Regulating water businesses

Response to Discussion Paper 3 Encouraging Innovation

25 October 2021

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Executive summary

IPART has proposed a range of far-reaching reforms in its third Discussion Paper. We welcome many elements of IPART's proposed reform agenda. We have been clear since this review began in October last year that we want our next submission to be more customer and performance focused, and more strategic, considering the long-term outlook that our customers face.[1] In anticipation of this, we have requested to make our next submission to IPART a year later than planned, in July 2024.

The goal of reform should be to develop a longer-term approach, more driven by customer needs and a focus on delivering environmental and social value, while driving higher performance through efficiency and innovation

Our view is that customers need more value from the regulatory process. We set out the graphic below at IPART's 21 September workshop to convey the need for change that we require to achieve better results for our customers. Our comments on the existing process are provided in the sub-bullets below each of the headlines:

Focus on the long term

- Information about long-term costs does not significantly inform short-term revenue and prices

Deliver more environmental and social value

- Limited focus on how we promote resilience, liveability, carbon reduction and sustainability

Better understand customers and communities

- No systemic focus on customer outcomes delivered beyond reference to mandatory requirements

Deliver higher performance through efficiency and innovation

- System encourages cost reduction, not cost-efficiency, and does not promote innovation

Financial incentives to deliver outcomes and to support innovation will encourage higher performance and better results for customers

We agree with IPART that strengthening the alignment between our performance for customers and our return to shareholder will enable the regulatory regime to deliver higher performance. We support putting revenue at stake aligned to the outcome delivery incentives that we set. This will help us better meet *all* the objectives we set out above. Developing outcome incentives will be a

[1] We have submitted extensive responses to explain why reform is essential and what it should focus on; notably, our responses in to: IPART Position paper - Regulating water businesses, September 2020, and Discussion paper 1 - Lifting Performance in the water sector, May 2021.

significant innovation and will require an extensive development program. It requires engagement to understand customer value, design outcomes, and calibrate measures and targets, as well as a strong commercial focus to ensure the organisation is focused on meeting those targets.

Setting outcome delivery incentives will require us to identify and measure the value our customers want. The externalities associated with our service provision are significant. As well as affordable bills, our customers and stakeholders have a range of attributes they value such as speed of service delivery (for example, so developers can connect customers in a timely way), clean and healthy waterways, secure water supplies, lower carbon emissions, and the contribution we make for councils and government agencies to liveable communities for local residents (for example, through integrated water cycle management).

To support the focus on long-term planning, performance and innovation, IPART should experiment with a small financial support program for early-stage innovation, as we have been proposing since October last year.[2] We guarantee this will have management attention and we expect any funds to be subject to some form of test, specific approval or competition before they are awarded. This approach to proactively sponsoring innovation is best practice in UK utility regulation. It recognises that regulators need to play their role in unblocking obstacles to utilities changing their cultures. The regulatory cycle does not fit with the innovation cycle and any breakthrough innovations made by Sydney Water will also benefit our peers (and vice-versa).

This is a low-risk opportunity for IPART to help demonstrate its focus on uncovering value as well as revealing lower cost. Since IPART will expect customers to benefit from the fruits of innovation, it is normal that customers should make some contribution to its funding, just like they contribute to funding any other benefit they receive from their utility.

Incentives for cost-efficiency have the potential to benefit consumers, provided they do not arbitrarily reward or penalise Sydney Water for factors outside its control

We agree with IPART that an operating expenditure incentive could in principle strengthen our incentives to find efficiency savings across the period that we can sustain for the long-term, which will benefit customers. Equally, we have a strong and simple incentive to save opex now within period through the hard budget constraint provided by our fixed opex allowance. So, we need to be clear whether customers will be better off on balance before introducing a new scheme.

