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Submission on IPART's Regulatory Framework Review – Discussion Paper 3

Dear Liz,

Thank you for the opportunity to comment on IPART's regulatory framework review discussion paper "Encouraging innovation in the water sector" (the discussion paper). Sydney Desalination Plant (SDP) appreciates IPART's genuine engagement with all parties throughout the review to date and we view many of the proposed changes as a step in the right direction.

A stable and predictable regulatory framework is critical to ensuring water businesses can respond efficiently to the water security challenges facing NSW now and into the future. For this reason, SDP supports an incremental approach to introducing proposed changes. We understand that the redesigned framework will not apply to SDP's upcoming 2022-27 (RP3) price Determination due to timing as well as the need for more consultation on detailed elements of the proposed changes. We support this position.

SDP supports the customer outcomes focus of the Discussion Paper. Although it is not efficient for SDP to undertake broad-based end-use customer engagement for the reasons set out in our submission, it is important to ensure that a customer outcomes focus is central to the regulatory framework. Thus, we strongly support balanced, symmetric and capped outcome delivery incentive mechanisms that align business incentives with desired customer outcomes.

We look forward to further constructive engagement with IPART on these important issues. Please do not hesitate to contact myself or Iftekhar Omar, General Manager Regulation [REDACTED] if you or your team have any queries regarding our submission.

Yours sincerely,

[REDACTED]

Philip Narezzi
Chief Executive Officer
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SDP submission on IPART Discussion Paper 3

Review of the regulatory framework for water businesses in NSW

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1. Introduction

Sydney Desalination Plant Pty Limited (SDP) welcomes the opportunity to respond to IPART's Discussion Paper *Encouraging Innovation in the Water Sector*, August 2021 (Discussion Paper). We understand that the revised framework will not apply to SDP's next price determination for 2022-27 (RP3) and we support this position.

IPART has put forward an ambitious package of potential reforms, drawing on elements of other economic regulators including the Australian Energy Regulator (AER), Ofwat in the UK and the Victorian Essential Services Commission (ESC).

In further considering and potentially implementing its proposed reforms, we request that IPART:

- **Adopts a cautious and consultative approach** - elements of the AER's framework such as efficiency incentive schemes, for example, have been developed over a long period of time, involving extensive stakeholder consultation. It will be important that IPART consults extensively with regulated businesses and other stakeholders in further considering and developing the detail of its proposals.
- **Holistically considers the broader framework and regulatory package** – for example:
 - the AER's Efficiency Benefit Sharing Scheme (EBSS) and Capital Expenditure Efficiency Sharing Scheme (CESS) are complemented by comprehensive cost pass through and contingent project mechanisms. Similarly, longer determination periods across a range of sectors are supported by mechanisms to efficiently manage cost and revenue risk.
 - the ESC provides not just financial incentives for good proposals, but also provides administrative incentives for high quality regulatory proposals by allowing for streamlined and targeted reviews – without undertaking complex cost benchmarking.
- **Considers the differences in the entities that it regulates and tailors its approach accordingly** – we are a privately owned single asset business, whose services and operations are highly unpredictable, subject to a simplified, regulated pricing structure which must account for this unpredictability, yet subject to a comprehensive water supply agreement (WSA) with our single customer (Sydney Water) which is itself a regulated monopoly. We are highly motivated to pursue efficiency gains within these constraints. We query how some elements of IPART's proposal, including its potential assessment of our pricing proposals against numerous customer principles, would apply to SDP in the future.
- **Identifies the priorities for improvements to its regulatory regime and focuses on these.** IPART has proposed a comprehensive reform package that will take some time (and cost) to fully implement. We urge IPART to identify the priority areas for reform and improvement, and target these over the short to medium term. In our view, priorities are for IPART to:
 - **Allow for streamlined and targeted expenditure and pricing reviews** and provide upfront clarity about how it would assess whether a proposal qualifies for such a review and how such a review would occur in practice. We consider that IPART can provide this strong incentive for high quality regulatory proposals, with significant benefits, without the need for complex benchmarking.
 - **Provide enhanced upfront clarity in general about how it will assess expenditure proposals.**

- **Ensure that its existing approach to applying incentive mechanisms are consistent with best practice principles** before introducing new mechanisms– including that they are proportionate, symmetric and capped. Currently, SDP faces an abatement mechanism that is not capped, proportionate, nor symmetric and in our view does not meet many of the principles set out by IPART in its Discussion Paper.
- **Enhance the cost pass through (CPT) framework** to allow it to conduct in-period assessments of the efficient costs of specific CPT events that are beyond the control of the business and consistent with a holistic risk management framework, to ensure prices reflect efficient costs over the course of the determination period without compromising incentives for businesses to efficiently manage risks.

