



# ENCOURAGING INNOVATION

**OCTOBER 2021**

**Response to IPART's Discussion Paper 3  
Regulating Water Businesses Special Review**



# Acknowledgement of Country

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Hunter Water operates across the traditional country of the Awabakal, Birpai, Darkinjung, Wonaruah and Worimi peoples. We recognise and respect their cultural heritage, beliefs and continuing relationship with the land, and acknowledge and pay respect to Elders past, present and future.

**Mariin Kaling - All for Water**

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Saretta

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## EXECUTIVE SUMMARY

IPART has published five papers and held four stakeholder workshops over the past 12 months, canvassing views and perspectives on better ways to regulate water businesses in New South Wales. We commend IPART for its openness in exploring new ideas and methods, and the quality of the engagement material. We are confident that collaboration between all stakeholders will result in regulatory reforms that further the long-term interests of customers.

As recognised by IPART, to lift performance of the water sector there must be *“a credible commitment from the business and regulator. ... It also requires an acknowledgement that there may be room for improvement and the journey should be taken together”*.<sup>1</sup>

IPART's Discussion Paper 3, *Encouraging innovation in the water sector*, puts forward the hypothesis that a well-designed regulatory framework will encourage innovation within the sector.

IPART's discussion paper is the most significant to date. IPART outlines a fundamental shift in its regulatory framework, multiple new regulatory mechanisms and substantial detail on how each mechanism would operate in practice.

IPART's paper incorporates four big ideas: the 3Cs model with 11 guidance principles, four financial incentive schemes, new ways of collecting and analysing cost data, and a six-year regulatory period.

Hunter Water supports IPART's overall objectives:<sup>2</sup>

- empowering water businesses to put forward a pricing proposal that is customer-focused and identifies the key outcomes that promote the long-term interests of customers
- including effective incentives so that regulated water businesses are accountable for delivering their commitments and continually improving over time.

IPART's overall approach combines elements of two markedly different approaches to economic regulation – the upfront guidance and grading of the Victorian ESC's framework and the operating and capital financial incentive schemes of the Australian Energy Regulatory. One approach rewards regulatory 'best offers', while the other relies on ex-post financial payments to influence in-period decision making.

Hunter Water has concerns that IPART is attempting to do too much in the one review. After maintaining the same approach over many regulatory periods, IPART's multiple new schemes and processes represent a dramatic shift in thinking and practice. To be successful, the schemes must work in unison, incentives must align, and businesses must be able to adapt and implement the changes prior to the next round of price reviews.

Hunter Water encourages IPART to consider a more incremental approach to reform. This would be consistent with periodic reviews of the regulatory regime after each round of price determinations. Each 'stand-back' review would look at the strengths and weaknesses of past changes, and work on the next set of reform priorities, continuing to lift sector performance.

Hunter Water supports IPART's 3C model and the preliminary guidance on how IPART would assess pricing proposals against the 11 principles. We consider the 3Cs model to be more outcome focused, less prescriptive and less complex than other regulatory regimes. The 3Cs model would provide incentives for high-quality pricing proposals, showing how we would reduce and control costs during the regulatory period. The customer outcomes would track our performance over time.

We question the benefit of layering multiple financial incentives from the AER's regulatory regime on top of the 3Cs model. The greater the level of cost ambition we show in our regulatory proposal, the more likely we are to be penalised under the efficiency benefit sharing scheme (EBSS) and capital efficiency sharing scheme (CESS). Hunter Water is likely to respond best to incentive schemes that have a reputational effect or procedural benefit, similar to the experience of the government-owned water businesses in Victoria.

IPART's stated approach gives water businesses the opportunity to propose an annual cap on payments under the EBSS and CESS. This step would moderate our concerns about the cumulative impact of multiple new mechanisms operating over a longer regulatory period.

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<sup>1</sup> IPART, 2021, *Promoting a customer focus*, Discussion Paper 2, p. 9.

<sup>2</sup> IPART, 2021, *Encouraging innovation in the water sector*, Discussion Paper 3, p. 2.

Throughout this review, Hunter Water has raised concerns with IPART's reliance on consultants to conduct bottom-up, line-by-line expenditure reviews. While it may look rigorous from the outside, this process involves a degree of subjective judgement and second-guessing. We support many of IPART's changes to the way it collects and analyses information, including the categorisation of costs, *ex post* prudence reviews by exception, and asking businesses to nominate ongoing efficiency factors. Conducting an early review of management systems and processes will reduce the administrative burden in the price review year.

Hunter Water had anticipated that IPART would commit, in the near term, to light-touch fast-track expenditure reviews as a reward for high-quality regulatory proposals. This incentive to invest in good proposals is an important component of the ESC's PREMO model. We appreciate that IPART intends to move to this approach in future price reviews. Nonetheless, we are likely to provide more cost data and spend longer on cost analysis in the next expenditure review. We invite IPART to set out a roadmap explaining how and when it will implement the various changes to data collection and analysis, as well as the criteria for a fast-track review. We would appreciate the opportunity to participate in any benchmarking working group, should IPART pursue this idea.

Hunter Water supports a longer regulatory period. The current four-year cycle does not provide sufficient time for IPART to do a step-back review of the framework and complete reviews of other components like WACC and regulatory depreciation. A longer regulatory period would allow IPART time to publish a 'framework and approach paper' at least a year out from the price review. The paper would include guidance for assessing the 11 principles, details on the expenditure review process and outline IPART's positions on matters such as price structures.

Hunter Water has reservations about the benefits of moving to a six-year period. IPART is proposing major changes to the regulatory model, including multiple in-period financial incentive schemes. We have no experience in applying these schemes, and we are concerned about committing to an entirely new package of measures out to 2031. We support a five-year regulatory period for the next price determination, providing an earlier opportunity to learn from experience and refine the framework changes.

While proposing a six-year regulatory period, IPART has made only minor changes to its existing cost-pass guidance. As IPART has noted, longer determination periods create the risk that prices become less cost-reflective. This can be due to changes in government policy or regulation, drought or flood, population growth, customer preferences, technology disruption and adoption, and other unknowns. In our view, developing the right suite of cost pass-through mechanisms is the best way of managing material cost events. In contrast, IPART proposes to address these risks through a '3-3-6' mid-period check-in, re-opening the determination if an unanticipated event occurs – two full price reviews in six years.

We are concerned about the impact of uncontrollable cost events on any payment or penalty under the EBSS and CESS schemes, possibly amplifying undue gains or losses. We propose changes to IPART's cost pass-through mechanism that would cover risks or events that are outside the control of the regulated business, and where a pass-through is the most efficient and equitable way of managing this risk. These costs would be subject to an IPART in-period assessment of prudence and efficiency after a predefined event occurred. The EBSS and CESS would exclude all cost pass-through events, increases or decreases. We see this as an important part of an integrated package of measures.

IPART's proposes a service level incentive scheme where water businesses are held accountable for identifying outcomes that promote the long-term interests of customers. IPART judges the work of each water business *ex ante*, as part of the grading of proposals, and *ex post*, through a financial incentive scheme.

We see IPART's emphasis on customer outcomes as the centrepiece of the proposed regulatory reform. The shift in thinking to outcomes will take time and effort to do well. Developing customer outcomes involves a broad-ranging customer engagement program, shortlisting and prioritising ideas, developing measures, coordination of data to monitor, assess and adjust performance, and calibrating targets. We have started this work, and we are learning from the Victorian water businesses. We would welcome the opportunity to work with IPART on the guidance material for customer outcomes and the final design of the service level incentive schemes.

We can genuinely say that IPART's discussion paper is an important document. IPART has gone much further and provided more detail than we thought possible at the commencement of this review. We look forward to the draft report, and the opportunity to explore and comment on specific issues in greater detail. We thank IPART for committing to such a comprehensive and open review.