We are also happy to explore the benefits of a capital expenditure incentive. It is well-known that incentivising more efficient capex without unintended consequences can be a challenge, so we need to be confident the scheme design will support us in driving efficient delivery of our $1bn per annum capital program. Deviations from forecast often arise due to changes in the timing of government, developer, customer or regulatory requirements. We do not have full control of these changes. Any scheme that penalises us if we need to bring forward or increase our capex needs careful consideration bearing in mind that the forecast included in the determination will be a forecast that we developed up to five years earlier based on the information we had at that time. Unless IPART addresses these concerns, it should not proceed. Alternatively, IPART could trial a

[2] Sydney Water, *Regulating Water Businesses - Response to IPART's position paper*, October 2020.

shadow CESS scheme. In this way we can both learn more about the possible effects before a later decision is made on full implementation.

Financial incentives need to be accompanied by procedural reforms that ensure rewards and penalties are credible

Any positive impact from incentive schemes depends on IPART providing clear methods, written in statute, guidelines and/or precedent, that limit its freedom of action at the start of the next regulatory period. Any multi-period incentive will not strengthen incentives if the regulator can make additional changes to cost allowances, rates of pass-through and/or incentive targets for the next period (or if the company believes that it might). If we outperform in the next period, there is otherwise little to stop IPART clawing back that outperformance, particularly when the rewards are not paid out until the start of the next period. A potential solution is for IPART to provide guidelines on its approach to setting incentives and future cost assessment, such as those provided by the Australian Energy Regulator (AER).[3] IPART would then have to justify departures from earlier guidance.

IPART proposes to set a sharing ratio of 20% rather than the 30% used by the AER. IPART says that the incentive should not be "too high" and there is always the risk of "regime changes", so 20% will "ensure the schemes provide benefit to customers".[4] Moreover, 30% may encourage the business to "inefficiently underspend". In the last 20 years, Sydney Water has had *within period*, on opex, a 100% sharing rate. Any opex gains (or losses) within period relative to our opex allowance accrue fully to Sydney Water. Despite this, we overspent our opex allowance by $300m in the last years of the 2016-20 period. This might suggest that even with strong incentives to save, we may have at times pressing customer priorities which lead us to increase opex, despite the incentive to reduce it. Whatever is the correct inference, this is an example of how IPART can usefully engage to ask us what we think, using its extensive historic experience of regulating Sydney Water to inform the discussion. This will give IPART more grounds to be confident that its incentives will have the impact they expect.

IPART appears to convey it is uncertain about the benefits of incentives and that is mainly concerned about the distribution of benefits between taxpayers and customers. A reasonable approach would instead be to focus in the first place on ensuring that there are benefits to be distributed. Having demonstrated that such benefits are available, a focus on their distribution would then be a good problem to have in the next cycle. In the meantime, while we understand the intent of the EBSS to promote sustainable savings for the long-term, our incentives to pursue a shareholder benefit of $1 for every $5 that we save are likely to be dulled if we cannot reliably bank on the shareholder keeping even those savings, due to the risk of further IPART rule changes in the intervening period over which we have no control.

Financial incentives do not by themselves unlock all the levers that we need to pull to become a higher performing business in the public sector ecosystem in which we operate

The longer-term challenges our customers face will not be solved solely by stronger alignment between our financial returns and our service performance. IPART, EPA, DPIE, NSW Health,

[3] Australian Energy Regulator, [Expenditure Forecast Assessment Guideline 2013](), accessed 20 October 2021.
[4] IPART, *Encouraging Innovation in the water sector - Discussion Paper 3*, August 2021, p. 22

Treasury, customers and the state-owned corporations (SOCs) are the main (albeit not the only) players in the NSW water and wastewater sector. The ecosystem in which we operate collectively produces outcomes from which customers benefit. The way this ecosystem operates is a function not just of the formal parameters that underlie the institutional relationships but of the assumptions, behaviours, culture and relationships that have developed between the main players. Regulatory reform should confront this policy co-ordination issue.

IPART has a strategic role to provide challenge as well as support to Sydney Water to help us deliver the best service can over time. Through more engagement, IPART can help us deliver more value as well more cost efficiency, recognising that the building block model culture is weak at encouraging a focus on value.[5] For instance, some of the easiest performance gains available to us may come from IPART, Sydney Water and the EPA working together to help ensure better alignment between environmental and economic regulation. More certainty in environmental requirements, tied to our next regulatory period, would help us plan and commit to delivery of more cost-effective solutions. A financial incentive may not by itself be sufficient to help us achieve our goal of delivering more environmental and social value.