The following sections outline those elements of IPART's proposed package that we support, those that we do not support and areas where we seek more information and consultation.

2. Encouraging good regulatory proposals

We support IPART's goal of providing clearer upfront guidance about its expectations of pricing proposals and how it will assess those proposals. This is important for providing required levels of investment certainty, promoting innovation and efficiency gains, lifting the performance of the sector, and enhancing customers' interests over the long-term.

IPART's explanation of its assessment principles and Appendix B of the Discussion Paper provide a good starting point for it to consult upon and develop further upfront guidance to water businesses about its expectations and the principles and criteria against which pricing proposals will be assessed. However, it will be important for IPART to tailor its principles and assessment criteria to the different circumstances of the different businesses that it regulates.

We also support IPART's principles that focus on achieving the best outcomes for customers and the community over the long-term. This includes, for example, customer choice pricing – which recognises that, in the right circumstances, a flexible approach to pricing can deliver the best outcomes for customers, rather than an overly prescriptive or rigid approach. We note that SDP has successfully implemented customer choice pricing over the last 18 months in response to water quality risks arising from bushfires and flood. This has involved supplying water to Sydney Water and being available to ramp up supply if called upon, with the costs of this requested and tailored service being recovered through negotiated pricing agreements.

However, as outlined below, we do not support financial rewards and penalties tied to IPART's assessment of SDP's pricing proposal against the '3Cs', at this time. We also seek clarification from IPART on its expectations of SDP regarding customer engagement given the role of SDP and its regulatory and operating environment.

2.1 Financial rewards and penalties should not be tied to IPART's assessment of SDP's pricing proposals against the '3Cs', at this time

Given current circumstances, SDP should not be subject to financial rewards and penalties tied to IPART's assessment of its pricing proposal against the '3Cs'.

IPART's proposed grading regime is focused on incentivising regulated businesses to understand what their customers value and reflecting this in their pricing proposals. The implication is that businesses would be financially rewarded or penalised, in large part, based on their customer engagement in developing their pricing proposals. However, SDP currently has only one customer (Sydney Water) and there are already formal, well-established means for that customer and the NSW Government to determine what services SDP provides, and how it provides those services. This is illustrated by:

- the NSW Government's current process of developing, and consulting on, the Greater Sydney Water Strategy (GSWS), with the draft GSWS out for public consultation and proposing a new operating regime for SDP whereby it would be always available.
- the WSA explicitly recognising that SDP and Sydney Water can negotiate agreements to mitigate public health incidents and that SDP's reasonable costs be recovered.

We note that IPART's '3Cs' principles could still be used to guide and assess our pricing proposals, provided they are suitably tailored to SDP's circumstances (see section below). Further, to provide incentives for good regulatory proposals we consider that IPART should focus on providing enhanced guidance and clarity around its expenditure review process, and 'rewarding' high quality proposals by undertaking more streamlined and targeted expenditure reviews rather than the typical detailed review.

In discussing the expenditure review process, IPART suggests that this could occur over the longer-term, after it has enhanced its collection of data and developed benchmarking models. However, the ESC has demonstrated that streamlined assessment processes and targeted expenditure reviews – to provide incentives for high quality pricing proposals – can be implemented without detailed data collection and complex benchmarking models.

