechanisms that it considers will better align with the new operating environment. For example, SDP proposed the energy adjustment mechanism apply to surplus energy at all levels of production, rather than to only shutdown and restart periods as per the current Determination.

SDP also proposed a new Service Level Incentive Scheme, or "SLIS", to replace the existing abatement mechanism, and we'll talk a little bit more about that in the slides that follow. Additionally SDP also proposed a combined cap on financial rewards and penalties for the SLIS and the efficiency carry over mechanism. The proposed cap is equivalent to 2.5% of SDP's annual fixed plant charges.

SDP's proposal also includes several cost items to be covered through cost-pass throughs and true-up mechanisms.

In addition to this SDP requested IPART to clarify the type of events that would lead the Tribunal to replace the Determination. It also outlined a set of conditions that proposes to be taken into account in these scenarios. I'll now move on to the next slide to talk about this SLIS.

So prior IPART determinations have applied an incentive mechanism which was known as abatement and that was designed to incentivise SDP to maximise its production during drought-response. The abatement mechanism was well suited to SDP at the time, because it reflected SDP's role as a solely drought-response asset.

As we move into the new operating environment, it's important to rethink the design of incentive schemes for SDP and ensure they're still fit for purpose. SDP's proposal recognises this need, and puts forward a new Service Level Incentive Scheme or a 'SLIS' to replace the existing abatement mechanism.

The proposed SLIS is designed to mirror the framework of SDP's new Network Operating Licence. This licence, which will come into effect alongside this Determination, provides SDP with the ability to produce water within a plus or minus 10% band of its Annual Production Request. SDP's proposed SLIS intends to reflect this framework by setting financial penalties and rewards for production outside the 10% band.

In our Issues Paper we sought stakeholder feedback on the design of this SLIS, and noted that incentive schemes should be designed with the primary goal of adding value to end-use customers. Towards the end of the session, we'd be interested in hearing stakeholder views on the design and implementation of SDP's SLIS. Next slide, please.

In its proposal, SDP noted a range of costs it considers "uncontrollable" and proposed that these be covered by costs pass-throughs or end of period true-ups. The cost pass-throughs, SDP proposed adding 3 subordinate Greenhouse Gas Reduction Plan (GGRP) cost items to the existing energy network costs pass-through category. These cost items include Unaccounted for Energy charges, Reliability and Emergency Reserve Trader Charges as well as generator compensation charges.

For end-of-period true-ups SDP proposed some energy costs along with some non-energy related cost items. The energy related items include ancillary service charges, market fees and network losses, while the other items include insurance premiums, chemical costs, land tax and council rates.

In our Issues Paper we sought stakeholder views on the balance of risk resulting from SDP's proposed cost pass-throughs and true-ups. Sydney Water expressed concern that the proposed range of true-ups would result in a greater share of business risks being shifted to end-use customers. Similarly, DPE reflected on the overall imbalance of risk between SDP and end-use customers.

Our Issues Paper raised several questions aimed at understanding stakeholder views on SDP's incentives and risks. On the overall allocation of risk between SDP and customers, some stakeholders flag that the proposal would transfer too much risk to end-use customers.

Stakeholders generally agree that the existing abatement mechanism is no longer suitable given the change in the operating environment. However, some stakeholders raised concerns regarding the design of SDP's proposed SLIS. Specifically, DPE considered that this SLIS should not reward SDP for overproduction while Sydney Water also questioned the scheme's effectiveness in delivering good outcomes for customers.

In terms of cost of capital, we received mixed feedback regarding whether SDP's proposed changes in risk allocation should necessitate changes to its WACC. On one hand, some stakeholders reflected on the need for SDP's rate of return to reflect the holistic level of risk that it bears. And on the other hand, SDP expressed concerns that the WACC should only be amended to reflect changes to systematic risks rather than to its business specific risks.

We note that IPART's WACC Methodology allows for the review of certain WACC parameters, including equity beta and gearing at each price review, where there is supporting evidence. In this review, we will consider all stakeholder views in reaching our decision, and we encourage any further views on this matter at this public hearing.

I'll now hand back over to Sandra for our discussion in Q&A session.

3.2 Discussion and Q&A

Ms Gamble: Thanks Rhea. Okay. So do we have any questions in the room? Ash.

Mr El-Sherbini: So I was just going to ask a question, perhaps to SDP to clarify the intent of this SLIS and whether it applies within the plus or minus 10%, or beyond the plus or minus 10%.

Ms Gamble: In particular, whether it rewards them for over production. You mentioned this earlier in as a misunderstanding. I think we're all in that boat.

Mr Omar: So the SLIS. That we've proposed is outside of the plus or minus 10%. So if we were to under produce below 90% of an annual production request. It's from that point downwards that the incentives would start to kick in, or the penalties would start to kick in.

