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Ms Liz Livingstone
Chief Executive Officer
Independent Pricing and Regulatory Tribunal (IPART)
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8 June 2021

Submission on IPART's Regulatory Framework Review – Discussion Paper 1

Dear Ms Livingstone,

Thank you for the opportunity to comment on IPART's regulatory framework review discussion paper on lifting performance of the sector. Sydney Desalination Plant Pty Limited (SDP) commends IPART on its genuine engagement with water businesses to understand the key issues facing them and the water sector more generally.

SDP considers that providing flexibility for customers to negotiate a desired service outcome, providing greater clarity in a few key areas and better alignment across different regulatory processes could substantially lift performance of the sector to the benefit of customers. In our submission we have outlined our views on the issues raised in IPART's discussion paper.

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
Sydney Desalination Plant
[redacted]

SDP submission - IPART Regulatory Frameworks Review - Discussion Paper 1

Lifting Performance of the Sector

8 June 2021

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Iftekhar Omar

General Manager Regulation
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1. Introduction

Sydney Desalination Plant Pty Limited (SDP) welcomes the opportunity to respond to IPART's Discussion Paper *Lifting Performance in the Water Sector*, May 2021 (Discussion Paper). We support exploring further improvements to IPART's framework to generate outcomes that lift the performance of the sector and better promote the long-term interests of water customers.

Our response outlines where we support IPART's preliminary positions, and our suggested additions or changes to IPART's approach.

The direction of IPART's Discussion Paper and its preliminary positions

We support the general direction of IPART's Discussion Paper and its preliminary positions, including:

- A greater focus on the long-term, including strategic meetings between IPART and the regulated businesses mid-way through a regulatory period
- Better consideration of the links between IPART's pricing and licensing functions, and price-quality trade-offs
- Customer choice pricing and negotiated (unregulated) pricing agreements
- Greater pricing flexibility, including as a means to manage some forms of risk
- Establishing a Regulators' Advisory Panel to promote better communication and coordination amongst regulators.

In relation to some of these preliminary positions:

- The licence should be set first and should include minimum performance standards, with greater flexibility provided through the price determination
- Pricing principles can be used to complement and support negotiated pricing agreements, and minimise the need for IPART to intervene in such agreements
- A key focus area for the Regulators' Advisory Panel should be to ensure co-coordination between the Government's strategic water plans and IPART's determination processes.

Necessary additional reforms to lift performance

In our view, this review provides an opportunity for IPART to make further reforms to lift the performance of the sector, including:

- Establishing a clear and comprehensive risk management framework that aims to holistically manage revenue and cost risk in a way that:
    - lowers costs and ensures prices reflect efficient costs, and
    - improves focus on risks reasonably within the regulated utility's control.

- Providing clear, comprehensive and consistent guidance upfront about how it will assess the efficiency of water utilities' expenditure
- Ensuring the incentive or performance measures in its price determinations are consistent with best practice principles, including consistency between its pricing and licensing decisions.
- Reviewing the measures used in IPART's financeability assessment to ensure they reflect the practical constraints and circumstances faced by the regulated businesses, providing greater clarity around how IPART assesses financeability and the processes it will follow if it identifies a financeability concern.

2. A long-term focus

IPART's focus on the longer-term

We support IPART's focus on the longer-term, including its proposals for:

- **Longer-determination periods** – SDP's 5-year period generally provides a reasonable balance of regulatory certainty, a longer-term focus, incentives for pursuing efficiency gains and cost-reflective prices. However, there is scope to increase flexibility to deal with unexpected events within the regulatory period, particularly those that are outside our control.
- **Strategic meetings with IPART early in the regulatory cycle** – this would be a good opportunity to discuss how the determination is performing and what approach should be taken at the next determination.

