

INDEPENDENT PRICING AND REGULATORY TRIBUNAL

REVIEW OF SYDNEY DESALINATION PLANT'S PRICES
FROM 1 JULY 2017 AND THE METHODOLOGY PAPER FOR ENERGY
AND EFFICIENCY ADJUSTMENT MECHANISMS

Tribunal Members

Dr Peter Boxall AO, Chairman
Ms Catherine Jones and Mr Ed Willett, Members

Members of the Secretariat

Mr Hugo Harmstorf, CEO, Mr Matt Edgerton,
Mr Jean-Marc Kutschukian, Ms Alexandra Sidorenko,
Ms Syvilla Boon and Mr Matthew Mansell

SMC Conference and Function Centre,
66 Goulburn Street, Sydney NSW

Thursday, 8 December 2016, at 10.00am

1 OPENING REMARKS

2
3 THE CHAIRMAN: Good morning and welcome to this public
4 hearing. I would like to begin by acknowledging that we
5 are meeting on the land of the Gadigal people of the Eora
6 Nation and wish to pay my respect to the traditional owners
7 both past and present.

8
9 Today we are holding a public hearing on two reviews
10 we are conducting. The first is to determine the maximum
11 prices that Sydney Desalination Plant (SDP) can charge its
12 customers for its monopoly services from 1 July 2017. The
13 second is a review of our 2012 methodology paper that sets
14 out our approaches to the energy adjustment and efficiency
15 adjustment mechanisms which apply to SDP and its prices.

16
17 My name is Peter Boxall and I am Chair of the
18 Independent Pricing and Regulatory Tribunal. I am joined
19 today by my fellow tribunal members, Catherine Jones and
20 Ed Willett.

21
22 This public hearing is an important part of our
23 consultation process for these reviews. In addition to the
24 views expressed in written submissions, we will consider
25 the views you provide today in making our decisions on
26 SDP's prices and our methodology for the energy and
27 efficiency adjustment mechanisms.

28
29 I would like to thank everyone who has provided a
30 written submission to our issues paper and SDP's pricing
31 proposal. Our issues paper was released in August this
32 year. It sets out the process we will follow to conduct
33 these reviews, the approach we will use to make our pricing
34 decisions and the key issues we will consider in making
35 these decisions.

36
37 SDP responded to our issues paper in October with its
38 pricing proposal. SDP's pricing proposal, our issues paper
39 and submissions to our issues paper are available to the
40 public on our website.

41
42 The desalination plant provides an additional source
43 of drinking water when dam levels are low and currently
44 operates under an intermittent on and off regime triggered
45 by dam storage levels.

46
47 Broadly, our terms of reference for the price review

1 require us to determine prices for:

2
3 (a) the supply of non-rainfall dependent drinking
4 water to purchasers; and

5 (b) making the desalination plant available to supply
6 non-rainfall dependent drinking water.
7

8 In doing so, we will consider SDP's prudent and efficient
9 costs of providing these services and the pricing
10 principles set out in the terms of reference.
11

12 An issue for this review is whether there is scope to
13 improve the plant's operating flexibility to enable it to
14 better respond to droughts while at the same time enabling
15 its efficient use when dam levels are high. In particular,
16 we are looking at whether SDP should be able to sell
17 drinking water to Sydney Water Corporation upon request
18 when dam levels are high. We are also considering refining
19 the mechanisms for sharing costs between SDP's customers to
20 better reflect the plant's role as a drought response
21 initiative.
22

23 Another key issue in this review is how best to manage
24 the plant's operation when in water security mode. SDP
25 went into water security mode - or shutdown mode - after
26 its proving period in June 2012 as dam storage levels were
27 around 98 per cent at that time. It has remained in water
28 security mode since dam level storages have remained above
29 70 per cent.
30

31 We are also examining the impact of the 16 December
32 2015 storm event on SDP, including considering what costs
33 SDP should recover from its customers in situations when it
34 is unable to operate, and the appropriateness and cost of
35 its insurance arrangements.
36

37 At all times we are mindful that any changes to our
38 pricing framework should enhance the overall long-term
39 interests of stakeholders, including end-use water
40 customers and investors.
41

42 As required by the terms of reference, we will also
43 determine the appropriate allowances for the energy and
44 efficiency adjustment mechanisms using the approaches set
45 out in the current methodology paper. The adjustments for
46 each mechanism would be passed through into prices from
47 1 July 2017.

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In addition, we are reviewing the methodology paper to determine whether it can be improved for future determinations. Any changes or updates we decide to make to the methodology paper will not affect prices in the 2017 determination. However, SDP will be responding to the incentives created by the methodology paper during the upcoming 2017 determination. This is why we have decided to review the methodology paper concurrent to this price review.

Before we commence proceedings today, I would like to say a few words about the process for this public hearing.

Today we will begin with SDP making a short presentation on its pricing proposal. We will then hold three sessions on the price review, and one on the review of the methodology paper. The first session will focus on SDP's price structures including the introduction of a base water security charge and an incremental service charge.

The next session will focus on the question of operating flexibility. We will then break for morning tea. The third session will cover issues related to the December 2015 storm event. We will then discuss the methodology paper in the last session.

At the beginning of each session, a member of the IPART secretariat will give a brief presentation introducing the topics for discussion. I will then invite participants at the table to provide comment on those topics. Following discussion by those around the table, I will then invite comments from those in the general audience.

Today's hearing will be recorded by our transcribers. Therefore, to assist the transcribers, I ask that on each occasion you speak, please identify yourself and, where applicable, your organisation before speaking. I also ask that you speak clearly.

A copy of the transcript will be made available on our website.

Assisting the tribunal today are members of the IPART secretariat, Hugo Harmstorff, who is IPART's Chief Executive Officer, Matthew Edgerton and Jean-Marc Kutschukian. They

1 will be joined by Alexandra Sidorenko, Syvilla Boon and
2 Matthew Mansell to facilitate each of these sessions.

3
4 I now invite Keith Davis, who is SDP's Chief Executive
5 Officer, to provide an overview of SDP's pricing proposal.

6
7 OVERVIEW OF SDP'S PRICING PROPOSAL

8
9 MR KEITH DAVIES (CEO SDP): Thank you, Mr Chairman, and
10 good morning, everyone. My name is Keith Davies. I am the
11 CEO of the Sydney Desalination Plant. If I could also
12 start by recognising the traditional owners of the land we
13 meet on today and pay our respects to the Gadigal people
14 and the Eora Nation and I pay my respects to elders past
15 and present.

16
17 Thank you to the tribunal and the secretariat for the
18 opportunity to present an overview of Sydney Desal's
19 regulatory proposal. We believe that hearings such as
20 these are an important element in the process of
21 determining prudence and efficiency in regulated entities
22 by giving us the opportunity to explain ourselves across
23 the sometimes complex and interrelated aspects of our price
24 proposals.

25
26 This will be a fairly short presentation aimed at
27 addressing the key aspects of our proposal to assist the
28 tribunal and stakeholders in understanding who SDP is and
29 what we are proposing for the 2017-2022 regulatory period.

30
31 This is the first time that the new owners of the
32 plant have had the opportunity to present our proposals for
33 prices to be set by IPART in the next regulatory period.

34
35 Apologies upfront for referring to ourselves variously
36 as "Sydney Desal", "SDP", or just "the plant". It has
37 become a bit of a habit of ours.

38
39 I am joined today, I should say, by my executive team
40 and I will introduce them - our Chief Financial Officer,
41 Justin De Lorenzo; our Chief Operating Officer, Mr Phil
42 Narezzi; and, last and certainly not least, Lisa Welsh, our
43 Executive Manager for Regulatory and Commercial. We are
44 here today to present our proposed prices and to address
45 any relevant questions you have about our business.

46
47 To kick off, here is a timeline and a snapshot of

1 history as it relates to SDP over the last 15 years going
2 back to 2002 and the start of the so-called millennium
3 drought, which was the trigger for fresh sources of potable
4 water all along the eastern seaboard.

5
6 The situation in our industry is now that every
7 mainland state has a major desalination facility and
8 Western Australia actually has two, which is still not
9 enough.

10
11 From 2002, the rainfall failed, as it did over the
12 next four years, and in 2006 preparations were made for a
13 desalination plant in Sydney if storage levels continued to
14 fall. In early 2007, as the timeline shows, dam levels hit
15 a low of just under 34 per cent and the New South Wales
16 government made the decision then to construct a
17 desalination plant and a connecting pipeline to provide
18 Sydney's only supply of non-rainfall dependent water as an
19 insurance policy against future droughts.

20
21 The plant and the pipeline took three years to build,
22 and it successfully completed a two-year proving period
23 before it was shut down in July 2012 in accordance with the
24 operating rules of the Metropolitan Water Plan.

25
26 In June 2012, the New South Wales government
27 established a 50-year lease with a private consortium, our
28 owners, for the plant and the pipeline. The plant has been
29 in water security mode since July 2012, although,
30 in December 2015, a severe storm event caused significant
31 damage to the plant and the damage has been assessed and
32 priced and is currently being rectified.

33
34 Session 3 today will allow us to elaborate on the
35 aftermath and the consequences of what I would like to
36 think of as a very cruel event timed just before the
37 Christmas break last year.

38
39 Along with Sydney Water and WaterNSW, SDP plays an
40 important role in meeting drinking water needs for Greater
41 Sydney. We are capable of producing just over
42 91 gigalitres of water per year, or roughly 15 per cent of
43 Sydney's annual drinking water needs, which it delivers
44 directly into the Sydney Water network at Erskinvile.

45
46 We are licensed, under the Water Industry Competition
47 Act, to provide water supply and water security services.

1 Under these arrangements, we maximise production when water
2 storage levels flow below 70 and then until they rise above
3 80 per cent.
4

5 In addition, and importantly, we also have a water
6 supply agreement with our customer - our only customer at
7 this time - Sydney Water, and under that water supply
8 agreement, Sydney Water can call upon to us supply it with
9 water in response to an emergency or to ensure security of
10 supply or network stability during a period of outage,
11 unavailability or maintenance. Currently Sydney Water
12 levels of storage now are about 90 per cent and, therefore,
13 we expect to remain in water security mode for most, if not
14 all, of the 2017-22 regulatory period.
15

16 Turning to some numbers, SDP's costs are a relatively
17 small part of the bill paid by end-use water customers -
18 around 9 per cent when we are in water security mode, and
19 this equates to an average cost per customer of around
20 about \$103 per year in the current regulatory period. Our
21 proposals to IPART for the 2017-22 regulatory period
22 deliver a decrease on this annual cost, as I will show in a
23 short while.
24

25 In developing our submission we consulted with
26 stakeholders such as the Metropolitan Water Directorate to
27 understand their requirements for water security
28 domestically and any potential changes to our operating
29 rules. We also consulted with our customer, Sydney Water,
30 particularly in relation to options to improve operational
31 readiness and to mitigate the consequences of SDP being in
32 water security shutdown for extended periods of time.
33

34 We forecast the prudent and efficient costs of
35 providing our water supply and security services in each of
36 the potential operating and shutdown modes as well as
37 funding costs for plant depreciation used in the IPART
38 building block. We then calculate prices required to
39 recover these forecast costs and, in addition, we review
40 the incentive and risk management frameworks from the 2012
41 IPART determination.
42

43 We have suggested some refinements to this framework
44 to strengthen the incentives for SDP to invest in and
45 operate our assets in a way that is consistent with our
46 water security role, which I will explain later in this
47 presentation, and, finally, we consulted further with our

1 stakeholders and Sydney Water before providing our
2 submission to IPART in October.

3
4 In both water security and operating modes, SDP is
5 proposing price reductions of between 1.6 and 2.7 per cent
6 for customers based on their total annual bill. These
7 price reductions capture lower funding costs offset by
8 higher operating expenditure, the energy adjustment
9 mechanism and a minor proposed change to the pipeline asset
10 lines. They also incorporate the projected increase in
11 customer numbers, as per Sydney Water's 2016 determination.
12 These reductions do not include the one-off costs of
13 transitioning between modes as it is not possible to
14 accurately predict when this transition might next occur.

15
16 For the contribution that SDP adds to the customer's
17 bill, we are proposing reductions to average costs per
18 customer of 21 per cent in water security mode outside of
19 the drought and 17 per cent when we are operating, compared
20 to the average cost per customer in the 2012-17 regulatory
21 period.

22
23 This graphic shows the changes in each category which
24 make up the SDP revenue requirement in water security mode,
25 which is the mode we expect to be in, as I have mentioned,
26 for most of the 2017-22 regulatory period.

27
28 We have in place prudent debt management strategies
29 and we are not proposing any changes to IPART's
30 methodology for determining funding costs for the next
31 regulatory period. Funding costs are lower than they were
32 in the 2012 determination and this is a key driver of
33 overall cost reductions. In addition, not surprisingly,
34 for an asset that has been built with an extensive design
35 life, we are forecasting minimal capital expenditure, which
36 means that, consequently, depreciation is largely
37 unchanged.

38
39 In water security, SDP is proposing increases to
40 elements of opex as the costs of keeping the plant in water
41 security for an extended period of time increases. This
42 category also includes the energy adjustment mechanism
43 payments in water security mode which are contributing to
44 the increase.

45
46 This graph, I think, demonstrates the volatility in
47 Sydney Water's storage level since 1960 which coincides

1 with when Warragamba Dam was completed. History shows
2 that, even in a severe drought, it takes a minimum of
3 12 months for storage levels to fall 10 per cent, although
4 it usually takes much longer than this. The data also
5 demonstrates that water storages can increase by more than
6 10 per cent in a very short time - in fact, in a matter of
7 weeks and sometimes even days.

8
9 This volatility means that the timing and the duration
10 of SDP's operations under the 70/80 rule is uncertain and
11 impossible to predict with great accuracy.

12
13 By the start of the 2017-22 regulatory period, SDP
14 will have been in water security shutdown for five years.
15 Large scale saltwater desalination plants such as SDP are
16 principally designed to run continuously and not shut down
17 for extended periods. This table shows that this is
18 unprecedented across the industry, both nationally and
19 internationally.

20
21 Although remaining in water security mode continues to
22 enable SDP to deliver cost reductions to customers, the
23 costs of remaining in this mode will increase over time as
24 more maintenance will need to be undertaken as the plant
25 ages and to ensure that the plant can start reliably within
26 the required frames when it is next called upon.

27
28 This diagram captures the relationship between
29 shutdown modes, the cost and the time it takes to return to
30 full operations. Longer periods of shutdown lower the
31 daily running costs but take the plant longer and cost more
32 to return to full operations. As recognised by Sydney
33 Water in their submission to the tribunal, SDP is unable to
34 control when it is required to operate, nor for how long
35 under the 70/80 rule.