The positive incentives were designed so that it's symmetric. But in practice given where the licence has landed, it's got a 10% buffer above and beyond. So when we go above 10%, we start actually breaching our licence, so we would be in breach of licence. We wouldn't get paid for any water over 110%. So, technically there's a potential, under the design of this SLIS, that we would be able to earn incentive rewards for over production. But practically, the incentives are outweighed by the cost to us of not getting paid for that water. So it just doesn't fit into the framework that we ultimately landed. It's fair to say that we started with a symmetrically designed scheme before the licence was fully landed. So kind of had to just finalise towards the last minute.

Mr Narezzi: Just to add just to be clear. So the intent was not to be rewarded for overproduction above our licence requirement.

Ms Gamble: Thank you. That's a very useful clarification. I was going to wait to the end. But I'll just ask a follow up question since we're on the subject.

So you have your licence, which says you have to produce the required quantity, plus or minus 10%. You've got the Water Services Agreement, which also sets out how you respond to Sydney Water's requests. You've got the Greater Sydney Water Strategy as well, and the decision framework. What gap is the SLIS trying to fill?

Mr Omar: I think it goes to what I alluded to, that it wasn't clear where the licence was going to land when we started designing this. So you know we do see the next period as one where we will test and learn what is actually the valuable service and what should be incentivised. This SLIS was largely designed before we knew there was going to be a plus or minus 10% band.

Ms Gamble: So is it potentially obsolete?

Mr Omar: Potentially obsolete for this reg period, yeah.

Ms Cope: I have a related question which is, is there something else that is worth incentivising in this regulatory period. You know, is it response, if there was a drought or managing the minimum level of water production efficiently, or something like that? Is there something else that is worth incentivising through some sort of incentive scheme or are we just too uncertain at the moment?

Mr Omar: Okay, I'll have a go first, I think in terms of a bespoke incentive scheme. I think we should be thinking about learning from the upcoming reg period rather than implementing something, because we don't really know. In terms of incentives I'd say the biggest one is ensuring that we are available, so that's all the things that Matt was saying, make sure the plan is operating in that sort of availability context.

Ms Gamble: And potentially you have an incentive to do that, because otherwise you contravene your licence. Well that's an incentive.

Mr Omar: It is an incentive. Yeah.

Mr Narezzi: The other thing I can add, we've got to be very careful that if we do construct something that is different, it drives the wrong behaviours and wrong incentives, and it actually impacts the level of service that we can actually provide because of the unknown nature of how this may actually work in practice.

And we did see that a little bit from the last determination, because we hadn't actually operated under the abatement regime that was put in place. And that did drive certain behaviours from us good and bad, that were driving because we were always focused on that large penalty regime. But you know we always tried to put the customer first, and delivered and met all our production requests, and we take that as a company. We take that fundamental as our and our owners do as well that that's our service. That's what we're here to do. And we've demonstrated that through our restart. We went early on the restart. We had cost at risk for a restart, because we were in drought, and the dams were falling. But we were restricted because we weren't allowed to start until the dams actually hit a level.

But we did all those things because that was the right thing to do, to help customers and to move forward and help Sydney overall. And we'll continue to do that. And same with emergency response. We've responded to every emergency response, even though at times it was commercially challenging. That's what we've done.

Ms Gamble: Okay, Thank you very much. Were there any other questions from the room, any questions online, no questions online. Guess what, I've got some questions.

Okay. So I'm just trying to amend my questions so that I don't ask the same thing again.

Okay, excuse me, for SDP we've noticed that many of the operating operational cost risks you've proposed should be borne by customers through cost pass-throughs and true-ups. If we allow that how can that change the cost of capital? Given that the cost of capital is for a business that does bear a level of risk, the standard one. Sorry, Justin.

Mr De Lorenzo: No, thanks Sandra. So we've been quite I guess specific about the sorts of cost pass-throughs that we're asking for. We're not, it's not some panacea of cost pass-throughs. They're quite specific to things that we feel we can't control or manage. And they're really in 2 buckets.

So there's the cost pass-through that is related to the energy market. And they are things like I think we can all kind of understand that the energy market is going through quite a transitional phase right now from traditional supply of energy, through coal gas and other means to renewable.

And the energy market operator and the energy market generally is looking at what are the new costs that come out of that regime. And some of them we're bearing at the moment. They are changing quite rapidly. Things like unaccounted for energy turned up as a new cost pass-through last year, and it moves around in a very volatile way. It really has nothing to do with the way we operate the plant. It's just about how the market works. Potentially there are new capacity charges coming. We've heard that there are generation compensation charges for events that occurred last year. Again, when markets were out of sync, again nothing to do with our operations. So we've put those in the cost pass-through category because we get those costs passed through to us directly.