Similarly, as we develop our long-term plan and engage on it with customers and stakeholders, we invite IPART to see our long-term planning process as an opportunity for it to engage in our processes exploring how our long term costs and investment outlook relate to short term revenue and customer bills. Regulating in the long-term interest of customers surely requires a regulatory process which significantly considers long-term costs and their implications.

It is also an opportunity for IPART to experience Sydney Water's governance at work. Effective customer engagement will be significantly assisted by effective long-term planning. Customers cannot help shape the future unless we present credible, costed scenarios to help them respond to the choices we present. All the big choices our customers face will only be delivered in the medium to long-term. Engagement in our long-term planning can also become one means through which IPART can assess its level of confidence in our systems and processes, ahead of a regulatory review. It could even give IPART information and insights to further consider how it can streamline expenditure reviews.

A procedural incentive is a more appropriate and effective reward for the submission of a high quality plan than a financial incentive

IPART should consider the incentives that are most suited to encouraging behaviours that will better align our focus with meeting customer interests. On incentives to make high quality submissions, we do not think IPART has sufficiently considered how it expects to encourage good behaviours or how its proposed solution will interact with the ex post financial incentives it proposes to introduce or strengthen. IPART should explain why it thinks both ex ante and ex post financial incentives are a necessary and proportionate allocation of risk in order to meet its objectives. No other utility regulator in the UK or Australia has reached this conclusion.

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[5] "The building blocks approach can result in a disproportionate amount of attention on the costs and efficiencies of inputs used to produce services, with less specific emphasis placed on the value of outcomes delivered to customers or potential value improvements to customers through more innovative service offerings". Littlechild, S., *Regulation, customer protection and customer engagement*, EPRG Working Paper, 23 June 2011.

The only jurisdiction where the idea of a financial incentive based on plan quality is in place is Victoria, where there is a long-standing culture of competition by comparison between a large number of retail water businesses of similar size with a common owner (the Victorian government). The Essential Services Commission (ESC) was therefore through financial means tapping into a reputational incentive. It found that a new incentive would change behaviour through a concern to protect or enhance reputation, and it thought this incentive would be sufficient to drive better performance, as a natural result of a more customer-centric submission.

Clearly the same market structure and circumstances do not apply in NSW. We do not have the same rivalry with a peer group and our challenges are of an altogether different scale and scope to other NSW water utilities. Our IPART review determines the financial and performance envelope within which we need to operate as a SOC. So, its strategic importance to us is not in question. Putting more of our funding at stake based on IPART judgement in a process where our funding outcomes already depend significantly on IPART judgement is unnecessary. It increases risk to Sydney Water with no incremental benefit to customers. If IPART's concern is to strengthen our performance focus, that will be enhanced by the outcome delivery incentives that we need to propose as part our plan. We will naturally have an incentive to propose outcomes that we think IPART will accept and which require us to aim to deliver higher performance.

If IPART still believes an incentive based on plan quality is beneficial, a better approach would be to give us a procedural incentive, through which a high-quality plan can secure fast-tracking or a lighter touch expenditure review, for some, if not all, parts of the review. In this way IPART can still apply its 3Cs framework to be specific about what a good plan is, holding both IPART and Sydney Water to an objective standard. It can provide a framework for identifying parts of the plan that merit more scrutiny. It may help Sydney Water to target its efforts at delivering analysis and evidence that meets IPART's standards. However, in providing guidance on what a customer-centric plan should contain, IPART should be careful not to send a confused message about the extent to which plans should focus on customer preferences or IPART expectations. They may not always be the same thing.

Reform is a process, not a destination. Focusing on the most material improvements first will lead to better results for customers.

The success of these reforms will be judged by how much the new process contributes to changes in behaviour that lead to better outcomes not just in the next period but also in future cycles in the 2030s. Reform is rarely a one-off event and there are frequently benefits from staggering implementation or experimenting with changes to better understand their effects.