36
37 I noted in a previous slide showing the water storage
38 levels that it takes a minimum of a year for water storage
39 levels to fall 10 per cent, and they can rise 10 per cent
40 in a few days. Therefore, our shutdown protocol is always
41 to enter water security mode when shutting down under the
42 70/80 drought, as this mode is most likely to result in the
43 greatest cost savings to customers. However, in our
44 submission, we propose that we should not be penalised if
45 we are required to operate within two years of shutting
46 down as SDP really has no ability to control when it will
47 next be called upon to operate.

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In addition to operating for drought-related water supply, if Sydney Water requires SDP to operate for emergencies, as I mentioned earlier, we propose that the IPART determination allow SDP and Sydney Water to agree a reasonable cost reflective charge consistent with the existing terms of the water supply agreement.

This rather busy diagram summarises our load-based charging. Broadly speaking, we are either on or off and it allows SDP to recover the varying costs of being shut down for different lengths of time.

For the 2017-22 regulatory period, we expect to be in water security mode, as I mentioned, for most if not all of that period, and our loads are cost reflective and allow the substantial cost savings associated with the shutdown of the plant to be passed on to customers.

But there are some risks that mode pricing cannot solely address, hence the need for a cost pass-through mechanism, which will be explained further on.

We have proposed some refinements to mode-based pricing to ensure that the framework provides the right incentives to SDP to operate the assets in a way that is consistent with our water security role and the water supply agreement with Sydney Water.

The nil usage price limitation outside of the 70/80 rule requires some amendments so that we can respond to a request by Sydney Water for emergencies. We propose an unregulated pricing agreement to accommodate this request.

We have proposed a minor amendment to the abatement mechanism to deem usage when SWC requests production of less than 250 megalitres per day so that SDP is not penalised for future abatement. This amendment would bring the abatement mechanism, we believe, in line with the water supply agreement.

We have also proposed a further amendment to the abatement mechanism to enable it to commence providing water as soon as possible to Sydney Water when recommencing operations, which we believe is the appropriate action to take when the drought is looming.

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Moving on and covering the tornado event last December, a column of spinning air, or a funnel, as it is known, was whipping up winds of over 200 kilometres per hour. It ripped a swathe through our site, tearing off roofs and flinging debris as it made its way towards the township of Kurnell, and after leaving its mark by severely damaging houses in its path, it drifted out to sea and dissipated. We were very lucky that nobody was seriously hurt.

But as a result of damage caused by the tornado, the plant is not currently operable. We are working closely with our insurers to reinstate the plant following the tornado and to minimise the amount of time that the plant is inoperable. We are obligated to maintain our assets in accordance with good industry practice and our WICA licences.

In addition, the government, as owners of the plant, are exercising their obligations diligently to ensure that we complete the repair in a timely manner and to a high standard.

We've undertaken a detailed visual damage assessment, and this is currently being completed through the procurement of a rebuild contractor.

The process has been undertaken in a planned, detailed and thorough manner to ensure that when the reinstatement is completed, we will have the same level of confidence in the plant's ability to provide water security and supply services as we did prior to the tornado.

IPART's 2012 determination of SDP prices includes a cost pass-through mechanism for electricity network charges, and we support IPART's proposal to retain this mechanism.

In addition, and consistent with what we believe is contemporary best practice regulation, we are also seeking a cost pass-through mechanism for unforeseeable and uncontrollable risks.

A cost pass-through mechanism is recognised in other regulatory frameworks as an efficient allocation of risk likely to result in lower costs for customers. We are

1 proposing a standard framework used in other jurisdictions
2 and previously used by IPART in its retail electricity
3 determinations, which would cover events such as force
4 majeure, regulatory and taxation changes.
5

6 Operating and maintenance costs and energy costs
7 comprise the majority of our operating expenditure. We are
8 the only privately owned regulated water monopoly business,
9 and SDP's owners drive cost efficiencies in the business.
10 For example, the way the plant has been shut down has
11 allowed us to minimise costs, passing these savings on to
12 customers. We have also reduced energy costs in shutdown
13 which will result in savings of \$2.85 million to customers
14 over the next five years.
15

16 We are a streamlined organisation with competitively
17 tendered outsourcing for the bulk of our operating costs.
18 The operations and maintenance contract for the plant
19 contains a number of incentives for our operator to
20 optimise costs of running the plant.
21

22 We agree that we should have incentives to continue to
23 lower these costs over time and share those benefits with
24 customers. The desalination industry is still in its
25 formative stages and we will look to capture the benefits
26 of technology improvements in the future.
27

28 We support the continuation of the efficiency
29 adjustment mechanism and believe that it complements the
30 incentives driven by our private ownership, and due to our
31 mode-based operations and the uncertainty over when SDP
32 will move between operating modes, the efficiency
33 adjustment mechanism requires some minor refinements to
34 fully meet its objectives. We have proposed carrying over
35 savings until the next time SDP enters the same mode.
36

37 Moving on to energy, energy is one of our major costs
38 when operating. We have contracts in place with Infigen
39 for the purchase of electricity and LGCs. These
40 competitively tendered contracts were recognised as
41 efficient by Sydney Water in their submission to IPART.
42 Contract prices compare well to other benchmark estimates,
43 including the long run marginal cost methodology used by
44 IPART in its 2012 determination of SDP's prices.
45

46 Under the contracts, prices are fixed in real terms
47 for 20 years, which means that neither SDP nor its

1 customers are exposed to price volatility which occurs
2 regularly in energy markets. SDP is also shielded from
3 policy-driven changes in the renewable power markets on
4 carbon prices.

5
6 The energy contracts do contain a minimum purchase of
7 electricity and LGCs, which means that we do have surplus
8 energy and LGCs when we are not operating, which we then
9 onsell.

10
11 The energy adjustment mechanism shares these losses
12 and potential future benefits between SDP and the
13 customers.

14
15 We note the proposal by Sydney Water for us to
16 actively manage the resale of surplus electricity by
17 engaging in what might be termed speculative trading or
18 forward selling with the aim of outperforming the spot
19 price.

20
21 SDP is not a merchant energy business and we are not
22 equipped, nor financed, to take on these risky functions.
23 Therefore, we do not engage in any speculative trading of
24 surplus energy or LGCs.

25
26 IPART's retail determinations on the WACC highlight
27 the risk that merchant energy businesses face, and this
28 would actually add to customer bills.

29
30 I would just like to make some closing comments,
31 perhaps. We have endeavoured to prepare our submission in
32 a format which is easily accessible to all stakeholders,
33 and we have tried to be as transparent as possible with the
34 information we have provided.

35
36 Like many businesses, we undertake a range of
37 commercial transactions which give rise to
38 commercial-in-confidence obligations which limit the
39 information we can provide publicly, and there are
40 situations where it may not be in customers' interests for
41 the information to be released.

42
43 If SDP is unable to answer any question during this
44 hearing today due to confidentiality, we note that IPART
45 has the ability to convene a closed session or accept
46 a written response. Either way, IPART will have our full
47 cooperation in this respect.

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We are looking forward to engaging further with stakeholders on our proposals and the issues raised by IPART in its issues paper. Thank you.

THE CHAIRMAN: Thank you very much, Keith. I now call on Jean-Marc to give a brief opening for the first session.

Session one - price levels and structures

MR KUTSCHUKIAN: Thank you, Peter.

Our first session today is on price levels and price structures. You have already seen this diagram - we borrowed it from SDP's pricing proposal. I think it neatly explains the charges that we need to set over the 2017 determination period.

In the 2012 determination we set mode-dependent prices, and prices were set in four defined shutdown modes and a plant operation mode. Fixed daily charges apply in each mode for making the desalination plant available, and these charges reflect SDP's fixed operating costs and capital costs.

Usage charges apply in plant operation mode on a \$ per megalitre basis, and reflect SDP's variable operating costs.

In addition, we have transition charges which recover the additional operating costs when transitioning the plant from the different shutdown modes.

SDP proposes retaining mode-dependent prices, as does Sydney Water, and in our issues paper we also had a preliminary view that mode-dependent prices still remain relevant.

However, SDP proposes an increase in some of its charges because of managing the plant in a prolonged water security shutdown. The plant has been in water security mode since 2012 and, as we just heard, according to SDP, it is likely to remain in water security mode for an extended period over the 2017 determination period.

As a result of this, SDP considers there are extra costs for plant testing and asset maintenance in water

1 security mode - that is the circle in the bottom corner of
2 the graph there - and there are also extra transition to
3 restart costs not included in the 2012 determination, which
4 are related to energy and pipeline flushing.
5

6 The table on the screen now outlines SDP's proposed
7 charges for the 2017 determination period. The fixed daily
8 charges are proposed to reduce over the five-year period -
9 in full operation mode by 9.9 per cent and in water
10 security mode by 4.1 per cent.
11

12 The principal reason for the reduction is that SDP's
13 financing costs are lower than the 2012 determination
14 period: SDP has proposed a real post-tax WACC of
15 4.52 per cent, which compared to about a 4.97 per cent WACC
16 in the 2012 determination period.
17

18 The transition to restart charge is proposed to
19 increase by around 577 per cent over the 2017 determination
20 period - I will outline the costs associated with that
21 charge in the next slide - and the transition to shutdown
22 charge is also proposed to increase by around 6.2 per cent
23 over the five-year period.
24

25 There is next to no change proposed in the water usage
26 charge. You can see there that it remains roughly constant
27 at \$688 per megalitre. The pipeline service charge is
28 proposed to reduce by 29.1 per cent, and again that is
29 because of the lower financing costs.
30

31 Some of the cost drivers underlying SDP's proposed
32 prices - the first relates to operating and maintenance
33 costs over the 2017 determination period. SDP has proposed
34 significant increases in operating and maintenance costs in
35 both water security mode and full operation mode. Over the
36 five-year period there's about a \$33.5 million increase in
37 water security mode and about a \$15.8 million increase in
38 full operation mode.
39

40 The O&M costs for water security mode have increased
41 due to one-off expenditure requirements, such as the
42 partial plant test and additional maintenance programs to
43 manage the operational risks associated with an extended
44 period of shutdown.
45

46 In full operation mode, the costs have increased due
47 to proposed preventive maintenance associated with the age

1 of SDP's assets.

2
3 The second item is the significant increase in
4 corporate overheads. The increase in corporate overheads
5 largely represents proposed expenditure to manage SDP as
6 a stand-alone entity rather than a subsidiary of Sydney
7 Water, as was the case back in the 2012 determination
8 period. The increase in corporate overheads is around
9 \$14 million over the five-year period in water security
10 mode, and about \$16.8 million in full operation mode.

11
12 The third item there is a proposed reduction in energy
13 costs in water security mode but an increase in full
14 operation mode. SDP has proposed a reduction in energy
15 costs in water security mode largely due to the actual
16 consumption during the 2012 period being lower than
17 expected. In full operation mode the increase in energy
18 costs is due to SDP's proposal for the prudent and
19 efficient energy cost to be based on its prices with its
20 contract with Infigen.

21
22 Fourth, there are increased revenue requirements due
23 to the energy and efficiency adjustment mechanisms. They
24 are part of the terms of reference, but SDP is proposing
25 around \$34 million over the five years in additional
26 revenue adjustments for those two mechanisms.

27
28 Fifth, SDP is proposing a modest capital expenditure
29 program over the 2017 determination period. It is about
30 \$2.5 million over the five years.

31
32 And, finally, there are large increases in transition
33 charges, mainly due to costs, according to SDP, not
34 accounted for in the 2012 determination. The proposed
35 transition charges range between \$37.3 million to
36 \$41 million per event, depending on the year of the restart
37 during the 2017 determination period.

38
39 In our issues paper we proposed refining the current
40 price structures for making the plant available by
41 splitting the fixed daily charges into the following two
42 components: a base water security charge reflecting the
43 minimum fixed cost of maintaining the plant and
44 mode-dependent incremental service charges reflecting the
45 different fixed operating costs in each shutdown and
46 operation mode.

1 For example, when the plant is in water security mode,
2 the current fixed charge is about \$391,000 per day. Under
3 the proposed price structures, this becomes the base water
4 security charge. This charge reflects SDP's fixed
5 operating and capital costs and is represented by area A in
6 the graph on the right-hand side.

7
8 If the plant is called into operation, the fixed
9 charges increase to about \$428,000 per day. Under the
10 proposed price structures, this charge is split into two
11 components - the base water security charge at A, which is
12 about \$391,000 per day, plus the incremental service charge
13 of area B on the graph, which is about \$37,000 per day.

14
15 The incremental service charge recovers the additional
16 fixed operating costs when operating compared to the water
17 security shutdown mode.

18
19 While this might seem like a minor refinement to the
20 price structures, and largely presentational, we consider
21 this actually adds transparency around the difference
22 between the fixed operating costs included in the base
23 service charge and each of the other modes.

24
25 In our issues paper we also proposed different cost
26 sharing principles for SDP and we proposed recovering SDP's
27 base water security cost, which was area A in the previous
28 graph, for making the plant available, from impactors, and
29 that is based on an impactor pays principle.

30
31 For the incremental fixed operating cost, which was
32 area B in the previous graph, we are proposing that those
33 costs are recovered from the users based on the beneficiary
34 pays principle.

35
36 Water usage charges, which are separate to the fixed
37 costs, would continue to be paid for by users.

38
39 This means that SDP's base water security charge would
40 be shared between Sydney Water and any other bulk water
41 customer based on their respective share of total water
42 system demand. Total water system demand is comprised of
43 bulk water sourced from WaterNSW's dams supplying Greater
44 Sydney and SDP's desalination plant.

45
46 Incremental fixed charges could be shared based on
47 each customer's respective share of water sourced only from

1 SDP.

2
3 We consider the impactor pays principle represents
4 a more cost-reflective sharing rule than the current
5 sharing rule. The current sharing rule shares all SDP's
6 fixed costs on a user pays principle. The impactor pays
7 principle links SDP's water security payments to dam
8 levels, which ensures those that create the need for
9 a cost - in this case, the desalination plant as a drought
10 response measure - contribute proportionately to that cost.

11
12 So to end the session we have a few questions to
13 prompt discussion:

14
15 Do SDP's prices reflect its prudent and efficient
16 costs?

17 Should we split the fixed costs into a base water
18 security charge and incremental service charges?

19 If so, what proportion of fixed operating costs should
20 go into the base water security charge?

21 Should we apply the impactor pays principle to the
22 base water security charge?

23 Should we apply the beneficiary or user pays principle
24 to the incremental fixed charges and usage charges?

25
26 Thank you.