And they're not things that on our side of operations we can really change because we have to produce water when we are asked to. And that is what we have been doing. So nothing in our internal production can change the outcome of those costs, and they get passed through to us immediately, as they do, as retail energy retailers do with other market customers like us, so that they are the specific things in the cost pass-through bucket.

The end of period true-ups tend to be things that are again uncontrollable from us. Land tax is a really good example. Council rates, which is based on the value of the land that that we sit on in Kurnell. Again, those things change rapidly. We received our most recent land tax valuation, which went up by 22%. That's something that the Valuer General determines. It's not something that we determine. But we're saying, look, we're prepared to live with that cost increase or decrease, which could go the other way of course through the regulatory period, but with a true-up at the end. And there are probably 2 or 3 other examples that we've put in. So we haven't used it as some sort of panacea. But where we have recognised it, there is a cost change that we cannot control, and that is directly passed through to us. We're a single asset business. You know we have one kind of income stream. We don't have a diversity of scope that the other water businesses have that we think that was a risk.

Sorry in terms of the WACC, I might get Ifty to make a comment. But I mean how I understand what methodology is, it is basically compensating us for systematic risk, not business specific risk. And systematic risk is the broader economy-wide risk for an infrastructure. And things like the equity beta compensate for that, and they are based on a broad market outcomes. And see how that fits with business-specific cost pass-throughs are therefore business specific risks.

Ms Gamble: Okay, so this systemic risk which is the risk associated with....Okay systemic risk, which is the risk associated with owning equities. And there's systematic risk which is around the industry I guess that you're in. And when we sample the industry that you're in, we're often sampling businesses that are taking those risks and if they are not taking those risks, they are in a different category, potentially more in the bonds than they are in the equities.

So would you suggest that we then look at a range of sample securities that reflect a level of risk that is commensurate with the one that you're proposing to apply here and potentially that means a lower WACC.

Mr De Lorenzo: Well let me just start by saying I don't think that the small group of costs that I just outlined before puts us in a different category, because they are clearly costs that we can't control. So no, we're not suggesting for one minute that we would look at some different WACC setting apart from what you have as your standard WACC setting that was published in the 2018 guidelines.

Ms Gamble: The other is there are some costs that you are proposing to pass-through to consumers that you probably have some control over, insurance and chemicals would be two of them. You go through a process, as all businesses do, to procure those inputs. Are you suggesting that consumers have more control over those costs than you do and that's why they should bear them?

Mr De Lorenzo: Our view is that we don't have control over some of those costs, and I think that I can speak about insurance because it's you know something that that I get involved in. But if you look at the past 5 years and the way insurance costs have played out we have exceeded our allowances for insurance.

We obviously take a lot of care in understanding what insurances we should have, and we put a lot of effort into that. So we haven't changed that insurance profile over the last 5 years, notwithstanding that the global market rates for insurance have increased exponentially mainly driven by global factors, like climate change or all factors within Australia like bushfire, and are climate related as well.

So certainly, from our point of view, they are things that are more driven by global factors than by specific business factors. And that's why we have put that in that category that maybe someone wants to make comment about chemicals.

Mr Omar: In terms of, you asked earlier Sandra, that do we agree with their statement that the risk should be borne by the party best able to manage them, and we agree with that. And that's the way we've designed our submission.

So if I take the insurance example first. If we've got a significant change in the insurance market, like we've had. Our insurance costs are probably about, I think, $2 to $3 million above the previous allowance, and that's driven fully by global market factors which we have no control over but have been affecting, I think all infrastructure businesses globally.

In terms of who's best able to manage that, if those millions of dollars for SDP is significant, for that type of cost to be spread across the larger customer base is small in the scheme of their overall bills. So would argue that the broader customer base is better able to manage that sort of risk, than SDP is able to. So that's what's reflected in our submission.

In terms of chemical costs, there's also, in terms of this true-up it's really symmetric. So when you're coming to a determination, you'll look at what the market is telling you at the start of a regulatory period that can change quite a bit. You can go higher or lower. And so what we are saying is that it's more efficient for SDP not to be unduly impacted by significant market changes when it could mean millions of dollars of change for SDP, which causes financial stress to the business, challenges our ability to deliver the service efficiently.

Whereas if that cost was, or that variability was reflected in the customer bills through a true-up the broad customer base would be better placed than us to manage the risk. That's the approach we've taken in the submission.

Mr De Lorenzo: Maybe, Sandra, when you posed that question you almost put it like a choice. So I might just say to you that from SDP's point of view, we're much more committed that IPART apply the 2018 WACC Guideline than anything else. That's a high priority obviously, than one or 2 cost pass-throughs.