However, other important measures would aid a longer-term focus and lift the performance of the sector, including:

- **a clear and comprehensive risk management framework** - to allow for the longer-determination periods proposed by IPART, provide appropriate incentives to manage events and risks reasonably within utility's' control and ensure prices reflect efficient costs
- **greater upfront clarity around how IPART will assess the efficiency of expenditure proposals.**

The need for a clear and comprehensive risk management framework

There are benefits from longer determination periods (i.e., beyond IPART's usual 4-years), as they can enhance the incentives for regulated businesses to pursue efficiency gains, promote a longer-term focus for both the regulated business and IPART, and reduce regulatory costs. However, as IPART's Discussion Paper notes, there are also risks that prices become less cost-reflective over time due to a range of unforeseen or uncertain factors. This suggests there are significant benefits to be realised if longer determination periods (5-years) can be supported by a sound risk management framework.

We also note that, in addition to highlighting the importance of risk in considering the length of determination periods, IPART's Discussion Paper recognises that risk is a key consideration in evaluating different forms of price control.

Given the importance of optimally allocating and managing risk between utilities and customers, IPART should establish a clear and holistic risk management framework. This would assist in evaluating appropriate determination periods, forms of price control, cost allowances (including insurance) and any additional compensation or measures required for managing business-specific risk.

A risk management framework

IPART's risk management framework should include:

- a clear process for assessing cost and revenue risks put forward by the regulated business
- principles that determine the appropriate:
    - allocation of risk between the business and its customers

    - compensation or allowance for the business to efficiently manage or bear the risk (where it is allocated to the business)
    - risk management measures to apply in price determinations – including clarity on the circumstances of when and how they would be applied
- a suite of well-designed risk management measures, consistent with the above principles - including measures to account for cost and revenue risks.

These elements are outlined further below.

Elements of a risk management framework

A clear process for assessing cost and revenue risks

A risk management framework should include clear steps for identifying risks, assessing risks, and determining how the regulatory framework should most efficiently address each key risk. This could include, for example, the following steps:

1. Explicitly identify and describe each risk (e.g., each risk relating to forecast cost allowances)
2. Identify the cause of each risk including whether it is systematic or non-systematic and assess its potential impact on the regulated business and its customers
3. Determine the most appropriate cost allowance or other regulatory mechanism for addressing each risk, considering the principles of risk allocation, the impacts of regulatory certainty, the incentives created for the businesses, implications for administrative costs, expert advice and stakeholder views
4. Ensure there is no double counting – e.g., that regulated business are compensated for each risk only once and are not compensated for risks allocated to customers.

Risk allocation principles

Risk allocation principles should be consistent with best practice regulatory principles and include, for example:

- **Risks should be allocated to those who are best placed to manage the risk, to provide incentives for efficient behaviour.** If it is within a water business's reasonable control to manage the likelihood and/or consequence of an event occurring, allocating the risk to the business provides it with an incentive to efficiently manage the risk (provided it receives an allowance to recover the efficient costs of managing or bearing the risk). However, if a risk is not within the business's reasonable control, allocating the risk to it can mean that customers end up paying more than they should (to compensate it for bearing or trying to manage the risk) or service outcomes are compromised over time.
- **The price determination should provide the regulated business with the opportunity to recover the costs of efficiently managing its risk or receive compensation for the risks it bears** – to provide incentives for efficient investment and the delivery of water to customers at prices that reflect efficient costs. For example, prices should allow water businesses to recover the efficient costs of managing business-specific risks (e.g., the costs of purchasing an efficient level of insurance to manage a particular risk) and provide adequate compensation when utilities bear systematic risks.
- **There should be sufficient levels of regulatory certainty and minimal unnecessary regulatory costs** – to provide confidence to water businesses to invest in, and maintain, their assets, pursue

efficiency gains, and innovate over time in the long-term interests of customers. There are benefits from a long-term focus and long-term planning, but this requires certainty about the 'rules of the game'.

- **Risks should be managed symmetrically** – i.e., the allocation and treatment of risk should apply equally to cost increases and cost decreases.