## KEY MESSAGES

 <b>IPART's proposed approach to encourage innovation in the water sector</b>	<b>Our assessment</b>	 <b>Comment</b>
<b>Customers, costs and credibility.</b> Focus the regulatory approach around the '3Cs' of customer value, cost efficiency and credibility.		We support the 3-C model, notably focus on customer centricity and customer outcomes
<b>Provide clear guidance.</b> Use 11 principles to outline its expectations for the customers, costs and credibility criteria, with a grading rubric showing how a business would meet the principles at a standard, advanced, or leading level.		We agree clearer upfront guidance is important for providing investment certainty, promoting innovation and efficiency gains, lifting the performance of the sector and enhancing customers' interests over the long-term.
<b>Encourage the best proposals from the business.</b> Allow the business to self-assess how well its proposal promotes customer value and cost efficiency, and justify that its proposal would be credibly delivered.		IPART's preliminary guidance provides an excellent starting point to assess proposals. Reputational incentives are the most powerful.
<b>Grade proposals.</b> IPART would grade proposals against customer value and cost efficiency at the 3 levels. The grading would apply only if the proposal is credible.		A grading would provide a strong reputational incentive to put forward a 'best offer'
<b>Reward high-quality proposals which promote customer value.</b> Provide a financial reward – a per cent of the revenue requirement – where it agrees with the business that its proposal is advanced or leading.		We prefer reputational and procedural rewards
<b>Tailor the design of the regulatory framework to the grading,</b> so every business delivers its commitments and improves over time.		We support the concept of providing a level of earned autonomy
<b>Promote customer outcomes.</b> Require all businesses to publish their annual performance against the customer outcomes that they have identified to promote the long-term interests of customers.		We agree it is appropriate for us to be accountable for delivering against our commitments
<b>Improve the incentive regime.</b> Expect advanced businesses, and require leading businesses, to opt-in to an improved incentive framework that applies to operating expenditure, capital expenditure, and key customer outcomes. A standard business would have a simpler framework with a limited range of incentive mechanisms.		We have some concerns about the complexity created by the interplay of multiple financial incentive schemes
<b>Focus the expenditure review.</b> Implement a range of improvements to the expenditure review process and focus the scope of our review – including any use of cost consultants – according to how well the proposal meets the '3Cs'.		Advanced and leading proposals should be rewarded with lighter-handed expenditure reviews at the first price review
<b>Focus on performance with a 6-year regulatory period.</b> Apply a '3-3-6' model, with a 6-year regulatory period and a mid-cycle health check.		We support a five-year period for the next round of metropolitan price reviews.

# 1. INTRODUCTION

IPART's Discussion Paper 3, *Encouraging innovation in the water sector*, the fifth consultation paper for IPART's review of how it regulates water businesses, sets out a number of fundamental changes to the regulatory framework.

This response provides Hunter Water's views on each of IPART's proposals in turn, following the structure of Discussion Paper 3:

- Chapter 2, 'Encouraging good pricing proposals', describes our support for the proposed 3Cs approach, the 11 principles and the associated grading guidance. It also discusses the strengths of different types of incentives for Hunter Water, as a state-owned corporation.
- Chapter 3, 'Using in period financial incentives', considers IPART's three proposed incentive schemes that would result in financial adjustments in the subsequent regulatory period.
- Chapter 4, 'Streamlining the expenditure review process', sets out our support for many of the incremental changes proposed to make the review more efficient and effective. It makes the case for further stakeholder engagement on benchmarking models and near-term procedural benefits for submitting an 'advanced' or 'leading' pricing proposal.
- Chapter 5, 'Long-term planning and managing risk', suggests an alternative approach for longer determination periods that has a stronger commitment to continuous improvement of the regulatory framework.
- Chapter 6, 'Funding innovation', addresses options to fund innovation and IPART's proposal to not provide any explicit funding.

Responses to IPART's specific questions are provided in the relevant chapters of this response.

## 2. ENCOURAGING GOOD PRICING PROPOSALS

Hunter Water supports IPART's proposed 3Cs model, the 11 principles and the associated grading guidance.

IPART has proposed an assessment and grading regime, combined with various upfront incentive mechanisms, to encourage water businesses to put forward their 'best offer' pricing proposal. This approach aims to encourage each water business to challenge itself to deliver greater value for customers, continuously improve from its own starting point and provide high-quality information to support scrutineering by external stakeholders.

IPART would provide principles-based guidance on the areas that it considers most important: customer value, cost efficiency and credibility. The publication of the businesses' self-assessment of the extent it has addressed these principles, along with IPART's subsequent grading decision, would encourage honest self-reflection and transparency. IPART proposes that high-performers be rewarded with a degree of earned-autonomy via procedural and financial incentives.

### 2.1. Better guidance on how IPART assesses pricing proposals

We support IPART's goal of providing clearer upfront guidance about its expectations of businesses' pricing proposals and the principles and methods it will use to assess these proposals. Doing this well will improve investment certainty and help ensure water businesses deliver services that customers value the most.

The pricing proposal captures, at a point in time, the business's investment priorities and plans, and the operating expenditure necessary to maintain services, and deliver new, or upgraded, services given multiple objectives and challenges. The pricing proposal provides forecast expenditure over a multi-year period; detailed capital and operating budgets over a five-year period; as well as ten-year forward capital program to help contextualise the short-term actions within the mid-term operating context.

IPART's primary task in the price review process is to assess the prudence and efficiency of the business's expenditure proposals. IPART's allowances for capital investment and operating costs form the key building blocks in the revenue requirement. IPART must make decisions about price structures and levels for different customer categories – *how* the costs are recovered and from *whom*. However, this is all secondary to IPART's judgment calls on expenditure levels – *which* costs are recovered.

To assist with the preparation of pricing proposals, IPART publishes '*Guidelines for water agency pricing submissions*', a 50-page document that compiles various guidance on key matters for each price review. While the document provides extensive detail on subjects like price structures, recycled water and discretionary expenditure, there is relatively little guidance on how IPART will assess and make decisions on capital and operating proposals. Consideration of service levels focuses on mandatory system performance standards and discretionary projects. In practice the boundaries are more nuanced, as described in our response to IPART's Discussion Paper 2, *Promoting a customer focus*. Indeed our 2019 pricing proposal was supported by a 90 page technical paper describing what we saw as our current and proposed service levels.

From Hunter Water's perspective, it would appear that IPART relies exclusively on the expenditure review process to set operating and capital allowances. IPART engages a small team of external consultants to undertake a review of the business's planning processes and expenditure proposals. Over a period of a few months, Hunter Water provides hundreds of documents to the expenditure consultants and answers hundreds of specific questions. With little previous knowledge of the business, the consultant is expected to make exact recommendations on the merits of all recent investment and budgeting decisions. This is a resource intensive exercise for all parties and one that may be spuriously perceived as rigorous and precise. Our understanding is that this approach is one of the most intensive across all economic regulators of the Australian urban water sector.

Hunter Water considers that IPART's existing processes are sound, but there is room for improvement. To this end, we strongly support the proposed 3C model. We believe this step alone will substantially improve the price review process.



We support IPART's continued focus throughout this review on changes to the regulatory framework that promote a customer focus. We acknowledge and accept the responsibility of understanding customer views and values. Our job is to reflect customer preferences in our business decision making. We must be able to assure our customers, IPART and others that we do that well.

We support the five customer principles outlined in IPART's proposed 3Cs model and the associated guidance. We consider IPART's approach puts an appropriate weight on robust, diverse and genuine customer engagement in shaping the regulatory proposal. We recognise that this approach will require a shift in thinking for all parties – from a focus on just meeting mandatory requirements at the lowest cost to efficiently providing the services that customers value.

## 2.2. Principles, grades and incentives

As set out in our response to IPART's Discussion Paper 2, Hunter Water supports the idea of linking the guidance principles to grades: standard, advanced and leading.

Under IPART's proposed model, each water business would submit a self-assessment of the quality of its pricing proposal. IPART's subsequent grading decision would confirm or contradict the self-assessment. This process would have a strong reputational effect on any water business, public or private.

We see IPART's approach of publishing principles and grading guidance as a significant improvement.

We note that IPART has an additional challenge compared with other context where this type of approach has been implemented. The grading approaches of the Essential Services Commission (ESC) in Victoria and Ofwat in England and Wales work well in the context of multiple water businesses lodging regulatory proposals around the same time – 19 and 16 utilities, respectively.

IPART regulates fewer water businesses with a mix of functions and scales. IPART acknowledges that it would need to tailor its approach to the scale and sophistication of each water business. IPART also does not have the benefit of comparing pricing proposals from many water utilities. The task of an economic regulator is inherently difficult and imperfect: replicating the outcomes of competitive markets, an unobservable counter-factual.