Ms Cope: Just on that so in the WACC you're absolutely right when you're dealing with the equity beta that's set by systemic risk. We also set the gearing ratio on a case-by-case basis and that is more about the risk of the actual business, and we do have precedent. I think it was in Essential Water back in 2012 when the gearing ratio was adjusted as a result of mechanisms that were built into their determination in order to reduce the risk of the business. So I think there's still issues there that we need to think through. But I don't know if you've given any thought around the impact on the gearing ratio of the reduction in the risk in the business.

Mr De Lorenzo: I think, whilst we don't have a public credit rating like some infrastructure businesses, the way that we are considered by our financiers is a true investment grade credit. So we would say that our risk profile, gearing, and all the components that go into that consideration, are clearly investment grade, which is, I think, what IPART sort of targets in terms of thinking about the benchmark business. So we would say that we meet that.

Also our gearing has been reducing significantly over time. I think last time we sat here it was 5 years ago. It was something like 80%, now it's 70% and it's going to come down considerably over the next period of time. So we're starting to converge on that ultimate gearing ratio. But having said that, as I say, there's a broader consideration about risk and risk profile that is done by financiers. The people that we, have to procure our debt from that is broader than just the gearing ratio in terms of risk profile, and we meet that benchmark risk profile.

Ms Cope: I think the point on the WACC though, is more, if you've got a business that's far less risky than you would normally expect that there'd be a higher gearing ratio associated with that in the WACC, and that's part of the current WACC methodology.

Then I just wanted to talk a little bit about the pass-throughs, and particularly those that Sandra raised around insurance and chemicals. And it is absolutely true that there is a market out there that's got rising prices in it, and you're not going to show how to shift the cost of chemicals. And it's a little bit like the question I had around the energy cost earlier.

What you do have choice over though, is who you buy those chemicals from and what the terms of that contract are. How do you maintain the incentive in the system to buy the best value chemicals for long-term interest to customers in a system, if you've got an automatic pass through of all of those costs?

Mr Blaikie: Thanks. I can definitely take that for chemicals. So what we've proposed is not necessarily a direct pass-through of our costs of chemicals. It's to set a chemical price and chemical usage. Then to use a chemical index which is like an ABS type index to adjust the whole lot up and down based on that index. So we are still incentivised to get the best possible prices for those chemicals, to go to different suppliers and try to find the best price.

Obviously it's been a little bit more challenging than in the past and with annual production requests, and the ability to know that we're continuing to run we can definitely use that as something to leverage as well. But it's still in our best interest to pay as little as possible for that, because we'll be incentivised. And then next time around you can come and have a look at you know how we've managed to do that in the market, and then take that into account when setting the prices next time.

Definitely in our operator, Veolia, we've got a very sophisticated operator that operates a lot of plants, particularly along the eastern seaboard. So we get the benefit of that very much in finding out, going out to market and getting those rates. So we're not just sitting there as a single entity, we're definitely getting the benefit of buying power there as well.

But yeah, we're not asking for exact pass-throughs for chemicals. Just an acknowledgment that you things like the Covid and supply chain issues have had big effects on the market, and it's shifted, greatly more than general CPI.

Ms Cope: Sydney Water is on the other end of this. What's your view on the pass-throughs that have been and true-ups that are being proposed?

Mr Blayney: I can answer not knowing the exact numbers of what's proposed in terms of ABS or CPI. Generally that does incentivise our existing contracts to search out for better prices, because it gives them a cap, and they work to that cap. But in terms of what the proposed I couldn't comment. I'm not sure if we could add any more to that.

Ms Cope: I'm trying to get a feel whether you agree with what SDP is proposing to pass in the way that it manages risk in its business given the impact that it would potentially have on you and your customers. Or whether there are things that you think we should be looking at when we're considering those proposals.

Mr Hollamby: So our written response does have a general comment in there about the number of pass-throughs or true-up mechanisms. Without access to the specific cost information, it's quite difficult for us to publicly comment on those. But that's our general statement we made in our written submission. I think there was one quite specific comment we've also made in regards to the insurance and the risk transfer related to the insurance levels as well. So that's our written submission, those are the areas that we've commented on.

Ms Cope: Okay. So if you can't you said you can't contact comment on the numbers. Do you have some views on what sort of principles we should be using then, when we are assessing whether those pass-throughs are appropriate or not?

Mr Hollamby: I'm not sure we've actually really thought through that for a fully informed position. And it is a very good question Deborah. I think there's a couple of things that come to mind. One is, we don't want the cost pass-throughs to be a ratchet, i.e. your efficient in 95% of the costs and then the 5% that goes up customers pay for. And so I think there's that concept of is it a ratchet or not.