2.2 We seek clarification of IPART’s expectations of SDP for customer engagement

IPART’s Discussion Paper rightly places focus on customers, including customer engagement. However, given SDP’s unique role, operating environment and regulatory constraints, direct end-use customer engagement is unlikely to be efficient for SDP. Engagement with our single customer, Sydney Water, is already a significant driver of our levels of service:

- Unlike other water businesses regulated by IPART, SDP has one wholesale customer (Sydney Water) – which has significant influence over the levels and nature of service that SDP provides, and this influence is reflected in its long-term contract with Sydney Water, the Water Supply Agreement.
- As outlined above, there are well-established mechanisms for Sydney Water and/or the NSW Government to determine how SDP operates – in fact, the current GSWS is focused on determining the optimal operating regime for SDP for the benefit of the entire Sydney community
- We would expect IPART would want SDP to operate in a way that enhances the long-term interests of end-use water customers (i.e. Sydney Water’s own customers), not Sydney Water’s own interests per se, but Sydney Water (not SDP) should be responsible for understanding its own customers’ needs and reflecting this in its pricing proposal to IPART.

We seek clarification from IPART about its ongoing expectations of SDP regarding customer engagement.

Related to this, if the upfront assessment and grading of pricing proposals was to apply to SDP, in our view a strict requirement to demonstrate 5% improvement in customer value would be problematic, particularly because SDP is limited by its Operating Licence in the range and quality of services it can provide. Although we agree with the importance of enhancing customer value, strict rules on quantification are likely to be difficult to implement. If IPART proceeds with a strict 5% improvement in customer value requirement, we seek clarity on how this would be calculated.

3. Ex-post incentive mechanisms

3.1 We support the principles of symmetric incentives with caps

We support IPART's key principles of its financial and performance incentive schemes, namely that they should be balanced, symmetric and be subject to caps. This is important for providing appropriate incentives to regulated businesses, and not imposing undue risk on them or their customers.

We note that this is in contrast to SDP's current abatement mechanism (a form of IPART's proposed outcome delivery incentive scheme), which has no cap on financial penalties and is asymmetric (i.e., no ability for SDP to be rewarded for outperformance). SDP supports development of a single clear service-based incentive scheme that aligns to the new levels of service that we expect will be implemented for SDP as part of the GSWS, one that is balanced, symmetric and be subject to caps. SDP believes one single service based mechanism should apply to each business.

If the existing abatement mechanism is to be used as the outcome delivery incentive mechanism for SDP, moving forward the mechanism should be amended to ensure it is balanced, symmetric and subject to reasonable caps.

We support IPART's objectives to provide enhanced incentives to innovate and pursue efficiency gains that are in the long-term interests of customers.

3.2 We seek further information and consultation on the ex-post incentive schemes

Before expressing a definitive view on IPART's proposed ex-post incentive mechanisms, we seek further consultation and information from IPART on the detail of its proposed Efficiency Benefits Sharing Scheme for operating expenditure (EBSS), Capital Expenditure Efficiency Sharing Scheme (CESS) and Outcome Delivery Incentive (ODI) scheme and how would be applied in practice.

In the past, regulators including IPART have undertaken significant consultation prior to introducing such schemes and this has enhanced their effectiveness. SDP proposes that further information and consultation should address issues including (but not limited to) the following:

- How the EBSS and CESS would account for non-controllable or efficient expenditure incurred through the regulatory period yet not reasonably foreseen at the price determination and therefore not included in the determination's expenditure allowances.
- How the EBSS, CESS and ODI would apply through various modes of SDP's operation throughout a regulatory period – including any period of negotiated or unregulated supply (as has occurred over the last 18 months).
- How IPART would factor EBSS, CESS and ODI payments (negative or positive) into its financeability assessment.
- Whether and how IPART may exercise discretion, decision rules or principles in applying the incentive mechanisms (noting that the AER has decided not to apply the EBSS in certain circumstances).
- The specific implications of the EBSS and CESS for IPART's subsequent expenditure review process.
- How an ODI might apply to SDP, and evolve over time if SDP's operating regime or required levels of service change.

- Whether the application of these schemes should be tied to a business's grading or its specific circumstances.
 - SDP does not consider that ex-post schemes should be tied to a particular business grading. In SDP's view, such schemes should be applied where IPART assesses it to be efficient considering the size and scope of each business, and the administrative burden that would be placed on the particular business.

3.3 Ex-post incentive mechanisms should be accompanied by appropriate risk management measures, as occurs in the AER's regime

The 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 therefore rely on these allowances reflecting efficient costs throughout the determination period. If they do not, for example because of an event and cost beyond the control of the regulated business, the application of the EBSS and CESS can amplify undue gains or losses to the regulated business.