A key feature of the ESC and Ofwat model relates to procedural incentives. Both regulators allow for a fast-track or light-touch expenditure reviews where the water business puts in a high-quality, ambitious regulatory proposal. We consider that IPART's could strengthen the administrative and procedural incentives in its proposed approach. An advanced or leading rating should trigger a streamlined and targeted expenditure review, rather than the typical 'line by line' expenditure review. We discuss this further in section 4.

A Farrier Swier 2019 review of the ESC's performance, risk, engagement, management and outcomes (PREMO) framework considered the relative power of different types of incentives, noting all water businesses are government-owned. The Victorian water businesses reported:

1. reputational incentives were consistently considered the most important
2. procedural incentives (e.g. fast tracking or the extent of scrutiny in expenditure reviews) were seen as being the second most important.
3. financial incentives were considered the least important on average, with very wide variation in their perceived importance.<sup>3</sup>

In earlier responses to consultation papers for this review, Hunter Water endorsed introduction of a grading approach linked to procedural incentives. IPART's proposed financial scheme, tied to an addition or deduction to the annual revenue requirement, would be set separate from the efficient costs of running the business.

Hunter Water is committed to putting together the best possible regulatory proposal, irrespective of incentive schemes. We are always mindful of bill affordability when prioritising expenditure plans. Our customer segmentation work shows a large cohort of lower-income customers relative to other parts of New South Wales. A financial incentive scheme would not motivate additional effort or ambition.

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<sup>3</sup>Farrier Swier, [Victoria's Water Sector: The PREMO model for economic regulation](#), Report for the ESC, March 2019, p 33.

## 2.3. Comments on the preliminary grading guidance

IPART's current guidance for pricing proposals does not provide sufficient clarity for a well-intentioned water business to maximise value for customers. We would welcome a clearer statement on what is important and relevant for IPART to make decisions. But we do expect, or want, IPART to prescribe all aspects of the proposal. The onus should always rest with the water business to describe, explain and justify its expenditure plans within the proposal. Getting the balance right between guidance and prescription, so that there is a shared understanding between the regulator and regulated on what 'good' looks like, will determine the success of IPART's changes.

We support IPART's idea of publishing principles and high-level guidance on expectations for each grading category. IPART's preliminary grading guidance, set out in Appendix B of Discussion Paper 3, provides an excellent starting point.

IPART's explanation of the grading process describes a step change in performance for advanced and leading assessments. IPART states that the business would need to deliver additional, tangible value that meets a minimum threshold of at least 5% per year, measured in terms of increased service performance and/or reduced costs relative to the status.

Hunter Water requests further clarification of how IPART would calculate a minimum 5% improvement. An annual change of this size, delivered over five or six years, looks like an impossible hurdle for any business to satisfy, however defined.

We support IPART's proposed guidance for the five customer principles, particularly the grading criteria for customer centricity, customer engagement and customer outcomes. These changes form a central component of IPART's proposed approach. This will take time and resources to get right.

We are less clear on the guidance for principle 5: customer choice. In our response to Discussion Paper 1, we supported the concept of unregulated pricing, but observed that it is difficult to identify situations where both parties are better off. We agree with providing water business the flexibility to pursue these arrangements, but disagree with the suggestion that the number of agreements should be used in the grading.

Hunter Water's response to Discussion Paper 1 made a detailed case for a water sales revenue cap. This is a standard approach used by economic regulators to reduce the reliance on demand forecasts and ensure water businesses recover efficient costs, no more and no less. In addition, a water sales revenue cap removes a disincentive for businesses to work with customers on water efficiency initiatives. This is a price structure question that IPART should resolve before the next round of price reviews. We are not convinced that it should be an option linked to grading.

IPART outlines its expectation that Hunter Water and Sydney Water would work to achieve a grading of advanced or leading in the next pricing proposals. We understand that all water businesses would start from position of 'standard', and that we would be entitled to any procedural or administrative benefit if we earned a higher grade.



IPART sought comments on the following specific question about framework design:

1. How effectively would our 11 principles promote a better regulatory process, and support our customer value, cost efficiency and credibility framework?



We strongly support the proposed 3C model and 11 principles. We believe this step alone will substantially improve the price review process.



IPART sought comments on the following specific question about framework design:

2. How effectively would our proposed grades, and grading rubric, motivate businesses to develop proposals that promote customers' long-term interests?



Hunter Water supports the concept of a guidance and grading. Our initial assessment of IPART's preliminary grading guidance is favourable. Looking ahead, if IPART pursues this approach, we would welcome the opportunity to provide detailed comments on the specific criteria that are applied in each grading category.



IPART sought comments on the following specific question about framework design:

3. How should an incentive matrix be structured to ensure water businesses provide maximum customer value for least cost?



The incentive matrix should be structured to encourage water businesses to provide maximum customer value at an efficient cost. The proposed matrix could be improved by:

- providing procedural incentives rather than financial incentives
- clarifying how the 'score' for each of the 11 principles will be considered in aggregate.

Without these changes, a risk adverse water business would be incentivised to self-assess at a lower grade (e.g. standard rather than advanced) in order to mitigate the risk of IPART setting prices that do not recover efficient costs. It appears that this outcome is possible where a pricing proposal is substantially advanced but is assessed by IPART as standard against 1 of the 11 principles.



IPART sought comments on the following specific question about framework design:

4. Should leading businesses receive financial incentives each time they achieve leading status? Should Sydney Water and Hunter Water receive financial incentives for achieving advanced status in the first round of reviews?



We consider that the guidance provided for the 11 principles and associated rating have 'lifted the bar' in terms of IPART's expectations. We do not believe that IPART would have assessed any of the most recent pricing proposals as 'advanced' or 'leading'. This is partly because IPART is shifting the significance that it places on customer engagement and customer value. Accordingly, Sydney Water and Hunter Water should receive incentives for achieving advanced or leading status in the first round of reviews. As detailed in section 2, and in response to question 2, we would prefer a procedural or administrative benefit. A financial incentive would not motivate additional effort or ambition.



IPART sought comments on the following specific question about framework design:

5. Do you support a tiered regulatory approach based on the grade we assign a water business? If so, how effectively would our proposed approach tailor the regulatory approach to the different businesses we regulate?



Yes

### 3. USING IN-PERIOD FINANCIAL INCENTIVES

IPART has proposed three in-period incentives schemes with an ex-post adjustment:

1. an Efficiency Benefits Sharing Scheme (EBSS) for operating expenditure
2. a Capital Expenditure Efficiency Sharing Scheme (CESS)
3. a Service Level Incentive Scheme.

Hunter Water has a number of concerns with the rationale for, and design of, the EBSS and CESS schemes. We support the idea of a service level incentive scheme.

#### 3.1. The interplay of multiple financial incentive schemes

The introduction of in-period financial incentive schemes is one of the four big reforms proposed in IPART's Discussion Paper 3. Individually, each of these initiatives will take effort to design and implement for both IPART and the water businesses.

IPART is proposing to combine multiple mechanisms and approaches from a number of economic regulators and implement an entire package of new measures all in one go. Each of these regulatory regimes has evolved over many years, allowing time for the additional effort required for design, trial implementation and refinement based on lessons learned. We are concerned that IPART may be trying to do too much at the one time.

Our key concern relates to the potential clash of approach, the two different regulatory philosophies. IPART combines the ESC's PREMO 'best offer' model with the AER's spreadsheets tracking annual movements in costs. The ESC and AER have developed mechanisms and processes which act as standalone frameworks. IPART borrows from both. Do we need both *ex ante* and *ex post* incentive schemes? Are the incentives consistent? For example, would a business receive a stronger reward by submitting a standard pricing proposal with low built-in efficiency challenge then outperforming these or vice versa (and which is in the long-term interests of customers)?

We encourage IPART to develop and implement the 3Cs model, as outlined in section 2. We have concerns with layering financial incentive mechanisms on top of a regime designed to encourage ambitious, high-quality pricing proposals.

IPART's review of the way it regulates water utilities has involved multiple discussion papers and workshops. In the spirit of proposing and challenging new ideas, the following section outlines our concerns and questions with IPART's proposal to adopt the EBSS and CESS in the next round of pricing reviews.