Then the other concept which has already been discussed is controllability and incentivisation, and what that looks like. So I think just off the top of my head, without a well thought through and discussed answer. That's a couple of things that we would point to.

Ms Cope: Okay, thanks.

Ms Gamble: Can you hear me now? Yes. Are there any more questions either in the room or online? I don't think so. That's been a really great discussion. Thank you very much I know there's some things that we could read in submissions. But it's important that we open these lines of inquiry, so that we give the opportunity for people to add additional layers of nuance. So I think that's what we've achieved today. So with that I'll pass back to Carmel.

4 Session D – Pricing arrangements

Ms Donnelly: Thank you. Okay, and let's move on to Session D, in the home stretch. We're going to talk about pricing arrangements. We'll follow the same format. Maricar Horbino from IPART will give a short presentation, and then we'll move into question, answers, comments from there. So over to you Maricar.

4.1 IPART presentation

Ms Horbino: Thank you, Carmel. Our presentation for this session will focus on SDP's proposed pricing arrangement over the 2023 determination period. I will begin with an overview of SDP's proposal, followed by comments we received to date from stakeholders.

SDP's proposal is broken down into 2 parts.

Firstly, it proposed to simplify its price structure by charging a 2-part tariff this means setting a plant service charge that applies when the desalination plant is operating, and recovers the fixed cost of the plant. Then a pipeline service charged to recover the fixed cost of the pipeline. And lastly, a single water usage charge to recover its variable cost.

SDP proposed to levy these charges to Sydney Water as its only direct customer at present but Sydney Water would then pass this charges to its end-use water customers.

SDP proposed to apply this 2-part tariff when it is producing water at minimum production level and above. For instances outside of this arrangement, it proposed to negotiate prices directly with Sydney Water, and will be captured on the negotiated agreements.

According to SDP this would enable the service scope, and prices to be negotiated without the risk that regulatory constraints could delay the timely provisions of those services. This arrangement would, for example, enable the plant to shut down in the likely event that it is requested by Sydney Water and negotiate the price. The SDP indicated that this could be done without the needing to assess all potential costs that may be related to shut down and set these prices for the 2023 determination period, or alternatively reopen the determination. Overall in its pricing proposal SDP indicated that the objective of this proposed arrangement is to have flexibility so that services can adapt to the circumstances and arrangements for this to occur can be agreed quickly.

In our Issues Paper we noted that we would assess whether the proposed pricing arrangements provide good value outcomes for Sydney Water and end-use water customers. Towards the end of this session we would be interested in hearing stakeholder views on how we could incentivise both SDP and Sydney Water to negotiate and drive the best possible outcomes for water customers.

The slide that we have here provides a high-level summary of the responses we received from the stakeholders on our Issue's Paper and pricing proposal from SDP. There are 3 broad responses we received.

Firstly, some stakeholders raise concerns about price increases and affordability.

Secondly, for the tariff structure some stakeholders provided support for a simple tariff structure going forward. For example, Sydney Water supported the proposal, as this would simplify payment at the administration, and provide clear prices. However, it also suggested that IPART may need to consider setting prices for shut down and restart, in addition to the proposed 2-part tariff.

For the for negotiated agreements, we receive mixed responses. On one hand Sydney Water did not support SDP's proposal for the 2023 determination period, however, it noted, that it is open to continuing this proposal in future determination. Once it has gained more experience on the flexible arrangement with SDP.

On the other hand, SDP clarified that its proposal did not mean automatic pass-through of cost to water customers. Rather it is proposed to have relevant costs be subject to review by IPART under the Sydney Water Price Review. It also noted that its proposal for negotiated agreement is consistent with other IPART water price reviews, for example, the Broken Hill Price Review that was recently completed. We would be interested in hearing more from stakeholders on SDP's proposed pricing arrangements and look forward to a good discussion, and that concludes our presentation. Thank you.

4.2 Discussion and Q&A

Ms Donnelly: Thanks Maricar. Well, I'll follow the same process and look for questions or comments in the room first then keeping an eye on people online in Zoom, and then I'll go to the Tribunal. So any questions or comments from people in the room, doesn't look like it. Oh yeah, Ash.

Mr El-Sherbini: Sorry, just in the absence of any other comments, I'm interested in the negotiated agreements point. And I was going to ask SDP to clarify the intent behind that.

Mr Narezzi: Just to just to clarify one point, we are not proposing unregulated agreements. They are negotiated agreements. So the intent was that, as we demonstrated in our presentation earlier today, that things may not occur as assumed for the next regulatory period, because that didn't occur in 2017. So, and we use the example of a shutdown just as an example, that if, for whatever reason something does occur in the next 4 years, that isn't envisaged at this point in time, and it's envisaged in the determination, that we still have the ability to be able to negotiate a service and a price for that service with our customer. That would be still subject to oversight by IPART.