Potential risk management measures

It is important to consider the full suite of options available to manage cost and revenue risk. These include, for example, measures such as the following:

To manage revenue risk:

- **Price caps:** the water business bears volume-related risk to the extent that price structures do not match the business's cost structure
- **Revenue caps:** customers bear volume-related risk, through potential changes to price over the regulatory period
- **Hybrid price and revenue caps**: a price cap may be in place, but measures such as revenue volatility allowances or demand volatility adjustment mechanisms can mitigate risk to the utility of over or under-recovering its efficient costs.

To reflect systematic risks:

- **Rate of return**: water businesses should be compensated for bearing systematic risks through the rate of return they receive on their regulated cost bases, consistent with regulated rate of return principles.

To manage cost risks:

- **Cost allowances:** water businesses should be able to recover their 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). An efficient water business will manage its risks by employing the most cost-effective combination of these strategies.[1]
- **Periodic reviews or adjustments of benchmark allowances:** whereby IPART determines the efficient costs of specified cost allowances within the determination period on a periodic basis (e.g., the cost of debt). This is best suited for costs that are challenging to forecast with certainty. Periodic reviews or adjustments maintain incentives for water businesses to manage risks and ensures prices better reflect the efficient costs of providing services.
- **Cost pass-throughs:** where event avoidance, mitigation, purchasing insurance or self-insurance under ex ante efficient expenditure allowances are either unavailable or inappropriate, then cost pass through mechanisms can be designed to ensure that prices reflect efficient costs without compromising incentives for efficient risk management. We consider there is scope (and precedent within IPART's own regulatory regime) to design such mechanisms to allow for IPART to conduct in-period assessments of efficient costs in response to pre-defined trigger events – thereby ensuring prices reflect efficient costs, the business maintains incentives to optimally manage its risks and costs, there is no undue price volatility, the business recovers its efficient costs and remains financeable.

[1] Australian Energy Regulator 2020, Draft Decision Powercor Distribution Determination 2021 to 2026, Attachment 15: Pass through events, September 2020, p. 15-11.

We note that, in considering how to best deal with risk, a potential reference point for IPART to consider is what would occur in a competitive market. We suggest that in competitive markets, prices would adjust periodically to reflect the efficient costs of providing services (taking into account changes in market conditions), or where there are long-term contracts in place they would contain mechanisms to provide clear ex ante guidance on how terms and conditions, including prices, change in response to certain events. That is, there would be measures in place akin to those listed above.

We also strongly encourage IPART to review its financeability test because it helps to ensure businesses retain reliable access to investment grade debt finance. Ensuring that this test is applied effectively within the regulatory framework will enable businesses to focus on innovating and investing for the long-term interests of customers rather than conserving limited resources to manage financeability risks.

The benefits of an efficient risk management framework

A risk management framework, comprised of an assessment process, best practice risk management principles and a suite of well-designed and applied risk management measures, can promote the long-term interests of customers by:

- ensuring efficient price signals are sent to customers
- supporting efficient cost recovery, financial viability, and access to finance on reasonable commercial terms (as would occur in competitive markets for an efficient firm)
- maintaining incentives for management to optimally manage risks within the utility's reasonable control
- providing clear 'rules of the game' ex ante about how risks will be managed and the process for assessing cost and/or revenue change 'applications'
- minimise unnecessary price shocks at subsequent price determinations or avoid the need to re-open a determination (and the associated regulatory costs)
- enhancing the opportunity for longer determinations, which can strengthen efficiency incentives, promote a longer-term focus, and reduce regulatory burden.

The need for greater upfront clarity around IPART's expenditure review

IPART's Discussion Paper recognises the importance of it providing reasonable levels of certainty to regulated businesses. For example, it notes that the 'strategic meeting early in the regulatory cycle' would provide the regulated business with more certainty, and that separate 'framework' reviews "provide more certainty for businesses in preparing their pricing proposals".

We welcome the strategic meeting early in the regulatory cycle, and we agree that it would be beneficial. However, we also consider it is important that IPART provides comprehensive upfront written guidance on how it will assess the efficiency of water business's expenditure proposals.