The AER's EBSS and CESS are supported by robust contingent project and cost pass through mechanisms. If IPART were to implement these schemes, it would be important for IPART to increase flexibility in the cost pass through regime. This could occur by amending the regime to allow for IPART's in-period assessment of the costs of a pass-through event, if that event occurs, with only IPART-approved efficient costs then passed through into the regulatory cost allowance and prices within the determination period, as occurs in the AER's framework (as outlined in Section 4 of this submission). In the absence of such mechanisms, there is the potential for a regulated business to experience significant windfall gains or losses arising from costs that are beyond their reasonable control.

SDP considers it critical that incentive mechanisms provide SDP with greater accountability for those things in our control, and less exposure to windfall gains and losses for those events outside our control.

4. The expenditure review process

4.1 We support greater clarity around the expenditure review process

IPART proposes a range of changes to its expenditure review process, over the short, medium and longer-term. We recommend IPART look at ways to enhance clarity and consistency around expenditure review. With this in mind, we support several key elements and principles of IPART's proposed approach, including:

- reviewing the quality of a business's systems and processes before a pricing review.
- clarity around categories of controllable and non-controllable expenditure, and recognition of non-controllable expenditure.
- consistent application of the base-step-trend approach to forecasting operating expenditure.
- ex-post review of capital expenditure by exception where there is a significant overspend relative to regulatory allowances.
- consideration of a business' proposed ongoing efficiency factor applied to controllable expenditure.
- the principle of more targeted expenditure reviews.

4.2 We seek further information on when and how IPART would conduct more targeted expenditure reviews

IPART's Discussion Paper refers to more streamlined expenditure reviews and discusses the benefits of targeted expenditure reviews. However, it is not clear on specifically when and how more streamlined, targeted expenditure reviews would occur.

IPART's Discussion Paper appears to suggest that once it has collected better information, developed benchmarking models and the upfront and ex-post financial incentive schemes are in effect, it will be able to rely less on detailed bottom-up expenditure reviews. It states that some of its proposed changes will take time to implement, and it presents a figure showing the high level 'Evolution of the expenditure review process' from short-term, to medium-term, to long-term.

This implies that more streamlined or targeted expenditure reviews may not occur until benchmarking models are developed in the 'long-term'.

In SDP's view, streamlined expenditure reviews as outlined in IPART's discussion paper, which assess expenditure governance frameworks and focus on step changes away from baseline actual operating expenditure, would greatly enhance the efficiency of Determination processes. In our view this could be implemented straight away and to this end, we recommend that IPART:

- Provide enhanced upfront clarity around its expectations and how it will assess expenditure proposals – including the circumstances in which it would conduct a streamlined or targeted review, and what this review would constitute
 - This could build on the principles and Appendix B in IPART's Discussion Paper (provided they can be suitably tailored for the circumstances of different businesses, such as SDP)
- Establish a framework and approach where its expenditure reviews are proportionate and tailored to the quality and nature of a pricing proposal – eg, so that high quality proposals could be subject to a streamlined/targeted review and/or review could be proportionate to the proposed increase in expenditure or prices.

Such an approach would provide enhanced incentives for businesses to submit high quality proposals (per the criteria to qualify for a targeted review). It would provide businesses with greater accountability for their pricing proposals, reduce regulatory burden, and allow IPART and the regulated businesses to target their efforts to the most complex/important

The Victorian Essential Services Commission (ESC) has shown that such an approach can be implemented without complex benchmarking models. For example, in 2018 the ESC fast-tracked four pricing proposals of Victorian water businesses. Notably, a review of the ESC's PREMO framework found that procedural incentives (i.e. fast tracking or the extent of scrutiny in expenditure reviews) was viewed by Victorian water businesses as a more powerful incentive than PREMO's financial incentives.¹

We therefore recommend that IPART reviews the ESC's approach to fast tracking pricing proposals, with a view to implementing streamlined or targeted expenditure reviews in the short to medium term, without the need for a significant increase in information or benchmarking models.

We also note that the AER is currently consulting on its *'Better Resets Handbook'*, which places a greater emphasis on high quality customer engagement and seeks to provide more clarity to regulated business on the characteristics of a pricing proposal that would be accepted or earn a targeted review by the AER.