27
28 THE CHAIRMAN: Thank you very much, Jean-Marc. Now,
29 comments from around the table. Would anybody from SDP
30 like to make some points?

31
32 MR DAVIES: Maybe an overall point there, Mr Chairman, on
33 the impactor pays and the classification of our fixed
34 charges. We have no objection to reclassifying costs into
35 the sorts of arrangements that have just been gone through
36 by Jean-Marc. But I should say we think there is no
37 realistic opportunity for SDP to gain any customers in the
38 next five-year period on the regulatory side,
39 realistically. We believe we will still just have the one
40 customer in Sydney Water. So although we would support
41 anything that adds transparency and is sort of
42 forward-looking, which this clearly would be - we would
43 support that, but realistically I think most of the
44 commentary should come more from the downstream side in the
45 Sydney Water area with their customers.

46
47 THE CHAIRMAN: Okay. Thank you, Keith. Sydney Water?

1 Kevin?

2

3 MR KEVIN YOUNG (Managing Director, SWC): I might just have
4 a few overall comments and then I will let the team go into
5 some detail on that.

6

7 Of course, I would start by saying that we welcome the
8 opportunity to be here today as part of an IPART process,
9 which is transparent and involves the public, and we have
10 always been strong supporters of this process. We really
11 commend IPART for looking at ways to incentivise and
12 maximise the efficient operation of SDP.

13

14 It is interesting for us because I think Keith might
15 have referred to us as "the previous owners", so we come to
16 this hearing not with an ownership hat on but with
17 a customer hat on, so wearing a different hat.

18

19 What we would like from the process, and it is the
20 same view, is a good outcome, not necessarily for SDP or
21 Sydney Water, but value for customers is what drives all of
22 us in this area.

23

24 I want to comment that it was great that SDP did reach
25 out and we had a number of conversations so that they could
26 understand views, and you will see from our submission that
27 there is a significant number of areas in which we do
28 support. You will also note that that does not mean that we
29 support all things; there will naturally be differences as
30 well.

31

32 I think one of the issues is, going back to 2012 and
33 being involved in that, I was very conscious that it was
34 such a complex and detailed governance framework back then,
35 from its inception to the refinancing and the accounting
36 standards, so probably some areas - any changes to the
37 water supply agreement become potentially problematic for
38 us, and that is why we haven't supported them.

39

40 If there were any changes in the water supply
41 agreement that could possibly result in a reassessment of
42 the lease, depending on that outcome, it could have
43 substantial financial impacts for Sydney Water and, in
44 turn, our customers. So that is just an overall - it is
45 a delicate, complex arrangement that IPART will need to
46 consider.

47

1 I have to say that we welcome any reduction in
2 customers' bills, so it is very pleasing to see that. That
3 is in line with what Sydney Water is doing. And we do note
4 that, as Keith mentioned, there are a number of areas that
5 they couldn't provide information on, and we understand
6 that, because some things are commercial in nature and, of
7 course, we would like to get a full understanding of how
8 that is all going to come out in the wash in terms of the
9 final deal.

10
11 Danielle, would you like to make any comments on the
12 questions?

13
14 MS DANIELLE FRANCIS (SWC): Sure, thank you for the
15 opportunity.

16
17 I have just a couple of comments in regard to those
18 questions. In terms of our views on prudent and efficient
19 costs, that is obviously something that IPART and your
20 efficiency reviewers will have a detailed role in
21 determining.

22
23 One thing we did pick up on in our submission is the
24 large increase in the transition charge, which we are
25 imagining may well relate to membrane costs for new
26 membranes. We have made the comment that we think that
27 perhaps the tribunal may like to consider that being
28 something that could be treated with a cost pass-through
29 mechanism so that the actual cost, when known, can be
30 passed through, rather than potentially imposing a high
31 cost in advance.

32
33 THE CHAIRMAN: I would be interested in SDP's response to
34 Danielle's observation about the large increase in
35 transition costs?

36
37 MR DAVIES: Sure. I will start the answer to that and
38 I may ask one of my colleagues to complete the answer.

39
40 You are correct, Danielle, the largest increase in our
41 transition charges does relate to our assumption of how
42 many membranes will be needed, depending on which year we
43 are asked to restart the plant. That is a fact.

44
45 The numbers that we have assumed - we have consulted
46 with the manufacturers of the membranes based on the
47 performance that they showed during the operation of the

1 two years that it ran, but also the time duration between
2 the last time it ran and the time it has been in mothball,
3 approaching five years.
4

5 Is there a different way that it could be assessed?
6 Absolutely. We have used the science of the manufacturer.
7 If there was to be an arrangement where it was based on
8 actual - which I think is what you are proposing, Danielle,
9 that it was more based on a cost pass-through after the
10 event, as a recoverable cost - that is something we could
11 consider, but I would like to ask Lisa Welsh here, our
12 regulatory manager, to have a comment on that, too.
13

14 MS WELSH: Thanks, Danielle, for your comment. The
15 restart charges were something that we did certainly
16 consider very carefully. We note that the IPART
17 determination for our 2012 charges was taken in very
18 challenging circumstances and in a very compressed time
19 frame and, on the whole, we think that they did an
20 excellent job reflecting our efficient costs.
21

22 The restart charges is one area that we believe does
23 require further scrutiny to pick up on things that were
24 perhaps not fully understood by a range of different
25 stakeholders at the time and we feel that there are some
26 fairly significant increases associated with that improved
27 understanding, but also associated with the fact that we
28 will have been in extended mothball for, as Keith was
29 saying, five years by 1 July 2017.
30

31 We recognise that there are a number of different ways
32 that we could approach this charge. Certainly one of the
33 things we were conscious of is that we did not want
34 customers paying for costs that weren't incurred. Our view
35 was that, given the uncertainty in the timing and duration
36 of our operations, we certainly would not be replacing any
37 membranes until next called upon to restart and, therefore,
38 in the event we remain in water security shutdown for the
39 next regulatory period, there would be no costs to
40 customers and indeed to the SDP.
41

42 As Keith has said, we are certainly open to
43 alternative solutions that would smooth the impact on
44 customers but which would ensure that SDP fully recover
45 their prudent and efficient costs in line with the terms of
46 reference.
47

1 THE CHAIRMAN: Thanks, Lisa. Danielle?

2

3 MS FRANCIS: Just to confirm that we agree with the view
4 that it is appropriate to recover those costs. I think we
5 have common ground there; it is more about the discussion
6 about different ways that the mechanism could work. It is
7 about, as you say, how we can smooth the customer impact,
8 and that is something the tribunal can look at.

9

10 With regard to the proposal to move from user pays to
11 impactor pays, we are happy to support that. In essence,
12 we can see the merit in the view that the desalination
13 plant is an insurance premium for drought, effectively, and
14 the water security payments are, effectively, like an
15 insurance payment and we are paying for that value. As
16 such, we would be happy to support an arrangement in the
17 sense that our large customer base is a very significant
18 contributor to water demand which can in turn lead to the
19 need to trigger the plant to operate under drought
20 conditions, so we are happy to support that.

21

22 We are also happy to support that to the extent that,
23 even though it might increase the proportion of costs that
24 our customers bear, is likely to increase the potential for
25 further customers to come along and share those costs with
26 us which could then, in turn, lead to a sharing and hence a
27 material reduction for our customers. We see that a
28 potential benefit, so we are happy to support that.

29

30 In terms of the actual splitting the fixed costs, do
31 you want to discuss that further, Will?

32

33 MR WILL DOLAN (SWC): We are supportive of splitting the
34 charges to have that base. We do think, though, if you go
35 back to your chart, that there is a little bit of B that is
36 sitting in A, to use the simple terminology. There are
37 some of operating costs sitting there. We would ask that
38 you consider looking at that, because otherwise there might
39 be some perverse outcomes in the ultimate costs paid by the
40 customers.

41

42 For the base service charge, which is the A, which is
43 the purple, we think that some of that variable charge is
44 actually being captured in that component, so B should be a
45 bigger representation on that chart.

46

47 THE CHAIRMAN: Thanks, we will take that on board.

1 Prue, would you like to say anything at this stage?

2

3 MS GUSMERINI (WaterNSW): First of all, thank you for
4 having me here today and apologies that my colleague
5 Yolanda Chora cannot join us. She is quite ill.

6

7 I am very satisfied that Sydney Water has covered off
8 on the main points relating to customer impact on those
9 particular questions, and we have nothing further to add,
10 thank you.

11

12 THE CHAIRMAN: Thank you, Prue. Are there any other
13 comments or questions? Any more comments from SDP?

14

15 MS WELSH: In relation to the first question about whether
16 SDP's prices reflect its prudent and efficient costs,
17 I would like to reiterate some of the points that Keith
18 made in his presentation, which is that SDP is a lean
19 efficient organisation. We have competitive tender
20 outsourcing in place for the vast majority of our costs;
21 indeed, many of these contracts were entered into with our
22 now customer, Sydney Water, and we are pleased that they
23 are happy to continue to support those contracts.

24

25 We have ongoing incentives to drive efficiency
26 improvements through our ownership and we also support the
27 continuation of the efficiency adjustment mechanism to
28 ensure that this mechanism continues to drive future
29 improvements in the meantime.

30

31 I would also like to add that our O&M charges and
32 projected costs were reviewed quite thoroughly by Advisian
33 on our behalf. They confirmed that our operator, Veolia,
34 manages the plant consistent with best practice and that
35 their asset management systems are also consistent with
36 best practice.

37

38 THE CHAIRMAN: Thank you very much, Lisa. Does anyone
39 want to make any further comment before I turn to the
40 floor?

41

42 Yes, Danielle?

43

44 MS FRANCIS: The only question I have not addressed so far
45 is the last one about applying the user pays principle to
46 the incremental fixed charges and running charges. That is
47 not something we support. In our view, we believe that

1 impactor pays is appropriate for water security charges but
2 for those incremental mode charges, we think user pays is
3 fair, particularly because in drought conditions everyone
4 should contribute equally.

5

6 THE CHAIRMAN: Thanks very much, Danielle. Any questions
7 or comments from the floor? No? Matt?

8

9 MR EDGERTON: Keith, could we just confirm SDP's position
10 on binding the impactor pays principle to the base water
11 security charge. I understand you said that you don't
12 necessarily see that it would have any effect over the
13 determination period. I just wanted to confirm what your
14 view is. Do you support it? Do you oppose it?

15

16 MR DAVIES: We fully understand the principles behind
17 impactor pays. It is interesting to hear our customer,
18 Sydney Water, giving their views on their customer impacts
19 and how new customers of ours would be treated in there.

20

21 We certainly agree with the principle of impactor pays
22 and we understand the principle. How it would roll out in
23 the next five-year period of 2017-2022, though, I think for
24 us largely depends on whether or not we are operating. If
25 we are not operating and we remain in an extended mothball
26 period, then the business is relatively static and given
27 that there are no variable charges, there would be no
28 impact on us, in that sense.

29

30 THE CHAIRMAN: Thanks, Keith, anything else? Now might be
31 a good to him to move on to session 2, which is operating
32 flexibility and Alexandra will give the presentation for
33 IPART.

34

35 Session 2 - operating flexibility

36

37 MS SIDORENKO: Thank you, Peter. I am Alexandra Sidorenko
38 from the IPART secretariat. My session follows on on the
39 previous one which talked about the price structures in our
40 determination.

41

42 Operating flexibility is linked to the pricing
43 mechanisms that we have in our determination. The 2012
44 determination established pricing mechanisms to align these
45 financial incentives with SDP's operating requirements in
46 this environment.

47

1 The two major pricing mechanisms that we use are an
2 abatement mechanism and nil variable price to Sydney Water.
3 Just to explain, the abatement mechanism is applied when
4 SDP produces less than full production levels when required
5 to maximise its output when dam levels are low - that is,
6 in drought or following the 70/80 rule.

7
8 Nil water usage charge applies to any water supplied
9 to Sydney Water Corporation outside the drought - that is,
10 when dam levels are high or outside the 70/80 rule.

11
12 We are going to look at these two mechanisms during
13 the review. We are considering refining these pricing
14 mechanisms to provide SDP with greater operating
15 flexibility while ensuring that it continues to deliver its
16 declared monopoly services in the most efficient way.

17
18 Operating flexibility when dam levels are low is
19 driven by the abatement mechanism. Our preliminary view is
20 that it is appropriate to continue the abatement mechanism
21 as it creates an appropriate financial incentive for SDP to
22 actually deliver its drought response services.

23
24 However, we recognise that the current abatement
25 mechanism has its limitations. In particular, it creates
26 the situation when if SDP were to restart, triggered by the
27 dam levels falling below 70 per cent, in the transitioning
28 to restart period, there may be an instance when SDP would
29 be able to start producing drinking quality water, but it
30 would be penalised should it start supplying it to Sydney
31 Water.

32
33 We recognise that this is not an optimal outcome
34 because, in this restart period, water availability is already low,
35 so we should allow this water to start contributing to the
36 total system.

37
38 Basically a revision or refinement of when they would
39 be able to apply the abatement mechanism could go along the
40 way of allowing for some grace period for SDP to start
41 supplying this water. However, the parameters that have to
42 be teased out and determined are when exactly that should
43 happen. For example, after four months, should SDP be
44 allowed to start supplying drinking quality water without
45 an abatement and then how long should that relief of
46 abatement last? This is something that we are exploring -
47 that is, when a grace period would apply and for how long

1 it would be considered.

2
3 There are also refinements along how we apply the
4 abatement mechanisms. We realise that there is potential
5 for SDP to fluctuate in its daily output above the
6 250 megalitres per day that was given as the capacity of
7 the plant. There is the question of determining the
8 averaging period to calculate this appropriate abatement
9 ratio. We will be considering refining those compared to
10 what we currently have in the 2012 determination.

11
12 Just to summarise that, we do consider that the
13 abatement mechanism to SDP's daily fixed charges, if the
14 plant produces volumes of water less than its full
15 production, is appropriate in the drought response role and
16 we consider it important to continue these financial
17 incentives.

18
19 There may be scope to increase operating flexibility
20 for SDP outside the drought response role when dam levels
21 are high. Of course, in doing so, we should be mindful of
22 the efficiency of these operations. Under the current 2012
23 determination, there is already scope for SDP to supply
24 outside the 70/80 rule when dam levels are above 80 per
25 cent. We have recognised the third party customer and we
26 regulate charges to the third party customer.

27
28 However, we do set a nil variable price to Sydney
29 Water when dam levels are high - above 80 per cent under
30 the current operating rules. In our issues paper, we
31 propose removing the nil usage price to Sydney Water for
32 SDP to be able to supply water, upon Sydney Water's
33 request, when dam levels are high - above 80 per cent.