Greater upfront clarity from IPART about how it will specifically assess the efficiency of water businesses' actual and forecast operating and capital expenditure would be consistent with good regulatory practice. It would also deliver significant benefits and assist in lifting the performance of the sector.

There are significant benefits from enhanced certainty around how IPART assesses efficiency

At a high level, IPART's principles for assessing the efficiency of expenditure proposals are reasonably clear. However, its detailed approach to assessing efficiency within this general approach remains unclear and can vary across reviews and based on the particular expenditure consultant it uses for a determination. This can create unnecessary uncertainty, regulatory cost, and sub-optimal outcomes. Other regulators – such as the AER – have published documents explaining their techniques for assessing efficient expenditure. This enhances clarity about the 'rules of the game' and is consistent with best practice.

IPART should provide greater upfront written guidance/explanation on the specific process and techniques it will use to assess whether expenditure is efficient, including for example details on:

- the expenditure review process
- the general methodology – (e.g., 'base, step, trend'; or alternative approaches)
- how it will specifically assess forecast capex, forecast opex, and corporate costs
- how it will specifically assess the prudence and efficiency of actual capex incurred over the current determination period (to be rolled into the regulatory assessment base for the start of the upcoming determination period) – to ensure regulated businesses know in advance how IPART will conduct its ex-post capex review.

Such guidance could be part of this framework review. Once established, it would be important for IPART to consistently adhere to this guidance to support stable long-term investments. Refinements, clarifications, and improvements could be made where justified, after consultation with stakeholders.

Such enhanced clarity and guidance would:

- promote both efficient expenditure and investment certainty, consistent with a longer-term focus
- reduce unnecessary regulatory burden and enhance the review process
- minimise inconsistency between expenditure consultants
- provide a consistent base from which IPART could improve its assessment framework over time
- be consistent with good regulatory practice.

3. Understanding price-quality trade-offs

The licence should be set first, followed by the price determination

IPART's Discussion Paper suggested there could be value in reviewing performance standards and prices at the same time to better understand price-quality trade-offs and to take advantage of apparent economies of scope between the two processes.

However, to provide optimal customer outcomes and minimise regulatory costs, performance standards and other licence conditions should be set first, followed by the price determination. This would allow the water business to assess its efficient costs of operating according to defined levels of service within its licence standards. The process of assessing efficient costs is complex. If required levels of service are unclear, the regulated business would need to spend significant time, effort, and cost to both define every potential level of service and the associated efficient costs.

Further, sufficient time is required between finalisation of the licence conditions and commencement of the price review process. The minimum lead time required from finalisation of the licence and commencement of a price review would be 6 months, as the regulated business would be required to consider the impact of the licence on its operations and efficient costs and reflect this in its pricing proposal.

Analysis of potential price-service standard trade-offs should occur outside of a price review. In fact, it is important that regulated business continually have a strong understanding of their customers' preferences, and optimal price-quality trade-offs. Therefore, analysis of price-quality trade-offs should be an ongoing process. However, to allow the regulated business to reflect its service standards in its pricing proposal, mandated service standards for the upcoming price determination period should be confirmed at least 6 months before the price review commences.

This sequencing of standard setting followed by the price review also allows IPART to conduct its review of prudent and efficient costs with reference to confirmed (rather than uncertain) standards, and to consider appropriate incentive and risk management measures consistent with these service requirements.

Therefore, rather than there being economies of scope in concurrent reviews of performance standards and prices, we consider it would create significant uncertainty, regulatory costs, inefficiencies, and lead to sub-optimal outcomes.

Once a licence is finalised, the service standards and requirements in this licence should take effect from the next price determination – unless there are mechanisms in the price determination to accommodate the impact of changes to licence conditions on efficient costs. This would ensure the changed licence conditions are reflected in prices to customers and allow businesses to recover their prudent and efficient costs of licence compliance.

As outlined below, the price determination could accommodate a reasonable level of flexibility in service standards, where this is consistent with customer preferences, but only if there is a mechanism in the determination to adjust prices for changed license conditions.