4.3 Benchmarking of costs is unlikely to be practical in SDP's circumstances

There are no comparable businesses to SDP within NSW and the other desalination plants across Australia all operate according to significantly different mandates, which drives very different cost structures. This severely limits the potential to benchmark SDP's costs in the way that other regulators such as the AER benchmark regulated business's costs. We do, however, support a categorisation of costs, particularly one that distinguishes between controllable and non-controllable costs. We also support the use of predictive models such as those that predict optimal membrane age and energy efficiency where global datasets are sufficiently deep to draw meaningful insights.

Benchmarking is data intensive, requiring sufficient depth, breadth and quality of data. For example, the AER collects data annually using Regulatory Information Notices (RINs) from the 14 electricity distribution businesses and five transmission businesses it regulates. The AER's RIN dataset contains data from 2006 onwards (i.e., 15 years in total, so far) for each company. Even with this deep dataset, the AER still needs to make significant adjustments for operating environment factors and apply judgment when making decisions, ultimately using benchmarking data as just one (not the only) source of data regarding the efficiency of proposed expenditure.

Across the water sector, differences in factors such as labour costs in different regions, terrain and topography, climate, population and network density, services and regulatory requirements all drive variances between the costs incurred by different businesses. Thus, IPART should be cautious about relying on benchmarking as part of its efficiency assessments in general.

¹Farrier Swier, [Victoria's Water Sector: The PREMO model for economic regulation](#), Report for the ESC, March 2019, p 33.

5. Encouraging long-term planning

5.1 We do not support the 3-3-6 model

To accommodate longer determination periods and longer-term planning, IPART proposes a '3-3-6' model, comprised of a 6-year determination period with a 3-year (mid-point) check-in between the regulated business and IPART.

We do not support the proposed '3-3-6' model as we consider this would introduce uncertainty and potentially increased regulatory cost and undermine the benefits of a longer-determination period. Instead, we propose a 5-year determination period consistent with current regulatory cycles for SDP. We consider this term best balances the need to manage risks and regulatory costs of a determination with the need for price stability and expenditure allowance certainty to enable businesses to plan for the long term.

We also consider that longer determination periods are best supported by a holistic risk management framework—where consideration is given to how each risk can be efficiently and holistically managed within the regulatory framework and appropriately allocated between businesses and customers—rather than 'locking in' a mid-point check-in as the primary mechanism to manage the risk that prices do not reflect efficient costs.

IPART has previously focused on revenue risk, through considering various forms of price control (including revenue caps) as well as implementing demand volatility adjustment mechanisms (where a business's price structure differs from its cost structure). There is scope to improve IPART's approach to cost risk, through enhancing its cost pass through (CPT) framework. SDP is subject to a range of cost uncertainties over a 5-year period, and IPART has already recognised that using mechanisms to manage the risk of movements *in specific costs* (such as the movement in AER approved electricity network costs) can be an efficient and effective way of ensuring prices continue to reflect efficient costs over the period, and that incentives are retained for the business to manage its costs.

Our proposed enhancements to IPART's CPT framework (discussed below) would ensure prices reflect efficient costs, the regulated business maintains incentives to optimally manage its risks and costs, there is no undue price volatility, and the business recovers its efficient costs and remains financeable. As we discussed in Section 3.3, a CPT framework of the type we propose is also an important complement to IPART's proposed EBSS and CESS – as demonstrated in the AER's framework.

5.2 We seek improvements to IPART's Cost Pass Through (CPT) framework

5.2.1 Overview of IPART's proposed revisions to its CPT framework

In its Discussion Paper IPART has proposed the following guidelines to underpin its cost pass-through regime:

1. There is a trigger event (to activate the cost pass-through), which can be clearly defined and identified in the price determination
2. The forecast efficient cost associated with the trigger event can be fully assessed, including whether there are other factors that fully or partially offset the direct cost of the event.
3. The resulting cost is assessed to exceed a materiality threshold. It must also represent a material risk for customers (in the absence of a pass-through) or a genuine financial viability threat to the business.

4. The regulated business demonstrates that a cost pass-through is the most efficient and equitable way to deal with the event.
5. If the mechanism is triggered, there is a symmetric treatment of any over- or under-recovery of actual costs, relative to the efficient forecast cost included in the cost pass-through.
6. It is clear that the cost pass-through will result in customer prices that better reflect the efficient cost of service.