34
35 In considering this option, our view was that allowing
36 SDP to operate more flexibly in these instances could
37 provide direct benefits to the parties who would be
38 involved in this supply of water. There could be
39 system-wide benefits. It could lower Sydney Water's costs
40 in some instances - for example, if Sydney Water was
41 calling for SDP to supply as an emergency response to
42 offset the water security due to some infrastructure works
43 in the Sydney Water network, that would be a cost-effective
44 way, in principle, to call upon SDP to supply.

45
46 However, our current determination and nil price for
47 Sydney Water prevents variable charges to be reimbursed to

1 SDP. We also considered the potential for unregulated
2 pricing agreements between SDP and its customers to arise
3 outside the 70/80 rule. In considering this, or enabling
4 this, we could see some indirect benefits to Sydney Water
5 through the increased responsiveness from SDP and also
6 through offsetting some of the charges that otherwise would
7 be payable by Sydney Water and would now be shared by these
8 third party customers.

9
10 We thought there could be some instances in terms of
11 removing or relaxing the nil price to Sydney Water outside
12 the drought response role. For example, when SDP is just
13 transitioning to shut down, having fulfilled its mandatory
14 run time, or, under the network operating licence, if dam
15 levels hit 80 and SDP is no longer required to maximise its
16 output and goes into shutdown mode, any water supplied
17 during this period effectively falls into the "when dam
18 levels are high" category, we would be looking at relaxing
19 the nil price to Sydney Water, in this instance.

20
21 Also another scenario would be if SDP is required to
22 operate for some minimum run-time period and that happened
23 to coincide with dam levels being already high.

24
25 Those are major circumstances - when dam levels are
26 low and when dam levels are high, how can we think of
27 making our pricing mechanisms more aligned with this
28 increased operating flexibility?

29
30 Basically the questions we would like to pose today
31 are:

32
33 Should SDP be able to ramp up production without
34 penalty to fulfil its drought response role?

35 Are there current aspects of the abatement mechanisms
36 that need modifying; and, if there are, how should we be
37 looking at modifying them?

38 Should SDP be able to charge for supply to Sydney
39 Water when dam levels are high; and, if so, for what reason
40 and in what circumstances?

41 Should SDP's prices remain regulated when dam levels
42 are high?

43
44 These questions are on the screen and I will now hand
45 you back to the Chair. Thank you.

46
47 THE CHAIRMAN: Thank you very much, Alexandra.

1
2 Comments or questions around the table. SDP, would
3 you like to start? Keith?

4
5 MR DAVIES: Sure, thank you, Mr Chairman. I'll take those
6 questions as they were put by Alexandra. Number 1, should
7 we be able to ramp up production without penalty to fulfil
8 our drought response role? We believe absolutely. We
9 think, in this respect, our customer would be in agreement.
10 It makes perfect sense that, when we are called on because
11 dam levels have hit below 70 per cent, every litre of
12 drinking water we could make should find its way to the
13 market, to the customers - Sydney Water's customers. We
14 believe it is more algebra at the moment in the
15 determination that is preventing what we believe makes good
16 sense. So, absolutely, we think this should be able to be
17 done without penalty.

18
19 On the second question - are there current aspects of
20 the abatement mechanisms that need modifying? - we have
21 proposed in our submission that there are some aspects. As
22 a general statement, we agree with the concept of
23 abatement. It is common in many facilities that are
24 producing products. We have no issue with performance
25 guarantees and the like, but we believe there are areas of
26 the abatement mechanism that could be modified to improve
27 the current mechanism that was laid down for us in the
28 current determination and we propose those in our
29 submission.

30
31 Should we be able to charge for supply to Sydney Water
32 when dam levels are high; and, if so, for what reasons? My
33 very simple answer to that would be we want to be available
34 to supply water whenever Sydney Water's customers need it.
35 We should do that both at full production during the
36 drought, and outside of drought we need to be available in
37 varying production levels, depending on what our customer
38 wants.

39
40 We believe at the moment the nil charge is the biggest
41 barrier for that. The water supply agreement contemplates
42 this activity happening where our customer can approach SDP
43 at any time outside of a drought and ask us to start the
44 plant to meet system constraints on emergencies. We want to
45 be there for that but the nil charge prevents us getting
46 paid.

47

1 THE CHAIRMAN: Just on that, I find this a very complex
2 area, as I think most do. My understanding is that the
3 reason why the nil charge is in there is because, in the
4 water supply agreement, there is something that effectively
5 says that SDP can "push" water onto Sydney Water - in a
6 sense, supply them even if they don't want it. One way of
7 preventing that was to effectively remove any revenue that
8 you would get from doing that.

9
10 This is, therefore, quite a difficult area because to
11 delve into it would start to change things in the water
12 supply agreement, in the stewardship documents which were
13 set up when SDP was sold by the government to the new
14 owners. There is the issue which Kevin mentioned earlier
15 about being careful that we don't do anything which
16 triggers a reassessment of the state of the relationship
17 between SDP and the government through Sydney Water and
18 issues about financial liabilities.

19
20 This is a very complex area. I just thought I would
21 take this opportunity to put in my bit. Possibly some
22 people in the audience will understand that, but I think
23 there will be some who do not understand it.

24
25 MR DAVIES: Mr Chairman, could I reply to that?

26
27 THE CHAIRMAN: Yes.

28
29 MR DAVIES: We agree fully with Sydney Water that not
30 changing the water supply agreement is an important matter.
31 We have no intention of changing the terms of that
32 agreement between us. We see the regulation pathway as a
33 way to tidy up this anomaly.

34
35 We have no intention of supplying water and putting
36 water on Sydney Water outside of a drought. If the rules
37 allow us to do that, I can tell you categorically today we
38 will not do that. What we do need to do is make sure that,
39 when Sydney Water require us for those very rare occasions,
40 we hope, outside of the drought, regulation can cope with
41 that rare occasion and allow us to agree the appropriate
42 costs for that activity as and when it arises.

43
44 MS WELSH: I would add to that that the water supply
45 agreement in its current and, as Keith mentioned, unchanged
46 form does allow for us to enter into an agreement to allow
47 us to provide those services to Sydney Water when called

1 upon. In seeking an unregulated pricing agreement, our
2 intention was that that agreement would be consistent with
3 the terms of the water supply agreement.
4

5 THE CHAIRMAN: Thanks, Lisa. Do you want to reply to the
6 fourth question, Keith?
7

8 MR DAVIES: The last question there is:

9
10 Should SDP's prices remain regulated when
11 dam levels are high?
12

13 The answer to that is linked to the previous answer. On
14 those occasions where we are outside of a drought and our
15 customer, Sydney Water, requests us to restart for those
16 emergencies or constraints we believe that the better way
17 to be paid for that would be a negotiated agreement
18 directly with Sydney Water in a non-regulated way. On all
19 other occasions, we are very happy with the regulated
20 prices.
21

22 THE CHAIRMAN: Thank you very much, Keith, Sydney Water?
23 Kevin, would you like to comment?
24

25 MR YOUNG: I'll comment on questions three and four. In
26 this area of the question of the nil charge, I look back to
27 the way it was originally set up. As I said, it is a
28 complex and complicated governance arrangement. I would be
29 interested to know whether there are people in the audience
30 who understand this because it has taken me a lifetime to
31 try and understand it. It involves generally meetings with
32 specialist experts in accounting and legal practices to try
33 and understand what the implications are.
34

35 In an intuitive sense there is some merit in that, but
36 when we go into it in a bit more detail, it quickly goes
37 to: was the nil charge set to encourage SDP, during
38 periods of high water levels, to look for other customers
39 in the market and relationships? That is the other way to
40 look at it.
41

42 THE CHAIRMAN: That is the other way, yes.
43

44 MR YOUNG: If you do that we can say, "Yes, that's good",
45 because, we all believe in competition principles, and that
46 is, in a sense, a driver. But if it was a direct
47 one-on-one negotiation with Sydney Water, that sort of gets

1 to the original intent of the competition. What our
2 greatest fear is that whatever we do, we do not want to
3 change the water supply agreement to a point where the
4 accounting treatment would change. If the accounting
5 treatment were to change, the detrimental impact on our
6 customers through the resulting higher costs would
7 certainly offset the benefits that we could see.

8
9 That is the complex area and it does get really
10 complex and really complicated fast. You need people
11 sitting in the room who are sort of experts in this area.

12
13 THE CHAIRMAN: Thanks, Kevin.

14
15 MR YOUNG: That's why IPART is dealing with some of these
16 issues.

17
18 THE CHAIRMAN: Yes, we are certainly applying ourselves.
19 Danielle or Will?

20
21 MS FRANCIS: In answer to questions 1 and 2, yes, Keith,
22 we agree with you that the abatement mechanism does create
23 a perverse incentive to actually dump water. I think we
24 all generally agree that that is not in the interests of
25 what the community would want to see and it is not what is
26 needed. We do recognise that that may have an impact on
27 what needs to happen with the abatement mechanism. We
28 think the proposed soft restart process could perhaps be a
29 means to address that, but it might need some pricing
30 changes to the abatement mechanism.

31
32 To answer the last two questions, if we separate the
33 question of whether SDP should be able to charge us for
34 supply into the circumstances described in the water supply
35 agreement - emergency outage and public health - in those
36 circumstances, then we do agree that there should be an
37 ability to recover reasonable costs. If it were something
38 like the equivalent of the regulated charge, yes, we would
39 agree with that.

40
41 However, in the other circumstances that have been
42 contemplated - that is commercial arrangements not for
43 those water security, water emergency network instances -
44 we understand the desire to look at that, but as Kevin
45 alluded to, one of the killers of the original financing
46 arrangements and the stewardship documents is that
47 incentive to SDP to find thirty party suppliers. That,

1 unfortunately, just creates a barrier against consideration
2 of the removal of any charge.

3
4 THE CHAIRMAN: Thank you, Danielle. Will?

5
6 MR DOLAN: No, nothing, thank you.

7
8 THE CHAIRMAN: Prue?

9
10 MS GUSMERINI: I would like to ask a question of SDP in
11 terms of what is the relationship between being able to
12 provide water outside of drought and your operating
13 licence? I would want to understand that a little bit
14 better before I make the comments.

15
16 MS WELSH: The operating licence requirement states that
17 we must maximise production of water when storage level
18 fall below 70 per cent and until they reach 80 per cent.
19 This requirement does not apply when we are in restart
20 period but when we were in shutdown. The operating licence
21 is silent on the provision of water and at what levels to
22 customers outside of this constraint.

23
24 MS GUSMERINI: I think that raises a really interesting
25 question from a regulatory point of view. As we know, the
26 government is currently looking at the Metro Water Plan.
27 WaterNSW would also agree that, in some circumstances, it
28 is favourable to have full contestability of supply in the
29 Sydney market. However, if we were going to move in that
30 direction, we think this discussion needs to be informed by
31 a proper consideration of the regulatory implications and
32 that probably needs to be a discussion to which the New
33 South Wales government is a counterparty.

34
35 So we have called for a regulatory review in the hope
36 that we may start to have this discussion with the New
37 South Wales Government, with yourself, with Sydney Water,
38 et cetera, and we would encourage IPART to engage with the
39 government on those terms as well.

40
41 We are not opposed, per se, to some of the things
42 being put forward, nor SDP's view, but we would say, if we
43 are going to move towards full contestability - ie, desal
44 can operate outside of drought - then let's think about the
45 regulatory implications and work through those together.

46
47 THE CHAIRMAN: My understanding, Prue, is that SDP can

1 operate outside a drought period - ie, when the dam levels
2 are not low now - and supply; it is just at this point they
3 haven't done it.

4
5 MR EDGERTON: I guess my understanding is the same as Lisa
6 said - that the operating licence is silent on this; it
7 does not prohibit SDP from doing this. It's just that some
8 of the issues we're talking about, particularly in the
9 current determination, may create a financial disincentive
10 or impediment for SDP to do that.

11
12 MS GUSMERINI: I think we would like to have some
13 clarification from the government on that, and it is
14 a discussion that we would like to have with them as well.
15 I think we have raised that in the context of the
16 Metropolitan Water Plan.

17
18 THE CHAIRMAN: Okay. Thank you very much, Prue. Are
19 there any comments or questions from the audience? Anybody
20 in the audience? No.

21
22 Matt?

23
24 MR EDGERTON: I just have another question of SDP.

25
26 Keith, you mentioned outside the drought response
27 role, so when dam levels are full, you would be proposing
28 a negotiated price between yourselves and Sydney Water?

29
30 MR DAVIES: Yes.

31
32 MR EDGERTON: What are your views on potential pricing
33 arrangements for other customers - other customers of yours
34 that may come along one day under those circumstances?

35
36 MR DAVIES: Thank you, Matthew. I wish I had a crystal
37 ball, Matthew, to answer that. I think, as I mentioned
38 a few minutes ago, the prospect of SDP obtaining
39 competitively priced customers we do not expect to occur in
40 the next regulatory period, but let's make the pathway for
41 the future.

42
43 If a day comes when our water is competitive on
44 a comparison with the alternative - the dam-based water -
45 then at the moment we believe that the costs of that, the
46 marginal cost or the increased cost, the variable cost of
47 that water could be negotiated directly with that customer,

1 but the costs of paying for the infrastructure, in sharing
2 the use of that, should be divvied up accordingly. So the
3 customer that has that supply shares the burden of the
4 fixed base costs with the foundation customer, Sydney
5 Water.

6
7 MR EDGERTON: We have proposed that be done on the
8 impactor pays basis.

9
10 MR DAVIES: On the impactor pays.

11
12 MR EDGERTON: But on the usage charge, I guess you would
13 have two broad options - one would be an unregulated price
14 and one would be a regulated price.

15
16 MR DAVIES: I am not sure we have thought that far ahead,
17 but Lisa might have a view.

18
19 MS WELSH: My only comment on that would be that the most
20 important thing for us is that that price is cost
21 reflective. At the moment, there is a regulated charge
22 which is cost reflective for us when we are operating at
23 full production. If we have a customer that comes to us -
24 whether it's Sydney Water or this fictitious third-party
25 customer - if they would like us to supply water at
26 a lower-flow mode, the costs associated with doing so are
27 different to our megalitre charges when we are operating
28 most efficiently at our full production levels.

29
30 THE CHAIRMAN: When you are, for example, gearing up or
31 operating at low flow now you can't sell the water to
32 Sydney Water and get paid for it because it is the nil
33 charge. In those sorts of circumstances, which wouldn't be
34 all the time, in terms of a price there because you are
35 producing the water anyway, in terms of, let's say, in the
36 build-up phase - you are producing the water anyway - at
37 the moment, as I understand, it is discarded, so you get
38 nothing for it. So, in a sense, anything more than nothing
39 would be worthwhile, even though it is below the cost of
40 producing it?