##### 3.1.1. IPART's 3Cs model creates incentives to reduce costs

IPART has proposed elements of the ESC's PREMO model – ie, upfront financial and reputational incentives tied to a grading regime that emphasises customer engagement and improving customer value. The ESC's approach is known for being less prescriptive and relatively light handed; putting the onus on the regulated businesses to understand what outcomes customers want, submit regulatory proposals that balance these outcomes with bill impacts and holding the businesses to account for delivering commitments.

In 2016, the ESC first outlined the PREMO model and the in-built accountability framework:<sup>4</sup>

*“Being customer-facing entities, water businesses will be held accountable for fulfilling their part of the economic bargain. They will be responsible for discovering their customers’ preferences. They will be responsible for determining how ambitious they wish to be when responding to those preferences. And uniquely, these service providers will be responsible for self-assessing their proposal before they submit them to us. Under the new framework, our role will be to assess the accuracy and honesty of the businesses’ self-assessments.”*

IPART outlines preliminary guidance for each of the 11 principles that it would apply when assessing regulatory proposals. Four of the 11 principles relate to costs, including the level of ambition to achieve cost efficiency targets and the steps taken to deliver cost improvement promises (see Table 3.1). Only then would a business earn a grade above standard.

<sup>4</sup> Essential Services Commission, 2018, *Water pricing framework and approach, Implementing PREMO*, page ii.



**Table 3.1**      *Expectations of cost efficiency challenge built into pricing proposals*

IPART PRINCIPLE	REQUIREMENTS TO ACHIEVE GRADING	
	ADVANCED	LEADING
<b>Principle 6: Confidence in costs</b>	The business demonstrates its proposed expenditure meets outcomes and targets at the lowest cost.	Proposes operating and capital expenditure that is at or below industry benchmarks, supported by robust modelling, including how the business will achieve its targeted efficient expenditure.
<b>Principle 7: Balance of risk and long-term performance</b>	It has the ability and strategies to respond to changes in circumstances and risks, and demonstrates how it will dynamically respond to changing circumstances.	Provides robust evidence that it has optimised the balance of risks and benefits to the customer and business in terms of long-term asset and service performance, utilising best practice, probabilistic investment decisions and asset management systems.
<b>Principle 8: Commitment to improve costs</b>	Proposes expenditures that are at the efficiency frontier, and continuously improve in line increases in productivity.	Pushing the boundaries of the efficiency frontier by proposing efficiency targets which would lead to a significant step-change in cost efficiencies below historical costs and industry cost benchmarks.

Source: IPART, 2021, Encouraging innovation in the water sector, Discussion Paper 3, Appendix B.

Hunter Water supports an approach that encourages ‘best offers’ from each water business. To earn a higher grade, we will need to show evidence of how we are focused on reducing costs across the business. The more ambitious we are with capital planning, cost control and savings, the greater the likelihood of exceeding capital and operating expenditure allowances. The EBSS and CESS schemes would penalise those overspends.

### 3.1.2. Adding complexity and uncertainty to the regulatory framework

IPART’s proposal to apply ex-post financial incentive schemes would be a move towards the AER’s regulatory framework. Experience has been that these schemes have not allowed the regulator to ‘step back’, or to take a more targeted approach. The AER applies benchmarking models, developed after years of refinement and extensive data collection, and they are still just one source of information in its overall assessment of efficient costs.

The AER regulates both government and privately-owned large energy utilities, and its incentive schemes were introduced in the context of significant increases in energy prices. While IPART has outlined a theoretical case for financial incentive mechanisms, we question whether the increased complexity of the regulatory regime is justified, particularly given the extensive other reforms proposed.

### 3.1.3. Deviating from a pre-determined level of forecast expenditure may be efficient

We understand IPART’s rationale for a symmetrical treatment of operating and capital expenditure. Nonetheless, we have specific concerns regarding its proposed CESS scheme.

#### Forecasting capital expenditure drivers

Capital investment cost drivers will change within a regulatory period as an uncertain future reveals itself. Key uncertainties include growth rates and location, asset condition, compliance risks, government policy and stakeholder expectations.

Under the CESS scheme, incorrectly forecasting growth and bringing-forward an investment creates a so-called 'inefficiency'. In many cases, this would be more aptly described as a forecasting error.

A well-run business responds to changing conditions. For example, only investing when growth projections are actually realised, risks of non-compliance exceed appetite, or when asset condition for a major asset or category of assets deteriorates to an unacceptable level.

We have concerns about a capital scheme that measures deviations from a capital allowance built on assumptions and forecasts, up to eight years earlier.

### **Relationship between outcomes and capital expenditure levels**

IPART's proposed 3Cs approach introduces a new focus on delivering outcomes valued by customers. IPART draws a link between incentives schemes driving down expenditure and an incentive to compromise the quality of services. Measuring outcomes can help determine whether an under or overspend is a genuine efficiency or inefficiency, but the relationship may not always be clear:

- Some expenditure will not be tied to, or detectable, through customer outcomes, such as capital expenditure on employee safety.
- Observable changes in outcomes may lag behind expenditure, especially in relation to asset condition and renewal expenditure.
- Mandatory standards, and associated compliance expenditure, are not always neatly delineated from discretionary standards. Expenditure above or below a pre-determined level may reflect risk management decisions as circumstances change without an observable change in compliance outcomes.

## **3.2. Design of the cost-reduction incentives**

### **We support capping the schemes**

We support the proposed application of caps to financial incentive schemes, particularly in the 'discovery and learning' phase when utilities, customers and IPART are seeking to gain insights as to how businesses might respond to individual incentives, the interplay of IPART's proposed upfront and *ex post* financial incentives and any unintended consequences may materialise.

Conservative caps on these financial incentive schemes would be consistent with the introduction of new incentive schemes in other jurisdictions.

IPART states that it would ask advanced and leading businesses to propose how much revenue they risk in the incentive scheme. We recognise that for the scheme to work, the cap would not be set too low as to mute any influence on decision making.

We seek further information on:

- any costs that may be excluded from the EBSS and CESS (e.g. non-controllable expenditure)
- the relationship between actual expenditure levels under an EBSS and CESS and IPART's expenditure review for the subsequent determination period
- any decision rules or principles IPART might apply in determining whether to make an EBSS or CESS payment or deduction and/or to continue to apply these schemes in the following determination period. In general, the more regulatory certainty provided to the utilities the stronger the incentives to make decisions that can drive efficiencies and improvements.
- The relationship between EBSS and CESS payments or deductions and IPART's financeability test.

## Ex-post incentive mechanisms should be accompanied by appropriate risk management measures

An EBSS and CESS means that regulated businesses can hold onto a greater share of efficiency gains and losses, where these gains and losses are measured relative to the regulatory cost allowances. Unless there are appropriate cost risk management mechanisms in place, this can mean there is potential for regulated businesses to experience greater gains or losses from uncertain or unforeseen cost changes that are beyond their reasonable control – windfall gains and losses that do little to drive performance.

The AER's EBSS and CESS are supported by robust contingent project and cost pass through mechanisms. We consider there to be a case for improving the approach to managing in-period cost uncertainties. We discuss this further in section 5.

### 3.3. Service level incentive scheme

IPART's proposes a service level incentive scheme where water businesses are held accountable for identifying outcomes that promote the long-term interests of customers. IPART judges the work of each water business *ex ante*, as part of the grading of proposals, and *ex post*, through a new financial incentive scheme.

We see IPART's emphasis on customer outcomes as the centrepiece of the proposed regulatory reform. This approach has worked well in other jurisdictions. The Cambridge Economic Policy Associates (CEPA) summary report for IPART concluded:<sup>5</sup>

*“Alongside the increasing levels of customer engagement, regulators have given more flexibility to companies to propose outputs and outcomes (i.e. services and service performance levels, and other outputs) that customers value. This has led to a broad range of outputs and output targets being adopted across the industries. We consider that this flexibility is needed to ensure that customer engagement is effective.”*

In past price reviews, IPART and the NSW water businesses have focussed on outputs rather than customer outcomes, partly due to the ease of measurement (see Table 3.1).