The role of the licence should be to set minimum standards

The licence should set minimum levels of service, with flexibility built into the price determination to:

- go above these minimum levels where customers are willing to pay, and
- recognise that ideal performance standards can vary over time and by circumstance.

This ensures customers are protected and receive adequate levels of services, while also allowing flexibility and promoting innovation through the price determination or negotiated pricing agreements. As recognised in IPART’s Discussion Paper, this approach would also be consistent with other economic regulatory regimes – including the energy industry, regulated by the AER.

The licence and price determination should also be consistent with one another. For example, SDP’s licence requires it to operate and maintain its assets consistent with Good Industry Practice, and to obtain and maintain appropriate levels and coverage of insurance. The price determination should therefore provide allowances and incentives consistent with these requirements.

Incentive or performance measures must be consistent with best practice principles

To complement licence conditions and drive improved performance, regulators can impose financial rewards or penalties through price determinations that reward businesses for good performance or penalize them for poor performance.

It is important that incentive or performance measures in a price determination are consistent with best practice principles. If not, they can be ineffective and even lead to perverse outcomes that are not consistent with the long-term interests of customers.

We consider that IPART should establish clear principles for incentive or performance measures and apply these principles consistently across price determinations.

A suitable incentive mechanism would meet the following principles:

- **Provide incentives that are in line with the long-term interests of customers**: The scheme should incentivise businesses to pursue innovation through actions reasonably within their control, and not penalise them for events or impacts that are outside their reasonable control. The scheme should not create perverse incentives for the firm that are inconsistent with prudent and efficient investment, maintenance and operation.
- **Be consistent with legislative requirements**: An incentive mechanism in the price determination should be consistent with other legislative requirements – for example, the business’s operating licence or the regulator’s Terms of Reference for the price determination.
- **Be symmetrical**: Incentives should be symmetrical (i.e., reward/share upside and downside equally, where applicable).
- **Be proportionate and timely**: The penalties/rewards should be commensurate to the impact of the business’s performance on its customers, consistent across regulated water businesses, not impose an undue impact or risk on the financial viability of the business, and be applied in a timeframe proximate to performance.

- **Be simple and clear**: Any incentive mechanism or framework should minimise upfront and ongoing administrative costs. In addition, clarity on how the mechanism will be applied would help to ensure that businesses are able to understand and respond appropriately to the incentives created.
- **Provide continuous incentives**: A firm facing a potential efficiency gain should not perceive a material advantage in either deferring or advancing an efficiency gain or loss. The firm should, instead, face an essentially constant benefit or cost from implementing a gain or loss as it arises. The measurement of gains and losses should not be affected by artificial factors such as the shifting of costs between years, but should represent genuine business outcomes that have arisen through prudent and diligent actions by the business.

4. Customer choice pricing

Negotiated agreements can promote innovation, reduce costs and benefit all parties

IPART has now allowed negotiated or unregulated agreements in a range of water determinations, including for:

- large non-residential customers of Sydney Water and Hunter Water
- 'wholesale' water or sewerage customers of Sydney Water and Hunter Water
- recycled water customers of Sydney Water and Hunter Water.

IPART's Discussion Paper recognises the potential benefits of adopting a 'light touch' regulatory approach and allowing more negotiated price agreements to promote innovation and more tailored 'win, win' pricing/service arrangements.

We support IPART's move to allow more negotiated pricing agreements in appropriate circumstances. Such an approach can deliver significant benefits over time, particularly when customers are sufficiently well-informed and capable of effective negotiation going into such agreements.

Negotiated agreements can:

- allow for tailored 'win-win' solutions to reflect the needs and circumstances of individual customers, thus promoting innovation and an enhanced customer focus
- avoid unnecessary regulatory costs associated with trying to estimate the costs of various supply scenarios in advance
- result in more 'accurate' (cost-reflective) prices relative to trying to estimate the costs of various supply scenarios in advance
- ensure a timely response to a customer's supply needs.

For SDP in particular, we note that we are obliged under our lease agreement with the NSW Government to search for third party customers to supply water, and this cannot be practically achieved unless there is flexibility to negotiate a tailored service with a third party customer.