41
42 MR DAVIES: That's true. Anything more than nothing is
43 better than nothing. What we are looking for is
44 a cost-reflective charge to cover our costs on the way up.

45
46 We don't want the incentive to remain where we need to
47 ditch that water, or dump it, as Danielle called it, back

1 into the ocean. It makes perfect sense to get that to
2 market.

3
4 Cost reflectivity is just what we are looking for
5 here. We are not looking to make a profit on it, we just
6 want to be recovering our costs.

7
8 MS WELSH: Just to be clear, under the current
9 arrangements, if we were to restart under the terms of the
10 2012 determination with the restart charges in place, the
11 energy costs associated with producing that water on the
12 way to full production are not currently recovered.

13
14 THE CHAIRMAN: Yes.

15
16 MR KUTSCHUKIAN: Could I just ask a couple of questions
17 about the grace period that you have proposed around the
18 abatement mechanism?

19
20 First, I think we had a graph up before which sort of
21 suggested the grace period would be about four months.
22 I am just wondering if you could comment on what you think
23 the appropriate duration is for the grace period; and also,
24 I guess, there's no proposal for a dual usage charge in
25 your pricing proposal. We have just mentioned then that
26 the cost per megalitre might be different as you are
27 ramping up; are you suggesting that you should have another
28 price as opposed to the \$688 per megalitre during the grace
29 period?

30
31 MS WELSH: In terms of the grace period, what we have
32 proposed is an eight-month period. There's a degree of
33 uncertainty as to when we will commence producing water of
34 the acceptable standard within that eight-month ramp-up
35 period. It is approximately four months. Do we know that
36 to the day? No, that is impossible. We haven't restarted
37 this plant from water security mode ever before. I am sure
38 we will learn a great deal when we eventually do. At the
39 moment I think it would be impractical for us to be precise
40 as to the period of time and, for that reason, we have
41 proposed that that be the full eight-month restart period
42 which is in line with our operating and maintenance
43 contract with our plant operator.

44
45 In relation to the charge itself - sorry, Jean-Marc,
46 would you remind me of the question?
47

1 MR KUTSCHUKIAN: So as you are ramping up you are
2 producing less than full capacity; you just mentioned that
3 the price that we currently have in the determination only
4 caters for a full level.

5
6 MS WELSH: Our belief is that the charge that would be
7 applicable during that grace period would be lower than the
8 full restart charge. It would only need to recover the
9 cost of energy, rather than the usage charge payments to
10 our operator, which are already covered within the O&M cost
11 components within that restart charge.

12
13 MR KUTSCHUKIAN: Okay.

14
15 THE CHAIRMAN: Thank you very much.

16
17 MR DAVIES: Could I just add a little bit more there to
18 Lisa's comments. The reason it would be lower on the way
19 up, as we come back, would be that our operating agreement
20 with Veolia involves them paying for other charges,
21 principally chemicals, to produce that water as we come
22 back on line. That's the reason.

23
24 THE CHAIRMAN: Anything else?

25
26 MR EDGERTON: Just a follow-up from Jean-Marc's question.
27 I guess, though, you have proposed one usage charge when
28 you are operating in your drought response role, but before
29 you said outside the drought response role, to ramp up, if
30 you're operating at less than full production, your
31 incremental costs may be greater than that. So given you
32 have just proposed one usage charge, is that based on the
33 assumption you are operating at full production?

34
35 MS WELSH: This is a very complex area and in our proposal
36 we did propose that we would have a soft restart, and our
37 proposal also suggested that understanding the cost
38 reflectivity of that restart charge is something that is
39 best done in consultation with yourselves to ensure that we
40 do no more than recover our prudent and efficient costs.
41 It is a complicated area, and rather than propose a suite
42 of charges that are based on a range of potential outcomes
43 of the tribunal's considerations, our preference is to work
44 with you to understand the outcomes that we are trying to
45 achieve and that you are willing to support. Then,
46 I think, the next step for that is to discuss what would be
47 an appropriate cost-reflective charge. Our understanding

1 is that that would require us only to recover the energy
2 costs and, for that reason, we certainly wouldn't be
3 advocating that the usage charge which we have suggested at
4 full production would be the appropriate charge.

5

6 THE CHAIRMAN: It is somewhere between zero and what you
7 get at full production?

8

9 MR DAVIES: That's right.

10

11 THE CHAIRMAN: We get the issue. It is complex and we
12 need to apply ourselves.

13

14 Is there anything else at this stage?

15

16 We might break for morning tea now and then move on to
17 session 3 and session 4. It is 11.25, so maybe if we
18 resume at 11.45, which is 20 minutes, thank you.

19

20 SHORT ADJOURNMENT

21

22 THE CHAIRMAN: Thank you. We will now move on to
23 session 3, which is the December 2015 storm event, and Syvi
24 will introduce it for IPART.

25

26 Session three - December 2015 storm event

27

28 MS BOON: Thank you. Today I am going to be discussing
29 the December 2015 storm event.

30

31 As most of you have heard today, SDP was badly damaged
32 by a storm event in December 2015 and since that time has
33 been inoperable.

34

35 We are considering two key aspects of the storm damage
36 today. First, the damage to the plant - specifically, is
37 further plant testing required, other than that covered by
38 insurance because of the damage to the plant; and also the
39 interruption to SDP's business because of the storm -
40 should SDP's costs be covered by insurance or through fixed
41 payments in its determination when it is inoperable.

42

43 We are also considering if there should be
44 a pass-through to customers of any gaps in insurance
45 coverage for SDP, as well as other unexpected events, and
46 we are considering how to treat any future event that may
47 impact SDP's plant and its operations.

1
2 Here is a picture of SDP's plant for you (slide
3 shown).
4

5 As I mentioned before, we are considering if
6 additional plant testing is required outside of the
7 insurance claim. Keith spoke briefly about the storm
8 before, and to give you a bit more detail, the high winds
9 and resulting debris from the storm event caused widespread
10 damage across SDP's site. According to SDP, the damage
11 assessed includes damage to the buildings housing the
12 plant, including the roof structure of some buildings;
13 damage to plant items within those buildings; and loss of
14 preservation fluid to the membranes. SDP is responding to
15 the damage including engaging with insurers.
16

17 A key challenge noted by SDP in its pricing proposal
18 is restoring and testing the plant to ensure the assets are
19 ready to restart when next required.
20

21 In our issues paper we considered if there is a case
22 to allow for periodic partial testing of the plant when in
23 extended shut down to improve SDP's availability and
24 reliability. This, of course, is separate to any testing
25 that might occur as part of the insurance claim.
26

27 Here on the screen is a picture of the actual damage
28 to the plant.
29

30 Another thing that we are considering is how SDP's
31 costs should be covered when it is inoperable. For the
32 2017 determination we are considering whether SDP should
33 recover its fixed costs, when inoperable, through insurance
34 or through fixed payments under our determination. For
35 instance, there may be an argument that SDP's customers
36 should not have to pay a fixed charge if the plant is
37 inoperable; rather, SDP's prudent and efficient business
38 interruption insurance costs should be included in its
39 operating expenditure allowance - that is, to be recovered
40 via its prices, if it is operable.
41

42 Alternatively, it may be considered more appropriate
43 for SDP's customers to pay for SDP's fixed costs while the
44 plant is inoperable. This is particularly the case if SDP
45 is unable to obtain business interruption insurance or
46 unable to obtain this insurance at reasonable cost.
47

1 We also raise the possibility of pricing an inoperable
2 mode in our issues paper. This would reflect the actual
3 efficient fixed costs if the plant is inoperable, but this
4 might not be practical.

5
6 In our issues paper we noted that we passed through
7 energy network costs in the 2012 determination and propose
8 that we should continue to do this in the 2017
9 determination. We also asked if there was a case to manage
10 any other of SDP's proposed costs through a cost
11 pass-through mechanism. This has been raised briefly this
12 morning already.

13
14 Our criteria for cost pass-through mechanisms indicate
15 they should only be applied in situations where the
16 regulated business cannot influence the likelihood of the
17 trigger event or the resulting cost. These criteria are
18 outlined on the slide for you to have a look at.

19
20 In the 2016 Sydney Water review we did not broaden the
21 application of cost pass-throughs because it is efficient
22 for the business to be at least partially exposed to risks
23 that it has some ability to control or influence. This
24 provides the business with an incentive to minimise the
25 likelihood and cost of downside risk and maximise the
26 likelihood and benefits of upside risk.

27
28 It is also efficient for the business to have an
29 incentive to influence new costs as a result of
30 a legislative, legal or regulatory development. It is
31 important that the regulated business retain some risk in
32 these situations in order to incentivise it to actively
33 engage in the consultation process and advocate for the
34 most effective and efficient solutions.

35
36 In its pricing proposal, SDP seeks to broaden the cost
37 pass-through mechanism. SDP states cost pass-throughs
38 should include unforeseen and uncontrollable regulatory,
39 taxation and extraordinary events - so some examples of
40 these could be changes to the Metropolitan Water Plan or
41 natural disasters.

42
43 We will now move to the roundtable discussion of the
44 storm event, and to facilitate this discussion we have some
45 questions for us all to consider, which I will leave up on
46 the slide. They are:

1 Outside of the insurance claim, is further plant
2 testing required? If so, who should pay for this?
3 Should SDP obtain business interruption insurance to
4 cover circumstances when it is inoperable?
5 If not, should IPART price an inoperable mode in the
6 2017 determination?
7 Given our cost pass-through principles, what, if any,
8 cost pass-throughs should apply to SDP - that is, in
9 addition to passing through network electricity costs?

10
11 I now hand back to the Chair.

12
13 THE CHAIRMAN: Thank you very much, Syvi. Okay, questions
14 or comments from around the table? SDP, would you like to
15 lead off? Keith?

16
17 MR DAVIES: Thank you, Mr Chairman. I will cover
18 questions 1 and 3. The first question is: outside of the
19 insurance claim, is further plant testing required and, if
20 so, who should pay? We very strongly believe that there is
21 a very big difference between the sorts of proving required
22 at the end of a rebuild, paid for by our insurers to give
23 SDP back the confidence we had prior to the storm - we
24 believe that is very different to the sorts of testing that
25 we need to do on a plant that is remaining in an extended
26 mothballed situation that it was never designed for. They
27 are two very different things.

28
29 So we believe the insurance market should pay for the
30 proving period post the rebuild, and that there is a case
31 to be made for customers to shoulder the cost of periodic
32 testing as we remain in an extended mothball for a period
33 we cannot yet determine.

34
35 THE CHAIRMAN: So that is paying for periodic testing,
36 irrespective of the storm?

37
38 MR DAVIES: That's correct. Partial ongoing testing we
39 believe is in the interests of customers, to allow us to
40 retain the confidence in the ability for our plant to
41 restart within the time frame, quantity and quality
42 constraints that we need, to ensure that we can do it
43 within the time and come on and stay on to cope with the
44 next drought.

45
46 Can I go back to my earlier comments about the fact
47 that we are in a situation that is unprecedented anywhere

1 around the world, in our view. No plant the size of ours
2 has been shut off in this way for this long, and that
3 brings with it certain risks that we need to understand as
4 we go through the extension of the mothballing.

5
6 Maybe questions two and three are linked, so perhaps
7 I will have a stab at both of those: should we obtain
8 business interruption insurance to cover circumstances
9 where it is inoperable?

10
11 We have business interruption insurance already in
12 place for when we are operable and we face things like
13 abatement, but when we are inoperable, we don't believe it
14 is appropriate that that should be covered by an insurance
15 product. We think that for various reasons, including the
16 confidence undermining of doing that in the regulatory
17 framework, it would also be inconsistent with IPART's
18 standing terms of reference. It would deny us an
19 opportunity, basically, to fully recover our efficient
20 costs, in our view. Ultimately it would result in higher
21 costs, we believe, to customers, because business
22 interruption premiums that we would be paying year on year
23 and passing through to Sydney Water to pass on to the
24 customers - it is an actuarial answer, in a sense, but we
25 believe that the costs of those every year would far
26 outweigh the risk of an event like this happening, given
27 that this is unprecedented; we've never seen a tornado
28 before in New South Wales. So I think the risk is very low
29 of that happening again, but it would be absolutely certain
30 that the premium would be passed through every year if we
31 were to take out what we believe would be a fairly
32 expensive business interruption policy.

33
34 I think that covers that one. I might ask our CFO,
35 Justin, if he wants to add anything.

36
37 MR JUSTIN DE LORENZO (SDP): I think I would just add to
38 Keith's comments around not only the cost of insurance that
39 would be borne by all customers if we were to take out
40 broader-scope business interruption insurance, but I think
41 the other point to make is that certainly the owners and
42 the debt providers really did understand, at the time of
43 undertaking the transaction for SDP, what the FM
44 arrangements were and how those were allocated as between
45 the owners, the banks and customers, and I think if there
46 was a change to that, as is being proposed or being mooted
47 as one of the issues in the IPART --

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THE CHAIRMAN: Has been raised as an issue.

MR DE LORENZO: Been raised.

THE CHAIRMAN: We are not proposing yet.

MR DE LORENZO: All right, thanks. That would mean a change in risk allocation, and, as I say, both the owners and debt providers keenly understand the current risk allocation and have accordingly priced debt and equity in that context.

I think the other point to make in relation to that original transaction is that the transaction documents - indeed, the stewardship documents that Sydney Water referred to earlier - also contemplate that allocation of risk in the way that it is currently allocated, and any change to that that may come about as a consequence of this determination might put those stewardship documents out of balance with the IPART determination, and that is an important consideration too.

I think the only other thing that I would add to the issue of the business interruption insurance - and it is an important point - is that the tornado event occurred, so that is a past event. If, for example, there was a change and we were required to take out business interruption insurance for these FM events, and it was applied from 1 July 2017, whilst the plant was still in an inoperable mode, and there was an element of, therefore, retrospectivity about it, it would be very difficult for us to access any insurance cover related to a past event. Indeed, we have had our insurance experts look specifically at that question. So that is another additional point just to consider in this arrangement.

We think the current arrangements and the risk allocation are most efficient and a continuation of those arrangements would not see a cost increase for customers, but a change to those arrangements would almost certainly see a continual cost increase for customers in the way of not only insurance costs but in the way of potentially debt and equity re-ratings as well and that cost being passed through in a different way, potentially, through a rate of return and the like. So they are important considerations and challenges that we have considered.