Because there were certain things that were put in place in 2017 that caused a lot of constraint and undue pressures on how we can provide a service. The emergency response is a perfect example, and other areas that we're just trying to propose a way of dealing with those unknown things that may occur.

We're not suggesting that the IPART should set a price for a restart or a shutdown, because under our current licence there is no provision for that to actually occur. And the issue with trying to set prices for those 2 transitional activities is we really need to understand the length, the scope, and the details of those transitional periods, or the prices will not reflect the actual what is required.

It's not as simple as we just need a fixed price for a shutdown for example. It depends on the length of the shutdown, how long will occur, what is required to come out of the shutdown, a whole bunch of things related. So that is the intent of these negotiated agreements, is to make sure that we have coverage from any unexpected things, so we can still provide that service if we are requested to provide that service.

Mr El-Sherbini: Sorry, I guess where I was going from was what happens if you can't negotiate that agreement with Sydney Water.

Mr Narezzi: Well we either don't provide that service, or we'll have to. It's not necessarily that we can't reach that point. We'll have to reach that point of an agreement, especially if it's an important service.

We also have the overlay of our licence, and so forth, and control on that side of it. So if our annual production requests, for example, can be adjusted so it could be adjusted down if water is not required and could be reduced down to the minimum level. Just, for example, if we can't agree to not providing water or a price that that requires.

Mr Omar: We are saying that if we don't have that flexibility, and its essential that we change the service then we'd think about reopening the determination. The reason we had this placeholder in here is to avoid the administrative costs and burden of having to revisit the whole thing.

Ms Gamble: I just want to ask Sydney Water for their view on the value and likelihood, perhaps urgency of allowing for negotiated agreements at this stage.

Mr Hollamby: As a general principle, we wouldn't negotiate something that put us or put our customers in a worse risk or cost position. So that's as a general principle. It would only work if there was something new or innovative that was being done that was going to result in a cost or risk reduction.

Obviously, as we're in a sole source procurement position with SDP. And so in those scenarios where that does occur, we don't have a strong negotiating position, if you like, in that scenario. And so I think that we have the option then to defer to IPART for decision making in those scenarios where we're not happy with that and I think that's a fallback position for Sydney Water to manage risks and cost to customers.

So I think there it's too early. This is a new operating regime. We're not sure what's going to come from that. We think there may be opportunities in the future for us to have direct negotiations with SDP around operation, and what that looks like. We just don't know what those are yet.

Mr Narezzi: But if I can just add that the practical example that both Sydney Water and SDP have tried to explore on this negotiated agreements area is a shutdown. So if there was an issue in the Sydney Water network that they couldn't take our water for whatever reason that they're not bound to an annual production request that they've already provided us. Effectively they're paying for water that we're not providing a service for.

So it would actually be a reduction in costs in that scenario. That we would negotiate with Sydney Water that we can do this or that to reduce cost to customers. That's the only scenario that we actually have considered for at this stage. We can't really come up with any other examples to be honest at this point. And that was the intent of these negotiated agreements was that it was going to be a reduction in cost not an increase in costs. And I know everyone falls to the increase side and that side of it. But it was actually trying to assist customers moving forward, of having those situations where we can actually reduce cost because our service will change.

Ms Gamble: And why wouldn't you include that in the Water Services Agreement?

Mr Narezzi: We can, but we also restricted in the Water Service Agreement that Sydney Water can only pay us for costs that are determined in the determination. And we ran into that situation where even though we were incurring additional costs in the response to an emergency for example, they were only able to provide maximum prices as per the determination.

Ms Donnelly: Okay, any other further comments on that?

Mr Hollamby: Just one other comment which Phil has raised there. Sydney Water doesn't really want to be in the position where we're asking for water and SDP say we can't produce because it's an unreasonable cost on us to produce. And so that how that plays out in practice is quite important because we want them to be incentivised to turn on the plant when we need it for customer service.

Ms Donnelly: Okay, thank you. Now, I will just ask if there's any other comments or questions in the room while I'm checking if we've got any others online. I don't think so. Matt we'll just pass the mic down. Thanks. Rhea.

Mr Mansell: Thank you very much. So it's very rare for us to have the 3 key parties in the one room. So I just really like to take this opportunity to clarify my understanding. So when SDP refers to its expectations around flexibility and responsiveness under this new operating environment. SDP uses terms along the lines of complete flexibility and responding at the 'drop of a hat', and I just really like to get DPE and Sydney Water's reaction to the way SDP has characterised the way it expects to be utilised under this new operating framework.