We support many elements of these guidelines, particularly 4 to 6. However, with guidelines 1 and 2 above, IPART's CPT regime would remain extremely limited. It would only apply to known events where costs are clear and to events where the business is able to model the impact upfront with a reasonable degree of accuracy. This is the approach other regulators have taken to contingent projects, rather than cost pass through events.

IPART specifically rejects applying a cost pass-through to:

- An unforeseen event where the business has no way of estimating its impact ahead of time (e.g. a government tax change such as the corporate tax rate or movements in land tax obligations).
- An event with a known outcome/obligation for the business, but costs would be difficult to estimate until details of the change were finalised

5.2.2 Overview of our proposed approach

We propose that a refined CPT mechanism would work as follows:

- The CPT would only relate to risks (events) which 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. These events such as a 'tax change event' would be included in the Determination with the methodology or process to propose a change in efficient costs, for IPART to assess 'in period' the proposal and make a decision on the additional efficient costs, and to adjust prices following any decision on additional efficient costs.
- The costs of managing this risk would not be included upfront in the determination (i.e. no opportunity for 'double-counting').
- Only IPART approved 'prudent and efficient' costs of addressing the risk or responding to the event would be passed through to customers – and these would be assessed for efficiency *at the time* a claim for cost pass-through was made *following* occurrence of the event (rather than in advance).
- Related to the above, only those costs which could not be more efficiently managed by the business through some other mechanism (e.g. insurance) would be eligible to be passed through to customers.

5.2.3 Our response to IPART's concerns

Below we address the specific concerns IPART has raised about establishing a more comprehensive CPT regime along these lines.

Incentives to manage risks efficiently

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

However, under our proposed approach:

- The CPT mechanism would only apply to events/risks that are beyond the ability of the business to control or manage. If a risk is not within our reasonable control, allocating the risk to us can mean that customers end up paying more than they should (to compensate us for bearing the risk) or service outcomes are compromised over time (if our management attention is unduly focused on risks we cannot control). Therefore, the CPT regime would not change the incentive for businesses to manage such risks.
- For those events where IPART can determine efficient costs with a reasonable degree of accuracy at the time of the price determination (i.e. the type 1 and 2 events in IPART's guidelines), costs would continue to be 'automatically' passed through if the event (trigger) occurs – as is currently the case.
- For those events where IPART cannot determine their efficient costs at the time of a price determination (e.g. a change in government taxes), IPART would undertake an in-period assessment of the efficiency of any such cost pass-through claim submitted by a regulated business during a regulatory period, in response to a trigger event occurring. This is how the AER cost pass-through mechanism works. As the business would not be compensated for any costs it incurs in responding to such an event not deemed by IPART to be efficient, it will retain a strong incentive to manage the risks efficiently and only efficient costs would be passed through to customers via price adjustments.

The 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.

Our proposed CPT mechanism is consistent with the outcomes of a competitive market and efficient risk management. In competitive markets, where firms consider what risks they are best placed to manage and competition drives firms to adopt efficient risk management strategies, many products and services have terms and conditions that set out how risks are managed. This includes the process for updating prices through time or in response to particular events.

Customers would only face efficient costs

IPART has also expressed a concern that a CPT mechanism that includes events for which the cost cannot be specified in advance creates the risk that customers will pay too high a price in response to such an event.

However, as noted above, 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. This will ensure that only the efficient costs of responding to the event are reflected in customers' prices.

Our proposal is aimed at ensuring that prices do reflect efficient costs, even in the face of unforeseen or unexpected events beyond the regulated business' control. Continuing to exclude such events from the CPT regime means there is significant scope for the business to make windfall losses (or gains) should an event which is beyond its control occur. This potential for windfall gains and losses would be magnified if an EBSS and CESS were to be introduced, without our proposed amendments to the CPT regime.

Accounting for unknown costs in the determination

IPART has also suggested that, unlike the AER, ESC and Essential Services Commission of South Australia, the IPART Act requires 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.