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THE CHAIRMAN: Okay. Thank you very much, Justin.
Anything else?

MR DAVIES: May I finish off on the last bullet point there, which is given our cost pass-through principle what if any costs should we apply?

We would certainly agree that the insurance policy that we have in place should respond to all insured damage. It would never be our intention to try and reclassify any of the costs of that and try in any way to put those into another category for customers to pay.

We are working hard right now, with our insurers under the policy, to make sure we get full recovery for the damage that was caused by the storm event. We have no intention right now of trying to pass any of those costs through in any other way. In fact, as I believe Justin will also reinforce, at this stage, we have no firm view on any quantum of pass-through costs to date. We simply put it up, as I mentioned earlier in my address, as a fairly contemporary way for regulators to consider costs such as pass-throughs in the future. It is for IPART simply to consider.

THE CHAIRMAN: Thank you, Keith. Sydney Water, would you like to make a comment? Michael?

MR MICHAEL ENGLISH (SWC): Thank you, Mr Chairman. I am filling in for Kevin, who had to step out.

In terms of partial plant testing - I think that is the terminology - the original O&M agreement certainly did not anticipate that the water security shutdown would go beyond five years. I think we would be generally supportive of the idea that once you get beyond that, there are probably additional costs that were not anticipated. It would be a matter for IPART to assess the efficiency and prudence of whatever those costs are, but in principle we can see the need for that.

That said, I guess we would want to be sure that the testing actually achieves something - ie, it provides greater certainty that the plant will actually restart when required in the future - and also potentially if it helps quantify the magnitude of costs we might be facing in the

1 future or if it reduces those costs. You should get
2 something for the test; you just don't do it for the sake
3 of it.

4
5 The tornado complicates things a little bit - and that
6 is with something that is already quite complicated. We
7 are nervous that, potentially, the testing for the
8 insurance could duplicate any partial plant testing. We
9 would not want to be paying twice for the same activity.
10 We appreciate there are differences in the details of what
11 that testing might involve but we want to be conscious of
12 not being required to pay twice for something.

13
14 THE CHAIRMAN: Thanks, Michael. Would you like to comment
15 on that, Keith?

16
17 MR DAVIES: Yes, thank you, I would, Mr Chair.

18
19 The concept of customers paying twice is something
20 that we would agree would not be appropriate either. We
21 will not be asking, through any form of cost pass-through,
22 for Sydney Water and your customers to pay for the proving
23 that is required at the end of the rebuild. That will all
24 be to the account of our insurers and it is our job as SDP
25 to make sure we maximise that return appropriate to the
26 policy wording.

27
28 With the double-up or the duplication, as I think you
29 called it, what we had in mind was to have a dwell time, a
30 delay between the proving period and a partial test that
31 would come towards the back end of the next regulatory
32 period to give us that back that confidence so that, as we
33 enter into the following regulatory period, we have that
34 confidence and knowledge of what should be included in the
35 build-up of the next one, so there would be a reasonable
36 time gap between.

37
38 THE CHAIRMAN: That's good. Thank you, Keith. Any
39 further comments? Michael?

40
41 MR ENGLISH: I might skip to the third dot point about
42 inoperable mode. We do not think it is practical to define
43 a mode. I guess the advantage of the O&M contract and the
44 modes we have currently is that you have a defined set of
45 procedures and that leads to resourcing and that leads to
46 costs, so it is pretty easy to define what the modes are
47 and set a regulated price.

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There are a range of circumstances that could lead to a plant being inoperable - it could be small damage; it could be large damage; it could be all sorts of different procedures and things you would need to do to manage those different events, and I think it is probably not practical in that sense to actually define a mode. That is the main reason we do not support that.

That said, we are also conscious that we do not want our customers to be paying for a service that is not being provided. The plant has two roles - to be available for water security and then to produce water, when required, under the operating rules.

If the plant is not providing one of those services at the moment there does not seem to be a consequence for that situation which can be storm-related, which has nothing to do with SDP's good management, but in rare circumstances, operators may contribute to an issue that leads to the plant being inoperable or not available. There does not seem to be a mechanism at the moment to handle that situation, other than it may delay things so much that when the plant is producing water it will not get to 250 and the operational abatement will apply. We need to cover off a bit earlier in the process if there is a means of doing that.

We have suggested that reducing the water service charge is a way of doing that and in seeking to manage that risk, SDP could take out, increase or adjust its business interruption insurance and we would pay the appropriate costs towards that. That is one way of doing it. There may be other ways.

The general point is - this is not going to be easy to define - how would you define whether the plant is available or not and then, if it is not available, what should apply? That is really what we are driving towards, basically because our customers are not getting the services they are paying for.

THE CHAIRMAN: That is easy to understand in principle, but to design something to make it practical, that is certainly an issue. Do you have anything more at this stage?

1 MR ENGLISH: No, thank you.

2

3 THE CHAIRMAN: Catherine has a question for Justin.

4

5 MS JONES: When you discussed before the interruption
6 insurance, you suggested that if you were to get a more
7 expansive insurance product to cover you for perhaps a
8 fully inoperable mode or the range of modes that have been
9 mentioned by Michael, the premiums would be too high
10 compared to the risk of it happening again. Then you
11 discussed how when the plant changed the ownership they had
12 a certain understanding of what the risk would be. I would
13 imagine that if you had more insurance, then that risk
14 perhaps would not change because the financiers and the
15 owner, et cetera, would consider that the insurance would
16 take care of some of that risk.

17

18 For us to consider inoperable mode, it is a little
19 difficult when we do not have a feel for the type insurance
20 and the costs. I just wondered had you investigated in
21 much detail what it would cost?

22

23 MR DE LORENZO: Thanks for the question. I have a couple
24 of points to make. One is we have not fully investigated
25 the additional cost other than our insurance expert has
26 said that it will cost more.

27

28 The other point I would make about insurance is that
29 the insurance arrangement cannot replicate the risk
30 allocation that occurred in the current sale in terms of
31 the force majeure risk. Insurance is not a perfect world
32 in the sense that there are a number of risks even when you
33 have insurance cover, be it BI or any other type of
34 insurance. You have deductibles to start with. The gaps
35 are deductibles; you have a limit, ie, once you exceed
36 limit, you have no cover; you have exclusions within the
37 cover that you have. Within this sort of insurance
38 arrangement, there are a number of exclusions typically for
39 these sorts of policy.

40

41 You then have settlement risk, ie, when you engage
42 with an insurer and you trigger your insurance cover, often
43 there are negotiations around extent of cover and the like
44 and policy wordings get looked at quite closely. Actually,
45 getting to the point of having that admission of liability
46 from insurers takes some time and all the while, if you
47 are not recovering any revenue, you are at significant

1 risk particularly for a business like ours which is a
2 single-asset business and has one customer and one revenue
3 stream. All of those risks still pertain in an insurance
4 product, and that is not particular to us; that is
5 generally the case with insurance.

6
7 I would say to you that it does not replicate what we
8 have at the moment and therefore there are additional
9 costs, not only the cost of the premium, but there are
10 other costs as well which I alluded to earlier that go to
11 our financing cost and our rating of risk as well, which
12 would be over and above those costs. It is not a perfect
13 solution to what we have now is probably the best way to
14 summarise it.

15
16 THE CHAIRMAN: Do you want to make any further comment,
17 Michael, on cost pass-throughs?

18
19 MR ENGLISH: We are a fan of cost pass-throughs where it
20 is appropriate. We have asked for it in the past
21 ourselves. We are supportive of the network energy,
22 definitely. With cost pass-throughs, generally it is not
23 opposed in principle, provided it is targeted, specific
24 and well-defined, but we should not be paying more than we
25 otherwise would.

26
27 MR DOLAN: As we spoke about earlier, I think the membrane
28 replacement would be a perfect example of where a cost
29 pass-through would be appropriate in their charge.

30
31 THE CHAIRMAN: Thank you, Will. Prue?

32
33 MS GUSMERINI: Nothing further, thank you.

34
35 THE CHAIRMAN: I would like to address one of the issues
36 that Michael raised to sort of clarify something in my own
37 mind at least. We are not talking about when the plant is
38 operating or force majeure. Take the situation where the
39 plant is in shutdown mode and you have an event which could
40 be related to something going on in the plant - it could be
41 some lapse in management or something else could have
42 happened - and the plant would not be fully operable in the
43 sense that if it had to start on the day this mishap
44 happened, it would not be able to. That means that the
45 customers who are paying \$103 a year don't have water
46 security on that day, or that week.

1 If the payment is just made every quarter, there is no
2 real incentive on SDP. I am wondering what would be the
3 incentive on SDP. Is it a situation where the customers
4 are paying for water security and they are not getting it
5 on particular days? What happens when the plant is
6 operating is you have abatement in costs. If you do not
7 produce the full amount then the cost is abated, but there
8 is no abatement or no equivalent to abatement on the water
9 security mode. This is a very difficult area. I would be
10 interested in any comments you might have, Keith, Justin
11 and Lisa.

12
13 MR DAVIES: I would be happy to address that, Mr Chairman.
14 It is true to say that if we were in, say, a water security
15 mode, as we are now, and there was to be a mechanical event
16 on site, maybe caused potentially by our operator or some
17 other reason that rendered it inoperable, then, yes, you
18 are right, there is no provision for abatement for that.

19
20 When we are needed to come back, when the trigger has
21 called us back, at 70 per cent currently - we have eight
22 months contractually to get that started with our operator,
23 which is also reflected in our licence which is in
24 alignment with our O&M agreement - then penalties start to
25 be applied to our contractor to keep them incentivised to
26 make sure they can start within that time. Abatement then
27 would be applied between us and our operator to make sure
28 that the plant was able to start in that time. So that
29 gives them the incentive to keep the plant in a situation
30 where it can restart satisfactorily.

31
32 By the way, we would already know that - because of
33 the interaction we have with the operator continuously, we
34 would be fully aware of the situation of the plant.

35
36 I think I do agree that there is the potential for
37 that issue not to be corrected in time to start the plant
38 and that we go beyond the eight-month period and customers
39 are not getting the water that they require at that time.

40
41 I will take that on notice. I think it is a fair
42 point. The only incentive in place at the moment is that
43 one I mentioned earlier in the O&M agreement.

44
45 THE CHAIRMAN: Thanks, Keith. Lisa?

46
47 MS WELSH: Could I clarify a couple of points that Keith

1 made in his presentation earlier. We do not agree with the
2 suggestion that there is an ability for us to potentially
3 take no action in order to address the inoperable state of
4 the plant. We do not operate in a vacuum. We are licensed
5 under the Water Industry Competition Act. IPART regulates
6 our compliance with that Act.

7
8 One of the very important licence conditions under
9 that framework and one which we and, in fact, our operator,
10 take very seriously is the requirement to maintain our
11 assets consistent with good industry practice. IPART can
12 audit us under that framework and the consequences to SDP
13 as a business of breaching those licence conditions are
14 extremely severe.

15
16 We also have some very interested asset owners in the
17 form of the New South Wales government who are empowered to
18 take certain steps if we fail to meet those obligations as
19 well.

20
21 THE CHAIRMAN: Thank you, Lise. Matt has a question.

22
23 MR EDGERTON: I take Lisa's point about those other
24 elements of the regulatory regime, but getting back to your
25 example, Keith, you were talking about a financial
26 incentive that could exist if you were to be called into
27 operation. If you were to experience another tornado or a
28 similar event in water security mode where the plant is
29 unlikely to be called back into operation in the
30 foreseeable future and that is an event that knocks you out
31 of action for a while, is it correct to say there is no
32 financial incentive for you to, in any way, increase your
33 capacity to be ready for this? Under the status quo, what
34 is the financial incentive for you at the moment to be
35 available to supply as soon as possible?

36
37 MR DAVIES: Matt, can I ask a clarification question
38 around that? Do you mean another tornado occurring while
39 we are repairing the plant currently?

40
41 MR EDGERTON: No, I mean a similar event to now. It is
42 responding to Sydney Water's concern where they are
43 basically saying that they are concerned that their
44 customers pay charges for a service related towards
45 security where that service may not be provided. One of the
46 issues we have to deal with is taking on board your views
47 and your argument, but a counterargument to that is that,

1 at the moment, there may be no financial incentive for you
2 to be ready to supply water security.

3
4 MR DAVIES: I understand. So the first incentive I will
5 talk about is not financial but it is still very real and
6 that is the incentive to avoid any reputational damage on
7 the company and our customer, which we completely see there
8 is scope for as we go into the extended time that it is
9 taking to get this repaired, which we acknowledge, but we
10 are doing everything we can to shorten it. That is the
11 first driver I will mention.

12
13 As to the second one, I will not go into the detail of
14 the transactional documents, but there are provisions in
15 the documents that we signed during the sale that give the
16 government as the owner - the ministerial holding company -
17 rights to step in and have a say in the way that the repair
18 progress is reported and, ultimately if that progress is
19 not in accordance with our projections and achievements,
20 they have some fairly strong provisions that they can
21 exercise that are financial in nature that would not be in
22 our best interest.

23
24 THE CHAIRMAN: In summary, you have the licence
25 obligation. This is a hypothetical - let's make this clear
26 that it is a hypothetical. Say in three years time, when
27 you are back in business and you are in the shutdown mode,
28 something happens and if you were called upon to start up
29 that afternoon, you couldn't. Then there is an issue of
30 why should people continue paying the water security charge
31 of \$103 a month for insurance which, essentially, is not
32 there? So what is the incentive for you guys to get back
33 up and running as quickly as possible to make that
34 inoperable mode at short as possible?

35
36 In summary I think there are the licence conditions
37 and you would be in breach of your licence condition if you
38 didn't get it back up and running as soon as possible.

39
40 What was the other one you said, Lisa?

41
42 MS WELSH: We have obligations to the New South Wales
43 government, the owners of the assets. I mentioned that.

44
45 THE CHAIRMAN: Yes, that is one. The asset owner might
46 not be happy that the lessee is not getting it up and
47 running.

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There is also the chance that you need to be ready just in case tomorrow you are called upon . If it is triggered by the dams, you have to be ready because if you are not ready, you would not be able to get started within the eight months and then you would face financial penalties through abatement.

Yes, Justin?

MR DE LORENZO: There was one other, Chairman, if I could.

THE CHAIRMAN: Yes

MR DE LORENZO: In addition to the items you mentioned, we also have debt refinancing at different intervals during the life of the SDP. We are keenly aware that we need to be in a repaired state for that refinancing. We have a very significant refinancing on the horizon. I cannot go into it in much more detail, but it is really important that we have the asset back to where it was before we go into that, particularly if we go into other markets, capital markets, because those markets and debt providers are obviously sensitive to the asset. At the end of the day, that forms part of their security package, and that is a really important driver for us as well.