Mr Blayney: I guess we think that the new mode…

Ms Donnelly: Ben, I'm sorry. Can I ask you to stand up because we're not getting you on camera?

Mr Blayney: Sorry I was trying to hide some of that sort of say the wrong thing I can blame the guy next to me. No, I won't do that, I'd get in trouble for that.

I guess we think that the new rules are a little bit uncertain. So some of the language maybe sound little bit emotive. 'Drop of a hat' is probably a little bit emotive. The decision framework was pretty clear on how we'll order water. We would expect that they would have arranged, SDP will have arrangements to the operators to respond to that, being good operators. We certainly have the confidence they will. But then uncertainly arises because we have not done it before. So I would anticipate we wouldn't have this conversation in 4- or 5-years' time.

Ms Donnelly: Thanks, Ben. And I'm just going to see whether Ash wants to say anything. But in the meantime I certainly I want to reflect back my understanding from an earlier exchange when we were talking about cost and efficiency, and ramping up and down, and so on. That I understood there to be a sense that Sydney Water and SDP are quite well aligned in the sorts of considerations and incentives you have towards looking for an efficient approach. So it's not 'drop of a hat', and you know discord in terms of an inefficient approach, looking at a more strategic level.

Mr Hollamby: Yeah, I think just to clarify my understanding of the decision framework. So that's one piece. The second piece is the ordering of water, which is done on a monthly and yearly basis. The daily operation is up to the professional operators to operate in an efficient way. There is a best endeavours clause, if you like, around ramping up more quickly in response to emergencies. And so that's the overarching framework around ordering and production of water.

Ms Donnelly: Ash, did you want to add something in response to Matt's question? Thank you.

Mr El-Sherbini: Just very briefly. Our interest is at a strategic level which is certainly that we are moving towards a significant degree of flexibility and the detail about what that means is really between the negotiations between Sydney Water and SDP. But we are comfortable with the direction of where things are heading.

Ms Donnelly: And Philip?

Mr Narezzi: Yeah, just to add, look, I don't think we've used the term 'drop of a hat'. Absolutely we've used the term total flexibility. And what that is related to is that yes, under our licence Sydney Water's ability they will set an annual production target for the year, how much volume we think we need from you for the year, for various considerations, and so forth.

Then there's ongoing monthly and weekly and daily scheduling of that annual production. And that's where the total flexibility comes in. So I think it's every Thursday Sydney Water will sit down and say, "what do they need from the system next week?". Ben alluded to that before. That will change, and that's been the experience that we've had because now we're part of the system.

There'll be system constraints, various things they need this water. It's not going to vary widely day to day. Hopefully. But there is the ability for Sydney Water to do that, and that's the total flexibility we're talking about, is the scheduling of that production. The decision framework is quite clear on how they set the annual but the actual scheduling is the total flexibility that we refer to you.

Ms Donnelly: Okay, Sandra.

Ms Gamble: Yeah. I just wanted to make a quick comment about what we're driving at here. And that's we're trying to ascertain the extent to which SDP's costs reflect the level of flexibility that you have agreed with Sydney Water. And that you are doing that in an efficient way, which doesn't mean you're always doing it in the most comfortable way.

Okay, you still got to be able to try a bit hard for the interest of consumers, because the more cost you incur potentially the more comfortable your life becomes, and potentially the contingencies that you're allowing for are not actually even required under the Agreement. So that's where we're getting to, that's what the core of this discussion is about.

Mr Narezzi: And I totally agree. I totally agree, that's what the balance needs to be. But there's also that balance as well to ensure we have suitable cost recovery for an unknown service so we can actually deliver that service has been alluded to. We'll learn a lot over the next 4 years, and we don't want to be constrained that we don't have suitable cost recovery. And what we've tried to construct our submission is around what we understand that needs to be moving forward. And if you don't have that suitable cost recovery we may not be able to respond to those daily, weekly monthly changes in that scheduling of production, because we just don't have the cost recovery and we have to look at different ways of how we operate the plant.

And the overlay of all that is also that emergency response piece. That is not to be underestimated because at a 'drop of a hat', normally, late on a Friday, when everyone's gone home, we'll get a call please ramp up the plant. We need the water. We need every last litre you've got, because we've got this issue in the system. And we respond, and we'll do that. But not having the plant available, and not having that baseline availability will make it challenging. And we're fine to be uncomfortable on that. But there sometimes, eventually something is going to give.

Ms Donnelly: Okay, thank you. Now, I'm just keeping an eye on the time. We had a bit of flexibility with how long each of these different sessions have taken, and I want to respect everybody's time and commitment. We're getting close to time. But look I'll admit I have one more question. But I'm just going to test if there's any others in the room. I've been watching online, and there doesn't appear to be anything online, or Tribunal Members. No, okay.