**Table 3.2 Outcomes and outputs**

OUTCOME	OUTPUT
The desired change, experience or condition for beneficiaries. The things that customers and society values Beneficiaries may include customers, customer segments, the environment, the business, or others.	The measurable things that result from projects or activities. The things that water businesses deliver to achieve those outcomes Outputs capture the things you produce (widgets), but do not capture impact or benefit to customers.

Source: Hunter Water. Adapted from Aither, and CEPA, 2020, *Economic regulation of water utilities – research*, p. 26.

The shift in thinking to 'outcomes' will take time and effort to do well. Developing outcomes involves delivering a substantial customer engagement program, shortlisting ideas, developing measures and calibration of targets. Ofwat introduced this approach in 2014, with substantial changes in measures and targets at each price review.

Hunter Water envisages that the customer outcomes would cover a wide-range of objectives and measures relating to all services, including core infrastructure performance, fixing problems in a timely manner, ease of doing business, and better environmental outcomes.

<sup>5</sup> CEPA, 2020, *Economic regulation of water utilities – research*, p. 6.

### 3.3.1. Outcome performance and incentives

IPART's service level incentive scheme, also known as an outcome delivery incentive, would tie financial rewards and penalties to customer performance outcomes. Ofwat and the AER apply similar models. IPART explains its approach:<sup>6</sup>

*“An ODI would tie financial rewards and penalties to the customer performance outcomes that businesses commit to in their pricing proposals. The performance targets would be informed by customers’ preferences, including willingness to pay surveys. For advanced businesses, these estimates could take some time to establish, and therefore these service incentives could be for only a partial set of indicators in the short run. As discussed below, ODIs for service performance would need to operate consistently with operating licence requirements.”*

Hunter Water observes that IPART's approach establishes strong procedural and reputational incentives:

- *Ex ante*
  - reputational reward by being graded ‘advanced’ or ‘leading’
  - procedural reward by receiving a lighter handed expenditure review for the expenditure required to achieve the outcome targets we commit to in our pricing proposal
- *In-period*
  - reputational reward through delivering a package of price and service levels that yield higher customer satisfaction and trust
  - reputational incentive through reporting of performance via Hunter Water's website or bills.
- *Ex post*
  - reputational reward in the grading of our next pricing proposal against the ‘credibility’ principles.

### 3.3.2. Designing the service levels incentive scheme

Hunter Water supports the development of a service levels incentives scheme centred on customer outcomes. We stress that is not an easy or straightforward task – designing the scheme, or designing the outcomes and targets. The first step of setting objectives will take time. We show an example of possible overall objectives for a service levels incentive scheme in Figure 3.1. The overall scheme objectives could be developed through further consultation between IPART, water businesses and other stakeholders. Then, in designing Hunter Water's outcomes and targets, we will need to draw on customer feedback and insights to identify priorities and make trade-offs, informed by costs and possible delivery timelines.

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<sup>6</sup> IPART, 2021, *Encouraging innovation in the water sector, Discussion Paper 3*, p. 21.



**Figure 3.1** Potential objectives for a service level (outcome delivery) incentive scheme



Source: Frontier Economics (UK), 2020, *The future of outcome incentives: How we can move to a better approach*, p. 5.

IPART’s Discussion Paper provides an overview of its proposed service level incentive scheme. We note a number of lessons learnt in other jurisdictions and sectors:

- Regulators provide for contingencies or exclusions in exceptional circumstances where continuing to apply the scheme may be contrary to the scheme’s objectives.

The AER can suspend the application of its Customer Service Incentive Scheme. It has cited the 2019-20 bushfire season and COVID-19 public health crisis as example circumstances.<sup>7</sup>

Ofwat considered several requests for interventions Outcome Delivery Incentive payment due to the impact of COVID-19 on performance.<sup>8</sup>

- The regulator needs to take account of local factors and local customer engagement findings in any setting of outcome measures and targets that apply to all water businesses.<sup>9</sup>
- We welcome a further opportunity to comment on the structure of any financial incentives. There are trade-offs to be made in a scheme that sets incentives for every outcome and target, compared with a single incentive based on a composite of all measures and targets.

We note that Ofwat’s outcome performance commitments “are set to cover all aspects of service that really matter to customers”.<sup>10</sup> We are cautious of unintended consequences, particularly if there are unequal incentives for cost reduction (via EBSS and/or CESS) and service improvements for a subset of service levels that are of value to customers.

- There is a question of who should receive any underperformance payments: affected customers or the entire customer base? Any scheme would need to dovetail with existing rebates for service interruptions as set out in Hunter Water’s customer contract.<sup>11</sup>
- There may be opportunities to incorporate longer-term thinking by developing measures around resilience and asset health.<sup>12</sup>

<sup>7</sup> Australian Energy Regulator, 2020, *Customer Service Incentive Scheme: Explanatory Statement*, p. 12.

<sup>8</sup> Ofwat, 2021, *Sector overview: Draft determinations of in-period outcome delivery incentives for 2020-21*, p. 2.

<sup>9</sup> Ofwat, 2021, *PR24 and beyond: Our reflections on lessons learnt from PR19*, p. 55.

<sup>10</sup> Ofwat, 2021, *PR24 and beyond: Our reflections on lessons learnt from PR19*, p. 54.

<sup>11</sup> Frontier Economics (UK), 2020, *The future of outcome incentives: How we can move to a better approach*, p. 14.

<sup>12</sup> Ibid, p. 10 and 12.



IPART sought comments on the following specific question about framework design:

6. Do you support a tiered use of *ex post* incentives to advanced and leading businesses?



We encourage IPART to carefully consider the design *ex post* financial incentives in this first round of regulatory reform. We support IPART's approach of allowing water businesses to propose the size of caps for each of the schemes.



IPART sought comments on the following specific question about framework design:

7. How effectively would our proposed use of *ex post* incentive schemes encourage cost reductions and improvements to service quality?



We consider IPART's proposed reforms to encourage good proposals would create a stronger incentive to encourage cost reductions and service quality improvements than *ex post* financial incentives.

## 4. STREAMLINING THE EXPENDITURE REVIEW PROCESS

Hunter Water welcomes IPART's examination of the expenditure review processes. We agree with many of IPART's proposed changes including the earlier review of systems and processes.

IPART suggests that through a combination of its upfront and ex-post financial incentives, the collection of better information and the development of benchmarking models, it can move away from comprehensive expenditure reviews – at some point in the future. There would appear to be no near-term procedural benefit for submitting a high-quality proposal.

### 4.1. Rewarding good regulatory proposals

IPART describes the goal of collecting the information it requires to have a high level of confidence in the efficiency of cost proposals, and to rely less on detailed bottom-up expenditure reviews.

IPART explains that its proposed changes will take time to implement. This suggests more streamlined or targeted expenditure reviews may not occur until IPART changes the way it collects cost information. We are likely to be asked to provide more cost information at the next price review, not less.

IPART has not adopted the procedural features of the ESC's PREMO model, at least not in the near term. The ESC is able to conduct preliminary assessments of all proposals. The ESC fast-tracked four businesses in 2018: South East Water, Yarra Valley Water, East Gippsland Water and Westernport Water. The ESC noted, in the case of South East Water, the pricing proposal: <sup>13</sup>

*“...provided clear and comprehensive information supporting its proposals and ... also provided evidence that its engagement captured the main priorities and concerns of customers and [had] taken this feedback into account. This enabled us to quickly assess South East Water's price submission against the legal framework that governs our role.”*

As noted in section 2.1, IPART's current approach to expenditure reviews is resource intensive for all parties and a process that may be spuriously perceived as rigorous and precise. Our understanding is that this approach is one of the most intensive across all economic regulators of the Australian urban water sector.

### 4.2. Clarity and consistency in information requirements

Hunter Water supports the IPART's various proposed changes to the way it collects and analyses cost information:

- consistent application of a base-step-trend approach to forecasting operating expenditure
- ex-post review of capital expenditure by exception, and establishing clear criteria for when this would occur
- requiring businesses to nominate ongoing efficiency factors
- requiring businesses to list achieved and forecast efficiency improvements
- asking consultants to recommend a range for the efficient expenditure allowance.

Hunter Water also agrees with IPART's proposal to split the expenditure review process into two parts. The review of corporate and management systems, including asset management and planning, provides a check on the governance and business case processes used to guide spending and management decisions. While we update and refine our approach over time, this assessment could be carried out well before the price review. This step would reduce the administrative burden on the business during the price review year.