To get the reform strategy correct, it is important to be clear what improvements in behaviours and outcomes we are trying to achieve and how the reform plan meets those objectives. IPART can then consider which areas to prioritise and how to sequence the various components, with some implementation decisions perhaps awaiting further information or the results of experimentation.

Once this review is complete, we will have two years to turn the design requirements into an operationally ready business plan. It will be a huge challenge (both for IPART and Sydney Water) to manage the proposed amount of change in one cycle, with virtually every aspect of the current model slated for a new approach. IPART needs to consider whether all the changes proposed are necessary and capable of smooth implementation in the time available given its objectives. An apparently faster pace of change in the form of regulation may not drive faster change in the customer outcomes, for instance because:

- *Capacity to respond to incentives is finite*: the customer benefit IPART believes will follow assumes behaviour will change in response to regulatory change. Phasing implementation will allow us to focus on responding to and managing risk in the new areas of risk we face.
- *The more the moving parts, the more the potential for rewards and penalties that are not credible:* Sydney Water, IPART and customers have a shared interest in a stable regulatory regime. Identifying the optimal balance between risk and incentives is inherently more challenging the more that novel moving parts are introduced. This heightens the risk of mis-calibrating incentives, which in turns risk undermining the path to reform over time.

These considerations highlight that the more of these schemes and incentives that IPART commits to introduce for this next cycle, the more the risk of unintended consequences or failed implementation. There are alternative, more incremental approaches to reform that IPART can consider that, by definition, will carry less risk, with no reduction in customer benefit. In fact, customer benefits over the medium term are likely to be greater with the approach proposed by Sydney Water.

Whatever options IPART selects, Sydney Water requests visibility as soon as possible about the precise designs that will apply so we can factor in the impacts as we understand them into our business planning.

We do not think that extending the regulatory period to six years will help address the long-term focus that we need to build into the regulatory regime. Long-term focus cannot be equated with longer determinations. We suggest a simple commitment to a five-year term for Sydney Water. The prospect of an IPART-initiated reopener after three years creates the risk of another layer of regulatory engagement which undermines the positive incentives we have to focus on our customers and our delivery over the regulatory cycle. This uncertainty removes any benefit of a six-year term. Five years, without the threat of an IPART-initiated reopener, is the minimum period required to give us time to respond to the determination that IPART will issue in 2025 so that we can then focus on delivery against the performance targets we set ourselves in our 2024 plan.

We are extremely positive about the opportunity that reform presents. We share much common ground with IPART, and we look forward to working closely with IPART as it outlines its plans more fully. A summary of our views in response to key aspects of the Discussion Paper is provided in the table below.

ASPECT	**IPART'S PRELIMINARY VIEW**	**OUR VIEW**
Encourage good proposals	Proposals graded based on Customer, Cost and Credibility underpinned by detailed guidance, with large financial incentives.	Use procedural and reputational rewards instead of financial (such as a fast-tracked expenditure review). Guidance to not be prescriptive.
Expenditure review	Systems, process and strategic planning review two years before proposal. Over time, shift towards expenditure trend assessment and benchmarking.	Accept split review with inclusion of utility's long-term plan, one year before proposal. Predictive modelling and benchmarking used with care.
Customer engagement	Customer engagement embedded in business processes; linked to service levels and the whole plan.	Support. Utility to propose clearly defined outcomes to be delivered to customers.
Regulatory engagement	Regulators Advisory Panel discussed previously, but unclear if still recommended.	Support. Greater alignment and collaboration between regulators will help improve outcomes at lower cost.
Length of determination	6 year with 3-year check-in/IPART re-opener option.	Utility proposes, with 5-year default.
Structure of price control	Utility proposes, option for revenue cap for higher-graded utilities.	Utility proposes, with option for revenue cap open to all.
Long-term costs	Default is expected revenue matches cost within period. Unclear if utilities can propose alternatives.	Utility can propose short-term revenue informed by long-term costs, with potential for bill smoothing.
Within period flexibility	Limited flexibility to address unforeseen costs (cost pass-through for pre-determined events only).	Support proposed changes to cost pass-throughs, but suggest more flexibility is needed, especially if expenditure incentives introduced.
Support for innovation	No explicit allowance for innovation.	Sponsor early stage innovation through a joint fund or scheme for approved projects, or ring-fenced funding with ex post review.
Financial incentives	Opex and capex incentive schemes designed to encourage revelation of efficient costs as soon as found. 80:20 sharing split with customers, capped at ±1% revenue.	We are open to the proposed opex incentive scheme, but do not support a capex incentive scheme at this point in time. If introduced, more consultation is needed on impact and application.
Outcome incentives	Incentives for meeting outcomes determined by utility with customers, capped at ±1% of revenue.	Support.