Principles to guide negotiated agreements

Principles to guide or inform negotiated or unregulated agreements can help to provide confidence to customers, stakeholders and IPART that any agreements do not involve the exercise of market power. This would minimise the likelihood of needing regulated prices and encourage the development of tailored 'win-win' solutions without concern that IPART will arbitrarily 'step-in' or override any agreements .

Potential principles could include, for example:

- The services to be provided should be clearly specified
- Charges for the agreed services should reflect prudent and efficient costs of providing those services (including clarity around how they relate to any prices for existing services)

- There should be appropriate incentive mechanisms to ensure that services are provided at or above the required levels, and risk management mechanisms that are clear how prices may be adjusted in certain circumstances
- The costs and revenues of the negotiated agreements should be ring-fenced, until or unless IPART determines they can be passed through to end-use customers.

5. Allowing different forms of price control

Greater pricing flexibility and a tailored approach to each utility

We support IPART's openness to price flexibility, and a tailored approach to match the circumstances of each water business.

For SDP, mode based prices caps, set to match the costs of each mode, are efficient. This is because SDP is most likely to switch between operating modes within the same regulatory year and because the volume of water SDP produces will be variable within operational mode. Corresponding with the different mode and the different volumes of production, SDP experiences different efficient costs (e.g. chemicals and energy use varies directly with the volume of water production).

Price caps dynamically respond to both the mode of production and the variable levels of water production changing within a regulatory year to ensure SDP's price structure and cost structure are appropriately matched.

The need to address risk more holistically

In its Discussion Paper, IPART recognises that the form of price control can be an effective means of managing risk. However, this is just one means of managing one form of risk.

For example, in discussing forms of price control, IPART considers revenue risk. However, it does not consider how to best manage cost risk.

As outlined earlier in our submission, we consider that IPART should develop a clear and comprehensive framework for managing all potential forms of revenue and cost risk.

6. Regulators' Advisory Panel

A Regulators' Advisory Panel (RAP) can deliver significant benefits

We support IPART's proposal for introducing a Regulators' Advisory Panel (RAP), as significant benefits can be achieved through better communication and coordination between key regulators and policy makers in the water sector.

We also generally support the key elements of IPART's outline of how the RAP might work. In particular, we support IPART's proposal that the RAP provides an opportunity for the regulated businesses to present ideas, test assumptions and bring conflicting directions to the attention of the group. We note that it is also important that regulated businesses be given the opportunity to speak at RAP meetings when there are critical issues that may impact them on the agenda.

We also note there may be times where the RAP needs to meet more than twice a year to ensure meaningful improvements in communication and coordination.

We also suggest that IPART makes it clear that the RAP is not intended to be a decision-making forum, but rather a vehicle for sharing information, ensuring better co-ordination and timing of related processes, aligning objectives and identifying any impediments to these objectives.

Below we suggest some focus areas and issues for the RAP to address.

The RAP should align strategic water plans with IPART's determinations

The Greater Sydney Water Strategy (GSWS) will make important decision about the water supply system. It is important that the government's timelines and objectives are well understood by IPART and other regulatory bodies so that they can make decisions that are aligned with those objectives and appropriately factor in the timeframes for decision making.

One of the primary goals of the RAP should be to ensure consistency and alignment between the Government's strategic water plans (including the GSWS) and IPART's pricing and licensing processes and decisions.

IPART should use the RAP to:

- work with the NSW Department Planning, Industry and Environment (DPIE) and other regulators to better align its reviews with the GSWS and those of other key regulators
- ensure its risk management framework allows for in-period changes by other regulators
- ensure its decisions create incentives consistent with the rules and aims of the GSWS.

This would lift the performance of the water sector by:

- ensuring IPART's regulation promotes outcomes consistent with the GSWS and other regulations
- ensuring cost-reflective prices, and
- minimising investment uncertainty, which would otherwise undermine outcomes that are in the long-term interests of customers.