Hunter Water has not reviewed the ESC's cost categories in detail – our Finance team is busy completing this year's annual information return. We will provide specific comments on the ESC's template in our response to IPART's Draft Report.

<sup>13</sup> Essential Services Commission, *South East Water draft decision, 2018 Water Price Review*, 7 December 2017.

IPART describes a base-step-trend approach to assessing operating expenditure. As IPART observes, this is not materially different to current approach where the consultants examine the base year, adjust for catch-up efficiency and step changes, and then apply a continuing efficiency factor. IPART suggests that the financial incentives should reveal catch-up efficiencies and that IPART would not make these adjustments in future reviews.

Hunter Water would like to work with IPART on the categorisation of capital investments. We only use the five IPART categories when reporting to IPART.

Hunter Water has developed a predictive asset renewals model that shows the likely profile of renewals expenditure over a period of decades. Historically, we have been able to accurately forecast the rate of new growth in the lower Hunter, but it is harder to forecast growth rates in particular zones or catchments.

We seek greater clarity from IPART about when it would implement each element of its proposed changes to the expenditure review process. We suggest that IPART's Draft Report include a 'roadmap' detailing the process and approach for the next price review and subsequent reviews.

### 4.3. Benchmarking models

IPART has flagged a greater use of benchmarking, and is exploring a cross-jurisdictional group of regulators and government agencies. Economic benchmarking can provide observations on performance without relying on a detailed 'line by line' assessment of expenditure. Subject to data availability, benchmarking can:

- inform the detailed cost assessment, including decisions on 'base level' opex in the base-step-trend analysis, and continuing efficiency factors for operating and capital expenditure, and
- be used to 'sense check' final expenditure allowances.

Most Australian economic regulators use some form of benchmarking analysis to assess the efficiency of regulated businesses' expenditures. Benchmarking analysis takes one of two forms:

- **Bottom-up benchmarking analysis**, sometimes referred to as process-level benchmarking, is used to support detailed engineering assessments of cost efficiency. Benchmarking compares the regulated business's unit costs and quantities of inputs used to deliver regulated services with a sample of comparable businesses. Bottom-up analysis is undertaken at the individual cost category level (e.g. labour costs, contractor costs, information technology costs).
- **Top-down benchmarking analysis** involves comparing the capital, operating, or total expenditure reported by the regulated business to costs reported by other comparable businesses in the same industry. The analysis needs to control for the drivers of those costs and other factors that might cause differences in costs between the businesses that are unrelated to efficiency.

Bottom-up analysis tends to be time and resource-intensive, and can provide information about the efficiency of a business's costs at a granular level. Top-down analysis provides a more high-level view of overall efficiency, and can be a lower-cost way to make broad assessments of general performance.

IPART would require extra information from the regulated water businesses to support benchmarking work. The AER, for instance, collects data annually using Regulatory Information Notices from the 14 electricity distribution businesses and five transmission businesses it regulates. The AER's dataset contains data from 2006 onwards for each company. Overseas regulators, such as the New Zealand Commerce Commission, Ofwat and Ofgem, have assembled similar datasets for benchmarking purposes.

There are well known practical challenges with benchmarking and statistical analysis. To get accurate results, benchmarking models must account for inherent differences in operating circumstances: terrain and topography, climate, population and network density. Different regulatory requirements will drive cost differences between businesses, most notably across jurisdictions.

Should IPART go down this path, we would welcome the opportunity to be involved in any benchmarking working group.

As a general comment, we caution against an over-reliance on benchmarking, using it too mechanistically or deterministically. Where it is used, regulators typically examine multiple sources of information in assessing the efficiency of each utility.



## 5. LONG-TERM PLANNING AND MANAGING RISK

Hunter Water supports a longer regulatory period. Given the scale and complexity of IPART's proposed changes to the regulatory framework, we support a five-year period for the next round of metropolitan price reviews. We are open to six-year regulatory periods in subsequent determinations.

Hunter Water supports further examination of approaches to better manage material cost events where the timing and efficient cost is uncertain at the time the regulatory proposal is finalised.

We consider there is scope, and precedent within IPART's own regulatory regime, to design a cost pass-through (CPT) mechanism to allow IPART to conduct in-period assessments of efficient costs in response to pre-defined trigger events. This can be done in a way that maintains incentives for the business to carefully manage risks and costs. An improved CPT could work in tandem with IPART's proposed cost efficiency sharing mechanisms.

### 5.1. A longer regulatory period

We commend IPART for initiating this review of the regulatory framework. We consider it good regulatory practice to do something similar, possibly a more targeted review, after each round of metropolitan price determinations.

In our 2019 pricing proposal we observed that longer regulatory periods were an enabler of a continuous improvement approach, providing time to 'step back', reflect on lessons learned and consider priority framework improvements. The current four-year regulatory period is too short to allow meaningful reflection and improvement.

In our response to IPART's Discussion Paper 1, *Lifting performance in the water sector*, we supported IPART's longer-term focus, including its proposals for:

- longer determination periods to enhance price stability, incentives for efficiency gains, and reduce regulatory costs
- 'framework reviews' to enhance regulatory certainty and transparency, and promote improvements to key elements of the regulatory framework over time.

We also put forward the position that the determination period should be principle-based, supported by a clear and comprehensive framework to manage revenue risks and cost risks. We noted that those principles indicate 5 or 6 years is about right.

We have observed that other economic regulators publish updated guidance material mid-way through regulatory cycles. South Australia's ESCOSA publishes a draft and final framework and approach paper more than two years before the final determination.<sup>14</sup> This document describes focus areas for the review, changes since the previous review and parts of the framework where ESCOSA can provide up-front clarity. ESCOSA's 2018 paper described the regulator's expectations around customer engagement. In addition, ESCOSA published nine technical papers.

ESCOSA's September 2021 paper sets out expectations for SA Water's July 2023 pricing proposal, almost two years in advance.<sup>15</sup> It flags the release of Guidance Papers to inform the development of SA Water's proposal and allow stakeholders to better engage with relevant regulatory issues. ESCOSA also intends to convene stakeholder sessions as required, to explain regulatory issues and methodologies, and to provide comment and feedback on regulatory matters as needed.

IPART does undertake reviews of parts of its framework during the regulatory period. Before the last round of price reviews, IPART reviewed its policies on the weighted average cost of capital (WACC) method, financeability test, working capital allowance and asset disposals. Hunter Water considers that a framework and approach paper, published at least a year prior to the submission of pricing proposals, would help water businesses address focus areas and streamline the review process.

<sup>14</sup> South Australia Essential Services Commission, 2018, *SA Water Regulatory Determination 2020, Framework and Approach*.

<sup>15</sup> South Australia Essential Services Commission, 2021, *SA Water Regulatory Determination 2024, Final Framework and Approach*.

IPART is supportive of a move to longer determination periods. IPART proposes a 3-3-6 model to promote better long-term planning:<sup>16</sup>

*“In the most obvious sense, it encourages long-term planning because it sets prices for longer, and businesses need to develop forecasts for a longer period to generate their proposals.”*

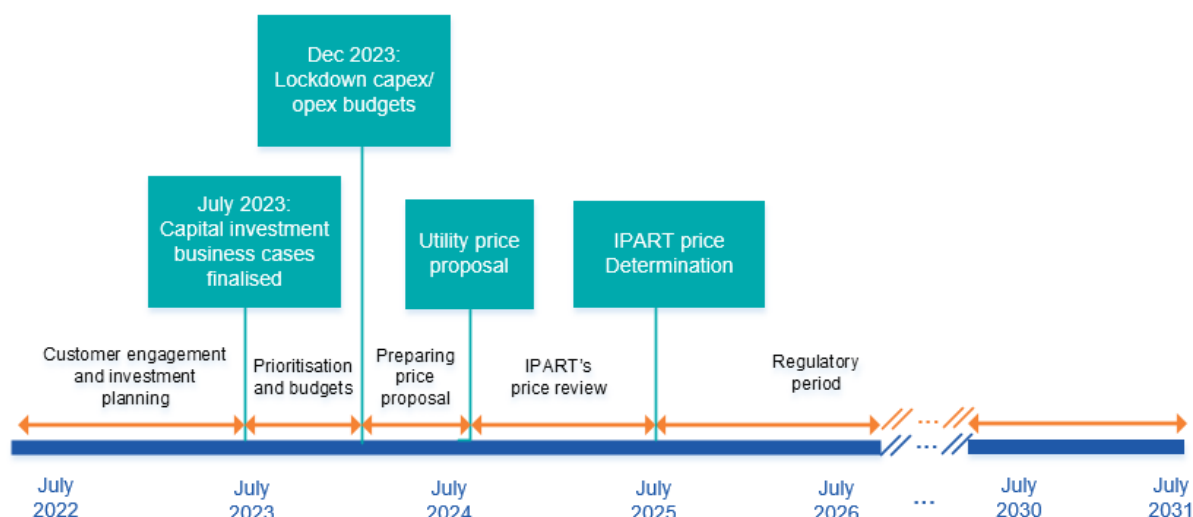
IPART currently requires Hunter Water to provide detailed five-year capital and operating budgets and a 10-year forward capital program.