MR DAVIES: If I could add one more thing, Mr Chairman.

THE CHAIRMAN: Yes, sure.

MR DAVIES: As we mentioned several times today, the dam levels fall relatively slowly, thankfully, even in a drought situation. Using your hypothetical example earlier, if there was to be some damage to the site that prevented the plant from starting up efficiently, because we have good vision of the dam levels falling, if we could see that on the horizon - and we would - then we would be able to pull out all stops to accelerate any work that needed to be done to repair that particular hypothetical incident.

THE CHAIRMAN: A devil's advocate - and I am not going to do that - can turn that around and say, "Something went wrong and we are inoperable, but don't worry we can see we won't have to crank up for several years so we will take our time to fix it up."

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I am not suggesting you would ever do that, but I am just saying that this is a question that has been raised on this issue. It has been raised not just by Sydney Water but it has been articulated today and it is an issue that we have to deal with when we come into a landing on the determination, so that is why we are having this discussion.

MR DAVIES: Yes, I understand.

MS WELSH: If I may, Mr Chairman?

THE CHAIRMAN: Yes, Lisa.

MS WELSH: There is one final point I wish to make. Under the current regime, we believe our interests and those of Sydney Water are aligned. We have had force majeure and that has caused widespread damage to the plant. We are undertaking a thorough robust and carefully considered process of reinstatement. The force majeure arrangement that we currently operate under allows us to do that. What that means is that when we reinstate a plant, we can do that in a way which gives us full confidence that when it is next called upon, it will operate reliably and to the standard expected by our customers - so full service will return to our customers.

In the event that we are required to reinstate the plant under a business interruption insurance regime, the interest of the insurance company is to minimise their losses and those of SDP and Sydney Water - which is to fix the plant as well as possible, maybe not necessarily as quickly as possible - those interests will diverge and we do not believe that that is in the interests of Sydney Water end-use customers.

THE CHAIRMAN: Thank you Lisa, that's good. Sorry, Prue?

MS GUSMERINI: No, thank you.

THE CHAIRMAN: Are there any questions or comments from the floor on this issue? No? Any further comments round the table before we move on to the next session?
Jean-Marc?

MR KUTSCHUKIAN: Thank you, Peter. If I could just

1 leverage off Sydney Water's comments regarding the purpose
2 of the partial plant test, I was just wondering how that
3 interacts with the transition charges that you have put
4 forward in your pricing proposal and the sequencing,
5 I guess, of the transition to restart and the partial plant
6 testing which will occur and whether there is any overlap
7 between the costs in the transition charge?.

8
9 MR DAVIES: Thank you, Jean-Marc. I think that is a
10 question that Lisa would be eager to answer.

11
12 MS WELSH: Thanks, Keith.

13
14 The short answer is there is zero overlap between the
15 charges. When we restart, the charges that we have
16 proposed enable us to fully recover the costs associated
17 with the physical restart of the plant required to take it
18 from the current water security mode and all the process
19 requirements in place that are needed to be undertaken by
20 our operator, including the consumption of energy and the
21 replacement, if necessary, of pieces of operating and
22 maintenance equipment that we would not replace unless we
23 were restarting.

24
25 The partial plant test allows us to restart the plant
26 in much the same way. Obviously there are certain pieces
27 of O&M equipment that we would not replace such as
28 membranes if we were simply starting a partial plant test.

29
30 MR KUTSCHUKIAN: Thank you.

31
32 THE CHAIRMAN: Thank you very much, Lisa.

33
34 Why don't we move on to the final session, which is
35 session 4, which is the methodology and allowances for
36 the energy and the efficiency adjustment mechanisms. Matthew
37 Mansell will make the presentation and introduce the topic.

38
39 Session 4 - methodology and allowances for the energy and
40 efficiency adjustment mechanisms

41
42 MR MANSELL: Thank you, Chair, and good afternoon ladies
43 and gentlemen. My name is Matthew Mansell and I am with
44 IPART secretariat. I will now introduce session 4 which
45 covers the application and review of two revenue adjustment
46 mechanisms that we are required to have in place under
47 our terms of reference - they are the energy adjustment

1 mechanism and the efficiency adjustment mechanism.

2
3 First, I will briefly review the application, updating
4 and potential expansion of the energy adjustment mechanism.
5 The purpose of the energy adjustment mechanism is to pass
6 significant risk of SDP's surplus energy contracts on to
7 customers. Here is a simple example to illustrate how the
8 energy adjustment mechanism works. The green bar
9 represents the contract value of SDP's surplus energy. For
10 simplicity let's say that is \$100. This surplus energy can
11 be sold for more or less than \$100 depending on prevailing
12 market conditions at the time and these are shown by the
13 subsequent grey bars.
14

15 The EnAM currently specifies a threshold of plus or
16 minus 5 per cent around the contracted value of surplus
17 electricity. Gains or losses within this 5 per
18 cent threshold are retained by SDP, while gains and losses
19 outside the threshold are shared between SDP and customers.
20

21 Just to zoom in and illustrate what that means, in the
22 first two grey bars - being the second and third bar - we
23 have a loss of, say, \$2.50 in the first bar and a gain of
24 \$2.50 in the third bar. In both those scenarios, SDP would
25 retain 100 per cent of the gain or loss.
26

27 In the fourth and fifth bars, we have a situation
28 where the gain and loss is outside the 5 per cent
29 threshold. In these cases, SDP would retain 100 per cent
30 of the gain or loss within the threshold, 10 per cent of
31 the gain or loss outside the threshold, and then the EnAM
32 would come in to pass on the remaining 90 per cent of the
33 gain or loss outside the threshold on to customers.
34

35 SDP is proposing to pass through \$26 million in losses
36 on surplus energy excluding the proposed holding costs to
37 customers over the 2017 determination period. While the
38 EnAM is designed to provide SDP an incentive to act
39 prudently such that it retains all gains or losses within
40 the threshold, we have engaged an expert consultant to
41 review and assess SDP's management of surplus energy.
42

43 Stakeholders have questioned whether SDP should have
44 more actively managed its surplus energy and whether this
45 could have reduced the size of the loss to be passed
46 through to customers under the EnAM.
47

1 We are currently reviewing the EnAM methodology, and
2 please note that any changes made to the EnAM as a result
3 of this review will not affect the 2017 determination but
4 will affect future price determinations.
5

6 This chart shows the allocation of gains or losses
7 between SDP and customers as the size of the gain or loss
8 increases. SDP is exposed to all of the gain or loss up to
9 the 5 per cent threshold. However, as we move beyond the
10 threshold, customers are exposed to 90 per cent of the
11 incremental gain or loss.
12

13 This chart shows that as the gain or loss increases in
14 size, customers receive a growing portion of the gain or
15 loss. It also shows that beyond the 5 per cent threshold,
16 SDP's retained gain or loss is relatively insensitive to
17 the size of the total gain or loss.
18

19 SDP considers that the EnAM should be retained in its
20 current form going forward. We seek stakeholder views on
21 whether the EnAM is achieving an appropriate and efficient
22 allocation of risk between SDP and customers.
23

24 Under the terms of reference, the EnAM is only
25 applicable when SDP is shutdown or in restart and when it
26 is in compliance with its network operator licence.
27

28 SDP is proposing the EnAM be expanded to include
29 partial production modes outside the 70/80 rule. SDP
30 considers this to be one of the most significant issues
31 with the current EnAM methodology.
32

33 We note that if the EnAM does not apply when the plant
34 has discretion to produce desalinated water outside the
35 70/80 rule, there may be times when SDP has an incentive to
36 either remain in shutdown when it would be efficient to
37 enter operation, or to enter operation when it would be
38 efficient to remain in shutdown.
39

40 Other stakeholders consider there may be merit in
41 SDP's proposal to extend the EnAM to partial modes of
42 production. However, there are concerns that this
43 approach, if not well designed, may lead to less efficient
44 outcomes.
45

46 I will now briefly review the application and review
47 of the efficiency adjustment mechanism.

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The purpose of the EfAM, the efficiency adjustment mechanism, is to equalise the incentive to achieve efficiency savings over the regulatory period - that is, the efficiency adjustment mechanism ensures the business is able to retain efficiency savings for the same period of time, regardless of when these savings are achieved.

The terms of reference set out three key requirements of the EfAM: one, efficiency savings should be net of efficiency losses; two, the mechanism should apply to both operating and non-operating modes; and, three, the mechanism should allow efficiency savings to be held for four years following the year they are made - that is, five years in total. Our methodology paper sets out the details on how the EfAM will apply in practice.

SDP has proposed an efficiency saving of \$50,000 per annum to be carried forward under the EfAM in the 2017 determination. The table that I have on the slide shows how SDP retains the saving in the final two years of regulatory period 1 and how the EfAM would carry the saving forward for the first three years of the next regulatory period.

We are currently reviewing the EfAM methodology and, as noted for the energy adjustment mechanism, any changes made to the efficiency adjustment mechanism will not affect the 2017 determination but will affect future determinations.

Key issues in relation to our review of the efficiency adjustment mechanism that we seek further input on include: the incentive properties of the current efficiency adjustment mechanism, which some stakeholders have suggested could be strengthened; the treatment of mode-specific savings, which SDP proposes to be changed to allow SDP to retain savings for five years whether or not these five years are consecutive.

An issue here is whether mode-specific savings, which occur only some of the time, should be incentivised to the same level as general efficiency savings which occur all the time.

The treatment of efficiency gains and losses under the EfAM: SDP has proposed that temporary and permanent gains

1 and losses be included in the EfAM. Not all stakeholders
2 agree that efficiency losses should be passed through to
3 customers.

4
5 To facilitate discussion, we will leave four questions
6 on the projector. The questions are:

7
8 What should the EnAM pass through to customers over
9 the 2017 determination period, taking into account
10 SDP's management of its surplus energy?

11 Are there opportunities to better align the design of
12 the EnAM with incentives for prudent management of
13 surplus energy?

14 Are there other aspects of the EnAM methodology that
15 we can improve?

16 Are there opportunities to improve the design of the
17 EfAM? Specifically, how should mode-specific savings
18 be treated and why?

19
20 I now hand back to the Chair.

21
22 THE CHAIRMAN: Thank you very much, Matthew. Comments or
23 questions from around the table. Keith?

24
25 MR DAVIES: Thank you, Mr Chairman. If I can start with
26 those questions - I will start with the energy adjustment
27 mechanism first. As we have said in our submission, SDP
28 supports the continuation of the energy adjustment
29 mechanism in its current form. We believe that the
30 thresholds that are in there, the 5 per cent that was
31 mentioned, are prudent, consistent with the terms of
32 reference.

33
34 We disagree with Sydney Water's suggestion that we
35 should become a more active trader in the electricity
36 market. We would accept that we need to do everything we
37 possibly can to minimise any losses or maximise gains,
38 whichever way around the market ends up being, as a holder
39 of those energy contracts - we do accept that - but within
40 the boundaries of the risk profile that we set the company.

41
42 If we were to become an active trader or a merchant
43 energy trader, the risk profile of the company would change
44 dramatically.

45
46 This is one area that I can speak on from experience.
47 Having first traded 27 years ago in electricity in Wales's

1 electricity pool, and more recently in Australia, I have
2 a very good understanding of what it means to become an
3 energy trader but, more importantly, I understand the risks
4 of the front and back office activities that you need to
5 put in place to effectively manage the risks you would be
6 taking on in forward selling, which is what we would need
7 to do in our case to try to cover off the risks of doing
8 that.

9
10 The second thing I would mention in relation to that
11 is that whereas it would be very tempting to look at SDP
12 when we are not operational, say in a long-term shutdown,
13 and say, "There is energy there that is not being utilised;
14 why don't we do something with it?", as we have spoken
15 about many times today there is always the possibility that
16 our customer, Sydney Water, will knock on our door to
17 restart the plant for the reasons that they can under the
18 water supply agreement that we have talked about.

19
20 THE CHAIRMAN: I would be interested in getting Sydney
21 Water's response to SDP's comment with respect to one of
22 the suggestions which was in your submission about SDP more
23 actively managing their interests.

24
25 MR DOLAN: Thank you, Mr Chair. In our response we had
26 a look at the current mechanism and our concern, I suppose,
27 is that there is an insufficient incentive for SDP to
28 manage this. We did some sums and we not surprisingly
29 ended up with the same sort of estimate of what the
30 pass-through will be for the current period, which was
31 about \$26 million.

32
33 Just to recap, what actually happens - SDP has
34 a natural take-or-pay long position. Whatever demand it
35 uses is deducted from that and then whatever is residual is
36 then settled to pool. That's a very passive approach.

37
38 What we did was we said if there was a little bit of
39 active management around that - and you could do that by
40 quarterly sales going forward; so we're not suggesting
41 years in advance, so that would negate the concern about
42 potentially having to be called on for those purposes - we
43 estimate that the actual cost to our customers could be
44 around \$13.5 million for the same period.

45
46 We recognise there is a little bit more risk that is
47 associated with the active management.

1
2 So that would redefine the benchmark to be moved away
3 from the spot price to redefining the benchmark to be
4 relative to the contract price.
5

6 If SDP were to perform better than that average sales
7 price, which achieves the \$13.5 million, we would propose
8 that SDP should benefit from that and be able to retain
9 that additional earning. But if they indeed do slightly
10 worse than that - if they do worse than that, they should
11 incur a little bit of loss.
12

13 We would make the note - and a very important point
14 here - that in our analysis we have assumed our
15 understanding of how the contract works: SDP made us aware
16 as late as yesterday that their understanding is different.
17 So the numbers may change, although the underlying outcome
18 will be the same: there will be a reduction in that cost
19 that is passed through to our customers.
20

21 We would make the note that the skew of peak energy
22 prices is such that it has a long tail to it, so there is
23 risk either side, but at least on average we feel that SDP
24 could do better than that average.
25

26 Maybe a different way to say it: I hear you talk,
27 Keith, about additional costs around staffing and finance
28 and all those sorts of things. I suppose all this does is
29 put on the table - it crystallises what we think the
30 benefit may be. Coming back the other way, if it could be
31 articulated that all those costs are more than that, well,
32 we obviously wouldn't support moving down this path. Does
33 that help, Mr Chairman?
34

35 THE CHAIRMAN: Yes, that's helpful, thank you, Will.
36

37 MR DAVIES: Mr Chairman, can I come back on that and just
38 reinforce my earlier statements and add a bit more.
39

40 This is not a numbers game at this stage. We are
41 talking principles here of whether or not a company like
42 ours should involve itself in the energy market to the
43 extent where it is taking positions on future prices,
44 which, through experience, it's impossible to predict.
45 I have not met anybody yet that can get the pool price
46 forecast right for next week, never mind three months' or a
47 year's time. It's all about risk management, which, when

1 you are an energy trader, you set yourself up to cope with.