However, there are examples where IPART has set prices in a determination and included provision for these prices to be adjusted later within the determination period, rather than the determination being entirely 'self-executing' at the start. For instance, Sydney Water's determination provides that its prices will be adjusted during the determination period to reflect changes arising from an in-period IPART assessment of some of Sydney Water's costs that are not known at the time of the determination – i.e. IPART's subsequent assessment of SDP's prices to Sydney Water. That is, the Sydney Water determination provides a methodology or process for prices to be adjusted when future information becomes available on the costs of providing its services.

Therefore, it would seem feasible for IPART's determination to set out specific CPT events and a process for both how it would assess the efficient costs of these events and then pass these efficient costs into prices if these events occur within the determination period.

We seek clarification from IPART on whether it sees any impediments to this option.

6. Funding innovation

6.1 We support innovation funding in the right circumstances

Regulated water businesses should conduct appropriate research to innovate and deliver services that maximise value for customers, as would occur in a competitive market. The regulatory framework should incentivise, but also enable businesses to make savings through innovation (including development and implementation of new technologies) so that they can stay at the ‘frontier’ and achieve the ongoing efficiency savings included in IPART’s expenditure allowances.

In its recent report to IPART, CEPA concluded that one of the emerging practices in regulation is for regulators to support innovation by providing funding and/or resourcing for companies to trial innovative approaches they would not otherwise undertake.² CEPA outlines the examples of Ofwat, Ofgem and the AER providing explicit allowances for R&D and innovation, and of the AER and the Ontario Energy Board (OEB) establishing innovation ‘sandboxes’.

In addition, the Australian Productivity Commission (PC) recently found that economic regulation should allow for R&D investment by water utilities. It considered that statements of obligations on businesses, or similar governing documents, should include an expectation that regulated utilities will invest in research and development activities relevant to their business. This would empower utilities and ensure that economic regulators include associated expenditure when making price determinations.³

These practices of other economic regulators and the PC’s recent findings recognise that R&D can deliver significant benefits to customers over time, through reduced costs, lower risks and/or enhanced services, but such R&D cannot always be directly linked to short-term cost savings or ‘payback’ within a regulatory period. Therefore, appropriate expenditure allowances are important for facilitating such activities.

Other urban water businesses, which are larger than SDP and have a broader range of assets and services, have been able to embed R&D activities in their proposed expenditure allowances. For example, appropriate research and innovation is one of the objectives included in Sydney Water’s Strategic Asset Management Plan and Hunter Water’s 2019 pricing submission noted that it had increased resources to undertake research and strategic planning during the 2016-2020 period.⁴ Such activity is necessary to enhance customer outcomes and provide innovative new services.

Over time, we have identified short-term cost minimisation strategies, or ‘low hanging fruit’, to achieve efficiency savings in operating the plant and pipeline, and these have and will continue to be reflected in our (lower than otherwise) proposed expenditure allowances at price reviews. We are now also focused on identifying activities that reduce risks, enhance services and/or reduce costs to customers over the longer-term. However, identifying these activities imposes a cost on SDP in the short-term, with benefits ultimately flowing to customers through lower costs and/or enhanced services levels in the future.

In the absence of an appropriate allowance for R&D, SDP would be constrained in pursuing such beneficial innovations. This is because SDP is a single asset business, subject to an abatement regime, with no control or certainty over when and how long it operates in certain modes. This means that relative to larger, more diverse businesses such as Sydney Water, we have limited flexibility and scope to pursue innovation

² CEPA, Economic regulation of water utilities –research, Final Report for IPART, 30 June 2020, p 10 & pp 47-49.

<https://www.ipart.nsw.gov.au/files/sharedassets/website/shared-files/investigation-administrative-how-we-regulate-the-water-businesses/legislative-requirements/consultant-report-by-ceda-economic-regulation-of-water-utilities-research-june-2020.pdf>

³ Productivity Commission, National Water Reform 2020 Final Report, 2021, p 214.

<https://www.pc.gov.au/inquiries/completed/water-reform-2020/report/water-reform-2020.pdf>

⁴ For example see: Atkins, Sydney Water Corporation Expenditure and Demand Forecast Review Final Report, 2020, p 56; and Hunter Water, Pricing Proposal to IPART, 1 July 2019, p 29.

in the absence of an appropriate allowance. This suggest that for a business like SDP, there is a case for an explicit R&D allowance.