The main difference between IPART’s ‘3-3-6’ model and Hunter Water’s previous feedback is the inclusion of a ‘mid-cycle health check’, which, in effect, could trigger a ‘4-2’ model with an early reopener.

We show a stylised timeline of a six-year regulatory cycle in Figure 5.1, assuming IPART agrees to Hunter Water’s request for an extra year in the current price period.

We finalise capital investment business cases one year prior to our price proposal, leaving six months to prioritise our capital program and accompanying operating budgets, so that our expenditure proposals consider the appropriate mix of service levels and bill impacts. This leaves a further six months to draft and finalise the pricing proposal. Under a six-year model, Board decisions in December 2023 would have an influence on expenditure levels out to June 2031 – more than eight years later.

**Figure 5.1** Hunter Water’s next regulatory pricing cycle



We can see merit in a six-year cycle for an established regulatory framework. IPART’s Discussion Paper 3 outlines multiple, substantial changes in the regulatory model. This is a step-change in approach, all in the one review. Under a six-year determination, we are concerned that four financial incentive schemes, in combination with a narrowly-applied cost pass through mechanism, would expose Hunter Water to financial and reputational risks. Given the scale of IPART’s changes, we support a five-year regulatory period, providing an earlier opportunity to review the success or otherwise of the new regulatory framework.



IPART sought comments on the following specific question about framework design:

8. Given the new 3-3-6 model, should we make changes to the way pricing and licensing reviews align?



Given the scale of IPART’s changes, we support a five-year regulatory period, providing an earlier opportunity to review the success or otherwise of the new regulatory framework. Reviews for pricing and licensing would maintain their current alignment under this approach. Future alignment between reviews can be considered closer to the time.

<sup>16</sup> IPART, 2021, *Encouraging innovation in the water sector*, Discussion Paper 3, p. 36.

## 5.2. IPART's cost pass-through guidance

IPART's Discussion Paper provides a useful categorisation of possible cost pass-through events:

- Category 1: An unforeseen event where the business has no way of estimating its impact ahead of time.
- Category 2: An event with a known outcome or obligation for the business, but costs would be difficult to estimate until details of the change were finalised.
- Category 3: An event where the business is able to model the impact with a reasonable degree of accuracy.
- Category 4: A known event where the costs are clear.

IPART's existing cost pass-through guidelines apply to category 3 and 4 events. IPART proposes relatively minor refinement to these guidelines. We support the revised drafting.

Hunter Water is of the view that the proposed revisions do not address more fundamental limitations with the current guidance. The scope of application remains extremely limited.

## 5.3. A cost pass-through mechanism that complements broader regulatory changes

Given the scope of IPART's changes, we believe it is critical to consider the role the CPT mechanism should play within the broader regulatory framework to ensure that the various elements complement each other.

### 5.3.1. Cost pass-through mechanisms to support a longer regulatory period

As IPART has noted, longer determination periods create the risk that prices become less cost-reflective, due to changes in government policy or regulation, drought or flood, population growth and other unknowns.

In our view, developing the right suite of cost pass-through mechanisms is the best way of managing these risks. The mechanisms would only be applied in pre-specified circumstances to manage material events.

In contrast, IPART proposes to address these risks through a 3-3-6 'mid cycle health check', with scope for the business to seek to re-open the determination if an unanticipated event occurs.

We consider this approach would significantly undermine the benefits from a longer determination period by adding unnecessary regulatory uncertainty and resourcing cost.

### 5.3.2. *Ex post* incentive schemes

IPART's proposed EBSS and CESS allow the regulated businesses to hold onto a greater share of efficiency gains or losses relative to the allowances set at price determinations. They rely on expenditure allowances reflecting efficient costs throughout the determination period. If an event and cost is beyond the control of the regulated business, the application of the EBSS and CESS can amplify undue gains or losses to the regulated business.

If IPART decides to implement the EBSS and CESS, it is more important than ever that there is a mechanism to adjust regulatory cost allowances within the regulatory period when warranted.

We note that the AER's EBSS and CESS include a contingent expenditure mechanism and a CPT regime.

## 5.4. A cost pass-through framework that addresses IPART's concerns

Hunter Water considers that the regulatory objective should be to ensure risk is allocated to the party best able to manage or bear the risk. A key tenet of an efficient risk allocation framework is that a water business should be able to recover its efficient costs of managing risk.

Management strategies include: prevention (avoiding the risk), mitigation (reducing the probability and impact of the risk), insurance (transferring the risk to another party) and self-insurance (putting aside funds to manage the likely costs associated with a risk event). A well-run water business will employ the most cost-effective combination of these strategies.

Where these management strategies are either unavailable or expensive, CPT mechanisms can ensure that prices reflect efficient costs without compromising incentives for efficient risk management. Reflecting this objective, Hunter Water proposes the following changes to the CPT mechanism:

- The CPT would only relate to risks or events that are wholly or predominantly outside the control of the regulated business and where a pass-through is the most efficient and equitable way to deal with the event.
- The costs of managing the risk or event would not be included in IPART's expenditure allowances (i.e. no opportunity for 'double-counting').
- Only IPART-approved 'prudent and efficient' costs of addressing the risk or event would be passed through to customers – and these would be assessed for prudence and efficiency *at the time* a claim for cost pass-through was made *following* occurrence of the event.
- Only those costs that could not be more efficiently managed by the business through some other mechanism would be eligible to be passed through to customers.

## 5.5. Incentives to manage risks efficiently

IPART states that a CPT mechanism which allowed 'unconditional' pass-through of costs that were unknown at the time of the determination would undermine the incentives of the business to efficiently manage those risks.

Under our proposed approach, the CPT mechanism would only apply to risks or events that are beyond the ability of the business to control or manage.

We acknowledge that it would be inappropriate for 'unconditional' cost pass-throughs to apply to unforeseen events, or known events with cost impacts that are difficult to estimate in advance.

We propose that IPART undertakes an in-period assessment of the prudence and efficiency of any such cost pass-through claim submitted by a regulated business during a regulatory period, in response to a trigger event occurring. The AER's cost pass-through mechanism works in this way (see Box 1). The business would only be compensated for any costs it incurs in responding to such an event if they passed IPART's prudence and efficiency test.

This incentive to manage risks efficiently would be reinforced by IPART's proposed guideline 4, which requires the business to demonstrate that a cost pass-through is the most efficient and equitable way to deal with the event. As IPART observes: <sup>17</sup>

*"...when there is a high degree of uncertainty about whether a significant event will eventuate in a determination period, it can be more efficient for customers to only pay if, and when, the event materialises, rather than pay the expected costs upfront. There are events where agreeing to pass-through the efficient costs, when the event is triggered, could save customers money over time and/or provide a more cost reflective price signal (for example, the efficient costs of responding to drought)."*

Hunter Water points out that IPART's current approach could encourage regulated businesses to adopt conservative costs forecasts or enter into costly insurance contracts to mitigate the risk of particular events.