2
3 I disagree that we would be taking minimal to no risk
4 if we did sell ahead for one quarter. Let's say the plant
5 was operational today, out of the tornado issue. If we got
6 the call today from Sydney Water that we had to start for,
7 say, a health issue, we start consuming more energy from
8 the first day and it ramps up fairly quickly as we start to
9 bring on the treatment, pretreatment and the rest. So if
10 we had sold that quarter ahead, we would be left high and
11 dry for energy. I think that is one of the biggest
12 barriers.

13
14 Those two barriers in particular, Mr Chairman - it is
15 the principle behind the activities that we engage
16 ourselves in and the risks around getting it wrong.
17 Customers wouldn't be thanking us if we tried to outpace
18 the pool price - which is what you try to do when you
19 trade; you try to get a better price than the pool,
20 otherwise you would be better off on the pool - we don't
21 believe we are in that game. And, secondly, there are
22 inherent risks in doing it if we were to be called on
23 unexpectedly.

24
25 MS JONES: Keith, could I ask a question? The way you
26 have explained it, it sounds to me like you are expecting
27 that you would do it all in-house. I just wonder why you
28 wouldn't go out and get a financial hedge product or a swap
29 product with people that do trading for a living. Is
30 that something that you have considered?

31
32 MR DAVIES: Thank you, Catherine. I'm happy to answer
33 that, but we also have another member on the panel today,
34 Justin, who also has a long history in energy trading as
35 well. I will give Justin a chance to answer that.

36
37 MR DE LORENZO: Catherine, thank you for the question.
38 The issue is, yes, you can, you can outsource anything, but
39 you can't outsource the risk. The risk stays with the
40 entity that puts the product out there or does the swap.
41 And whilst we wouldn't have to necessarily have traders
42 in-house, if we had them externally, yes, we would have to
43 pay for that service, but the risk would stay with us, and
44 I think it's the risk that is the thing that concerns us
45 the most. It puts us into a different business, a merchant
46 energy business, and, as Keith has said, he has a long
47 history in it, as do I. It is a completely different

1 business to the sort of business that we have, which is
2 a low-risk infrastructure provider of an essential service.

3
4 It is a highly competitive and highly volatile
5 business and you need to stump up different capital. Your
6 capital providers - our equity owners - would have to
7 consider that, and, indeed, debt providers would look at us
8 in a different light; they would confer a different risk
9 profile on us.

10
11 Those things ultimately will flow through into
12 additional costs - particularly on the debt side it would
13 not be trivial. We haven't tested exactly what that
14 quantum is, but it would certainly put us into a different
15 risk category than we are currently in. We know that. So
16 they would be our biggest concerns, I think, and our
17 biggest challenges.

18
19 MS WELSH: Just to quantify the sort of risk in terms that
20 perhaps IPART is more familiar with, we note that in the
21 recent IPART Biannual WACC Update from August 2016, water
22 businesses had a WACC of 4.5 per cent as a midpoint, and
23 gas retail, a business more actively engaged in this,
24 a market not dissimilar to the one we're discussing today,
25 was at 7.1 per cent. In addition, the IPART 2003
26 determination WACC for an electricity retailing business
27 was 7 per cent post-tax real, compared to the 2012
28 determination for Sydney Water's prices, which was at
29 5.6 per cent.

30
31 MR DAVIES: Mr Chairman, I would like to add one more
32 thing, if I could, which I think is important in this
33 context.

34
35 It's absolutely true to say that we in SDP have not
36 been passive over the last four and a half years in
37 handling the minimum takes in both the energy and the LGCs
38 area. The fact is that the market for LGCs in the early
39 part of this regulatory period was extremely low, bottoming
40 out in the high 20s, well below our contract price for
41 LGCs. We took a pragmatic approach not to take positions
42 and play games with when we on-sold those, and we have
43 a policy in place that sells those in periods and we don't
44 speculate. And, thankfully, the tides have turned with
45 more recent comments, more in the federal area, that green
46 is back; RET targets are --

1 THE CHAIRMAN: That was two days ago.

2

3 MR DAVIES: Yes. In the last year we have been able to
4 sell overhang LGCs, unutilised, for very good prices -
5 worlds apart from the years previously. So that is on the
6 LGC side.

7

8 On the energy side it is similar. The prices in the
9 peak market have fallen through the floor in recent years.
10 They have only just started to come back in recent months
11 with the SA blackout, the nervousness around wind power in
12 SA generally and the closure of Hazelwood - 25 per cent of
13 the state. Those things spooked the market. The energy
14 market is very similar to the finance market: they get
15 spooked very easily, prices go up, prices fall. We are
16 seeing a bit of an artificial increase in prices in the
17 market today. That will level off and they will tail away.

18

19 Hopefully, that goes a little bit towards the sorts of
20 intelligence you need in a market like that to be ahead of
21 it and trade effectively.

22

23 THE CHAIRMAN: Okay. Thank you very much both to Will and
24 to SDP on that.

25

26 So in terms of the questions, do you guys want to make
27 any more comments on those issues?

28

29 MR DAVIES: Number one, we're happy with the current
30 theme, but we're always receptive to improvements,
31 Mr Chairman.

32

33 Can I suggest, given, as Will mentioned earlier, that
34 there may be still some little bit of confusion between
35 certainly us and maybe IPART, that we do have some extra
36 dialogue to fully understand exactly what Sydney Water are
37 saying to us? We're very happy to take all comments on
38 board and understand those better.

39

40 In terms of the energy efficiency mechanism, Lisa, do
41 you have any comments on that?

42

43 MS WELSH: We're not proposing any further changes. We
44 think it represents an appropriate allocation of gains and
45 losses between ourselves and customers as contemplated
46 under the terms of reference.

47

1 THE CHAIRMAN: Okay, good. Sydney Water, any comments on
2 these issues?

3

4 MR ENGLISH: I think we have covered most of it. We
5 haven't really talked about the efficiency costs mechanism.
6 We had something slightly different, maybe more generous.

7

8 MR DAVIES: Let's talk.

9

10 MR ENGLISH: We tried to be nice sometimes. I guess
11 basically our thinking was chiefly whether the incentive is
12 strong enough, particularly around operational savings.
13 It's more likely the plant is going to be off than on over
14 the very long term, so if your efficiency adjustment
15 mechanism only lets you carry forward - say you have two
16 years of operation and it's going to be 20 years until the
17 next operating period, or a very long time, what's the
18 incentive, really, to look for operational efficiencies?
19 So I guess our slightly generous mechanism was that you
20 would be able to carry those savings on even if the plant
21 sort of went into a shutdown mode, just to provide an
22 encouragement to really drive those operational savings.
23 That was our thinking.

24

25 THE CHAIRMAN: Okay. Prue?

26

27 MS GUSMERINI: Nothing further from WaterNSW, thank you.

28

29 THE CHAIRMAN: Any other issues? Any comments or
30 questions from the floor?

31

32 MR DE LORENZO: Mr Chairman, there was just one comment on
33 item 3, which is in respect to the methodology. We did
34 include in our submission that one potential change could
35 be in a situation where we were producing, and production
36 was curtailed for circumstances outside of our control, and
37 that produced some surplus energy, that the mechanism apply
38 to that surplus energy.

39

40 So, for example, if Sydney Water said they couldn't
41 take the water because of a constraint upstream in their
42 system, and it reduced our production below our maximum
43 production and that produced the surplus, then that energy
44 adjustment mechanism apply to that circumstance. That is
45 the only nuance or change that we have proposed.

46

47 THE CHAIRMAN: We will obviously have to think about that

1 one, because if the plant is operating, which means dam
2 levels are low, if you don't supply the maximum amount
3 under those circumstances you would be subject to the
4 abatement mechanism in terms of the price that you receive.
5

6 Obviously if there is a force majeure, that is
7 different, but that is talking about a situation where you
8 are to supply the maximum. So we will just have to think
9 about how that would interact with the abatement mechanism
10 and in terms of the incentive. Have you already thought
11 about that?
12

13 MS WELSH: If I could, Mr Chairman, the current abatement
14 mechanism already contemplates a situation where our
15 production is reduced at the request of our customer for
16 reasons that are, as Justin said, upstream and out of our
17 control. So what we are suggesting is that in those
18 circumstances --
19

20 THE CHAIRMAN: Oh, it is in the circumstances where they
21 have requested; not where you have failed to supply?
22

23 MS WELSH: Correct.
24

25 MR DE LORENZO: That's right. Only when it is imposed on
26 us.
27

28 THE CHAIRMAN: Okay. That's fine. We will think about
29 it, yes. That's a separate issue.
30

31 MR DAVIES: It would be a very similar situation, going
32 back to the earlier conversation, where even in a drought,
33 when we're outside of the drought mode and Sydney Water
34 called on us to start for an emergency, the production
35 level at that time may well be less than maximum. We could
36 be running at, say, 50 megalitres a day instead of
37 250 megalitres a day, and in that situation we would still
38 be facing - we are in production now but we're facing
39 difference payments in our energy contracts that would need
40 to be factored into the cost of start-up.
41

42 THE CHAIRMAN: Yes. I think we understand that issue, but
43 it's actually a different issue from the one that Justin
44 has just raised, because it goes to the issue about to
45 which modes does the energy adjustment mechanism apply, and
46 this has been raised with IPART - it may well even have
47 been by you, Keith, about two or three years ago - and we

1 have looked into that and looked into the terms of
2 reference. That is quite a difficult issue, given the
3 current terms of reference, because, as you know, the
4 minister introduced an amendment to the terms of reference
5 for this, and our interpretation of that term of reference
6 is that it's quite specific as to in which modes the
7 energy adjustment mechanism operates.
8

9 So it is similar but a different issue and we know
10 your position on that and we will look at it again. But we
11 have already looked at that really thoroughly about two or
12 three years ago.
13

14 MS WELSH: Mr Chairman, just to be clear, we're certainly
15 not suggesting any changes are required to the terms of
16 reference, and to the extent to which there might be some
17 gap-related costs associated with providing water to Sydney
18 Water at their request and outside the drought rules, our
19 suggestion was that that would be a prudent and efficient
20 cost that would be included within the unregulated charge.
21

22 THE CHAIRMAN: We could look into that in terms of setting
23 the price, yes.
24

25 MR KUTSCHUKIAN: If I could touch on question 2 again and
26 the issue of active management for surplus energy.
27 I suspect I know the answer to this question, but I will
28 ask it anyway. If there was not an EnAM in the terms of
29 reference, would your position change in your contract --
30

31 MR DAVIES: No
32

33 MR KUTSCHUKIAN: Would you be more active?
34

35 MR DAVIES: No.
36

37 MR KUTSCHUKIAN: So there is no case to change?
38

39 MR DAVIES: We don't think so. However, I will just
40 repeat there, Jean-Marc, that we are receptive to any ideas
41 that anybody has, including IPART, to bring to us to
42 discuss a better way of doing it. If the absolute aim is
43 to minimise losses and maximise gains, we are receptive.
44

45 THE CHAIRMAN: Thank you, Keith. Matthew?
46

47 MR MANSELL: I have a short question, thank you. In

1 relation to Sydney Water's comments around the
2 mode-specific savings under the current EfAM. The
3 hypothetical, I think you gave, was that the plant was in
4 operation for two years and then goes into shutdown, so the
5 saving would only be held for two years. That obviously
6 provides a weaker incentive than the general saving when
7 the saving is kept for five years.

8
9 It is important to keep in mind that there is another
10 side to this equation, which is what customers receive. In
11 that case. Where we are talking about a mode that is only,
12 let's say, two out of every five years, customers will only
13 be receiving that benefit going forward two out of every
14 five years. So it might be appropriate to have a weaker
15 incentive for those specific instances given the value not
16 only to the business but also to customers.

17
18 THE CHAIRMAN: Thank you, Matthew. Matt?

19
20 MR EDGERTON: We have spoken a bit about the EnAM. I want
21 to confirm what SDP's position is in regards to the
22 efficiency adjustment mechanism. Is there a need to make
23 any changes?

24
25 MR DAVIES: Thanks, Matt. Did you cover some of that in
26 your previous answer, Lisa, or is there anything more you
27 want to add?

28
29 MS WELSH: Is this on the EfAM?

30
31 MR EDGERTON: Yes.

32
33 MR DAVIES: Yes, the efficiency adjustment mechanism.

34
35 MS WELSH: On the EfAM, we think this mechanism represents
36 something very close to best practice regulation and we
37 certainly support the continuation of that. We recognise,
38 as has Sydney Water, that it is complicated by our
39 mode-dependent pricing structure and, as a result of that,
40 the current incentives are weaker than perhaps IPART had
41 initially intended. In order to overcome that, we were not
42 perhaps quite as generous as Sydney Water is suggesting.

43
44 An alternative to that would be to hold over those
45 savings until the next time that we re-enter the mode to
46 allow us the benefit to recover those costs over the full
47 five years, as outlined in your mechanism, but, at the same

1 time, making sure that the customers are receiving those
2 benefits as well.

3

4 THE CHAIRMAN: Thank you very much, Lisa. I'm just about
5 to wrap up. Does anybody want to make a final comment?
6 No?

7

8 CLOSING REMARKS

9

10 THE CHAIRMAN: I would like to thank you all - SPD, Sydney
11 Water and WaterNSW and people in the audience. Thank you
12 very much for your participation. It has been, I think a
13 very good session in terms of giving the tribunal an
14 understanding before we make our draft decisions. We
15 appreciate very much your efforts and the contributions you
16 have made.

17

18 A transcript of today's proceedings will be available
19 on our website in a few days.

20

21 We will consider all that has been said today when
22 making our decisions on SDP's prices to apply from 1 July
23 2017.

24

25 Following this public hearing, we plan to release a
26 separate draft report on SDP's prices and a draft
27 methodology paper for the efficiency and energy adjustment
28 mechanisms in March 2017. We will invite further comments
29 from stakeholders and SDP before we make our final
30 decisions on SDP's prices and a methodology of the
31 efficiency and energy adjustment mechanisms in June 2017.

32

33 Finally, I encourage you to check IPART's website for
34 updates and further information on our timetable including
35 the actual release date for the draft reports and the date
36 which submissions are due in response to those reports.

37

38 Thank you very much and have a good afternoon,
39 everyone.

40

41 AT 1.03PM, THE TRIBUNAL WAS ADJOURNED ACCORDINGLY

42

43

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45

46

47