Mr Blaikie: So look, I know we've talked a lot about the new operating rules and the flexibility and the sort of cost impacts for that. One thing that Phil talked about in the original presentation also was there are costs like cyclical costs that will be going to start incurring for the first time in our history, and they're related to the aging of the plant.

So a lot of the sort of instrumentation and controls, and those sort of assets of which there are thousands and thousands are starting to hit the end of their life in sort of 10 to 15 years and that's where we are now.

And then also there's cyclical overhauls of things. So we need to go and do a major overhaul of a pump, and they would generally happen every 4 or 5 years. Now we're starting to do those overhauls for the first time, because we're sort of hitting that 4 or 5 years operation. So we only do these things when we are measuring a need for them to happen.

And I just wanted to bring that to the attention because it is the reason why okay, with some of these big-ticket items are covered under a capital expense. But a lot of these smaller things will need to be replaced and overhauled as part of our just our fixed operating costs.

And some of those and a lot of those are going to start occurring for the first time over this reg period. And while we're cognisant of being flexible, so we need to do some of those things so that we can be available and able to respond in the future. A lot of it is just around the time and the age of the plant, and that you know these things are a little bit lumpy. They're not necessarily year by year, and ultimately, once we get to a BAU and we operate over 10, 15, 20 years. These things will get to a period where they are a little bit flatter. But at the moment it's very much the first time we're incurring them. So I just want to make sure that's taken into account.

And even with the operations the number of times that we're requested to go up and down, yes that has a bearing on some costs, but by far the biggest ones are running the plant in a way, so it's available to do that. So you know, keeping bits of the plant available to ramp up quickly. The actual ramping up yes, does have some effect, but it's not the biggest cost impact of everything. Thank you.

Ms Donnelly: Okay, thank you, Matt. So look my question and it may in fact, be a question that I pose for people to think about, and then tell us more when we consult next on the draft report. But I will ask it now to get people thinking, and I certainly know that we have quite a lot of expertise in the room and also online that there might be someone who has something to say in response to this.

There's been quite a strong thread of acknowledging that this pricing period that we're setting prices for the maximum prices for now is a new world compared to the past for SDP. And that comes with a level of uncertainty. And so you know, thinking more broadly, often uncertainty generates a bit of a premium in the price.

And so my broader question is, is there anything else that people could be doing, you know, and we could be doing in thinking about understanding, quantifying that uncertainty, modelling, sensitivity analysis, etc. In order to be very focussed and precise where we can on the impact on prices of the unknowns.

So I'll just see whether anyone wants to wade into that one right now, or leave otherwise as an invitation for us to be thinking critically at the point of consulting on our draft report. Okay, Jamie.

Mr Hollamby: Thank you. As a city, as a State we've invested in a significant asset in the SDP. It provides us with an opportunity to secure water in the city both from a quality and a quantity perspective. And I think that's really important to put into context around the level of maintenance and level of renewal on the plant and certainly we want the plant available to meet customer service when required.

And so in that context, I think it's really important for us that the plant is kept in good repair and one thing that we haven't touched on today is also the abatement mechanism and the incentives or disincentives for the plant to not be available.

And I think that's so when you look at that bigger picture context around what the asset is there to do, it's there to be available. We want it well maintained and we want to be able to turn it on for the benefit of the community when required.

Ms Donnelly: Okay, thank you. Philip?

Mr Narezzi: Carmel, I'll also add that you mentioned uncertainty can lead to a premium. I think it can also go the other way. And that's also a concern, that we haven't been in this world, it's a new world as you mentioned and we've tried our best in our proposal to reflect what those true costs will be for that new world. But there's always that risk that it's not a premium necessarily for that uncertainty. It's the opposite because we don't know what the true costs will be.

Ms Donnelly: Take your point on that.

5 Closing remarks

Ms Donnelly: Alright. Ok I might just move to some closing remarks and begin by thanking you all, we will consider everything that's been said today as well as obviously the submissions. We've been here to listen, and I thank you very much for those people who've suddenly found themselves being questioned and for the really constructive approach from everybody. I definitely believe it's been very valuable.

We will produce a transcript of today's public hearing, and put both the transcript and a link to the recording on our website so that it's transparent what we've taken into account. We will then move to a Draft Report being released in April, and as I've alluded to already further consultation submissions that will be called for then, and then the Final Report in June, and prices commencing in July.

We also invite you. If there is anything that you think of after today to get in contact with us, and the details are both on the website, on the inside of our Issues Paper, and on the next slide you should have some contact details.

And in just in closing, I will just say like to very much thank you again. It's been extremely useful from our perspective. Hope it's been useful for you as well and with that I will close the public hearing. Thank you.