<sup>17</sup> IPART Encouraging innovation in the water sector Discussion Paper August 2021, p.37



### **Box 1: AER's cost pass through and contingent project mechanisms**

The AER has mechanisms that enable the utility to recover foreseen and unforeseen costs within a regulatory period.<sup>18</sup>

The contingent project mechanism applies when an investment can be clearly defined, but the timing is linked to an uncertain trigger. Triggers are required to be reasonably specific and capable of objective verification.<sup>19</sup> The occurrence of the trigger event must be probable during the regulatory period, likely costs must exceed a materiality threshold, and it relate to an event where including the expenditure ex-ante is not appropriate because:

- it is not sufficiently certain that the event or condition will occur during the regulatory control period or if it may occur after that regulatory control period or not at all; or
- the costs associated with the event or condition are not sufficiently certain.<sup>20</sup>

The AER allows contingent costs to be recovered, within a regulatory period where the timing or costs of the investment are uncertain (IPART's Category 2). Service providers must identify the trigger event and likely costs ex-ante in their regulatory proposal and can then make an application for consideration as soon as practicable if the trigger event occurs. The AER seeks stakeholder submissions as part of their review process in deciding an appropriate adjustment to the expenditure allowance.

Cost-pass throughs are allowed for a variety of unforeseen and uncertain events including: regulatory change, tax change, and service standard events where service provision is altered as a result of a legislative or administrative act or decision.<sup>21</sup>

There is also the ability for 'other events' to be pre-specified in a regulatory determination as potential pass through events. Under this mechanism, service providers give the AER information on both positive and negative changes when they occur. The AER undertakes a detailed review and consultation process in evaluating the merit and specifics of the cost pass through claim prior to making a final decision.

## **5.6. Specifying events in advance**

IPART expresses a concern about a CPT mechanism for events for which the cost cannot be specified in advance. IPART argues that customers risk paying too high a price for an event that is vastly different to what was expected when the pass-through was allowed.

We propose that the pass-through for any event for which costs cannot be determined accurately in advance is instead subject to in-period review by IPART, if and when the event occurs. In this way, only prudent and efficient costs of responding to the event are reflected in customers' prices.

Our proposal is aimed at ensuring prices do reflect efficient costs, even in the face of unforeseen or unexpected events. Continuing to exclude such events from the CPT regime means there is significant scope for the business to make windfall losses or gains.

## **5.7. Transparency**

IPART contends that its framework, and the IPART Act, require any potential cost pass-through to be included in the determination ahead of time, and that the costs to be recovered are known. This would preclude providing for cost pass-through where costs associated with managing the event are subject to an in-period review.

We would welcome a clarifying position from IPART - is this constraint a legal requirement or a policy position adopted by IPART?

<sup>18</sup> National Electricity Rules (NER), version 173, available at: <https://www.aemc.gov.au/regulation/energy-rules/national-electricity-rules>

<sup>19</sup> National Electricity Rules (NER), version 173, clause 6.6A.1(c)(1), page 831

<sup>20</sup> National Electricity Rules (NER), version 173, clause 6.6A.1(c)(5)(i and ii), page 832

<sup>21</sup> National Electricity Rules (NER), version 173, clause 6.6.1, page 815 for Distribution Network Service Providers

We note that there are other examples where IPART has set prices in a determination which include provision for prices to be adjusted later to reflect costs to be assessed in the future. IPART's Sydney Water determination provides that prices during the regulatory period be adjusted to reflect changes in bulk water prices resulting from a subsequent determination of Sydney Desalination Plant's prices.



IPART sought comments on the following specific question about framework design:

9. How effectively would the proposed refinements to our cost pass-through criteria promote the long-term interests of customers?



We consider that the proposed revisions do not address more fundamental limitations with the current guidance. The scope of application remains extremely limited.

A longer regulatory period and the potential introduction of *ex post* expenditure efficiency incentive schemes, magnify the risk that expenditure allowances diverge from efficient costs and amplify the risk of under gains or losses for water businesses. We have provided an alternative CPT model that better aligns with IPART's overall framework package.

## 6. FUNDING INNOVATION

IPART's earlier Position Paper (September 2020) and Review Update (November 2020) canvassed stakeholder thoughts on various mechanisms to fund innovation within water businesses. This was a keenly discussed topic at IPART's workshop 3 in August 2021. Indeed, we expected this to be the focus of IPART's Discussion Paper 3. Instead, the Discussion Paper focusses on the innovation brought about by having a well-designed regulatory framework in place.

Research, development and innovation are important in preconditions for identifying cost efficiencies or opportunities for new or altered services that customers value. Ongoing investment in innovation is in the long-term interests of customers as it enables businesses to deliver what customers want at an efficient price. It also enables businesses to flexibly respond to emerging challenges.

The NSW Government's Water Strategy, August 2021, provides a supportive environment for innovation, noting that *"innovation, research and development are critical to the development of long-term strategies for managing and sharing water"*.<sup>22</sup> It sets out a priority to *"enable a future focused, capable and innovative water sector"*, including a number of actions for the Government to:

- partner with water utilities, research organisation and the private sector to pilot new technologies and sources of water
- collaborate with research and industry partners to harness technology for measuring, monitoring and reporting, focusing on digital, data and modelling innovations.

An assessment in 2018 found that 1.0-1.2% revenue invested in research by urban water businesses would be required to minimise future costs and would result in a net benefit to society – compared with (then) current levels of 0.3% to 0.5%.<sup>23</sup> We do not agree with IPART's assertion that the traditional building block approach creates profit incentives and weak incentives to innovate.<sup>24</sup> As a state-owned corporation our four principal objectives are equally weighted: being an efficient business, being socially responsible, operating in an economically sustainable manner and supporting regional development. Unlike the private sector, Australian urban water businesses investing in innovation are less likely to *directly financially* benefit from innovation and more likely to share research and development findings through industry bodies such as the Water Services Association of Australia and Australian Water Association. Despite this efficient sharing of resources in the long-term interests of customers, funding of research, development, pilots and trials can be challenging due to the uncertainty of outcomes.

IPART's Discussion Paper 3 has given some consideration to recent innovation funding initiatives by the AER and Ofwat, however IPART sets out the case for rejecting targeted measures to fund innovation as part of the regulatory framework. IPART describes problems of de-risking projects with a long lag until benefits are realised, if at all. IPART also points to the smaller number of NSW water businesses in New South Wales and the limited scope to compete for innovation funding.

Given the focus on innovation, Hunter Water had anticipated that IPART may trial and test a modest innovation measure as part of a new regulatory framework – like the AER's 0.1% revenue allowance suggested by a number of water businesses. We see merits in trialling a similar approach for regulated NSW water businesses.

IPART flags there may be scope to consider innovation funding as an option for businesses that are graded highly.<sup>25</sup>

*The onus would be on the business to put forward a compelling case about how it would address the 'moral hazard' aspects of innovation funding to ensure it is allocated efficiently and receives appropriate management attention. There should also be strong rationale and evidence of long-term customer value at the outset, demonstrating that that expected value to customers is high (accounting for the likelihood of success and failure).*

Hunter Water accepts the 'compelling case' challenge posed by IPART. Our strategy and planning teams are developing a number of pilot and test projects that would defer capital investments in both the water and

<sup>22</sup> Department of Planning, Industry and Environment (DPIE), 2021, *NSW Water Strategy*, p. 131.

<sup>23</sup> Dillon, P., Palmer, N., Vertessy, R., and Radcliffe, J., *Research Investment in the Australian Urban Water Industry – Towards an optimal level and a funding model*, Water e-journal, p.1.

<sup>24</sup> IPART, 2021, *Encouraging innovation in the water sector*, Discussion Paper 3, p. 2.

<sup>25</sup> IPART, 2021, *Encouraging innovation in the water sector*, Discussion Paper 3, p. 41.

wastewater systems. Rather than discuss innovation as an abstract concept, we expect our next regulatory proposal will document actual projects, costs and the expected value for customers.



IPART sought comments on the following general question about its proposed approach:

2. Should separate funding for innovation be a part of our regulatory framework? If so, how would such a scheme be designed to promote a demonstrably better outcome for customers?



Research, development and innovation are important if we are to efficiently address emerging challenges and continually provide better value for customers. We accept IPART's proposal to reject integration of innovation funding mechanisms into its new regulatory framework and instead challenge each water business to provide a 'compelling case' as part of each pricing proposal. We would have preferred a trial of a modest expenditure allowance as part of the next pricing reviews, similar to the AER's 0.1% of revenue.

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