1 Change, complexity and behaviour

Key messages

- The purpose of reform is to use the power of regulation and incentives to encourage positive changes in our behaviour that better align what we do with delivering more value to customers.
- We agree with IPART that there is plenty of scope for reform that will benefit customers. We are clear that stronger financial incentives are part of that. There are, however, other equally important ways in which IPART can help Sydney Water be higher performing.
- We urge IPART to consider whether the amount of change and complexity it is proposing, including multiple forms of financial incentives, is the right formula at this time.
- The amount and speed of change in regulation has no necessary correlation to the rate of improvement in customer outcomes. Indeed, if the transfers between taxpayer and customers that arise through IPART's various schemes do not appear credible to stakeholders, or do not clearly relate to performance, faith in reform may be damaged.
- There are more incremental reform strategies available to IPART that would reduce financial risk for both the company and its customers, while having a better chance of delivering the changes in behaviour and improvements in customer performance that IPART would like to see.

1.1 Focus change where confidence of positive impact is largest

The proposed changes put forward by IPART in its third Discussion Paper are far-reaching and significant. Implementing a new framework will require both utilities and IPART to develop skills and understanding of how to administer different types of regulatory mechanisms, and to work within a new regulatory environment. However, even if we successfully manage these technical implementation challenges, this is no guarantee of a commensurate improvement in customer outcomes.

IPART appears to assume that the introduction of stronger financial rewards and penalties will, by definition, improve performance. We happen to agree that there is some scope to improve the alignment between shareholder return and delivery of customer outcomes, and that this may lead to better performance for outcomes. However, it does not follow that more financial incentives in all areas of the building block model, introduced all at once, will produce even better outcomes. Money may move around between taxpayers and customers as a result of these schemes, but if those financial transfers cannot be credibly related to improvements or reductions in our performance for customers, this is not likely to improve stakeholder confidence in the regulatory process.

The proposed individual changes borrow heavily from a number of other regulated industries and jurisdictions. However, some elements of the change proposed by IPART are notable. Firstly, as far as we are aware, IPART will become the only utility regulator in UK or Australia which employs significant ex-post and ex-ante forms of financial incentive. It is not clear to us from IPART's proposal why it thinks both forms of incentive are necessary and/or how it believes the two types of incentive interact with each other. Other regulators are apparently content with one or another (see Table 1-1).

Secondly, refinements to incentive regulation in other jurisdictions have developed over time, based on lessons learned from earlier regulatory cycles. For instance, Ofwat's regime has been continually fine-tuned over the last 20 years, while AER first introduced the EBSS about a decade ago, with the CESS following later. This highlights the implementation risk inherent in IPART's plan and whether IPART really understands the possible range of outcomes that could materialise from this sort of big bang approach to reform. We too support radical reform, but we start with a vision of the objectives that we think regulatory reform needs to better address. By contrast, IPART's priority appears to be "lifting performance", with the introduction of four new types of financial incentives proposed as the best way to achieve this.

Table 1-1 Comparative approaches to financial incentives

Suite of proposals	IPART current	IPART proposal	ESC	Ofwat	AER[1]
Ex-ante financial incentives linked to proposal	○	●	●	○	○
Administrative or reputational incentives linked to proposal	○	●	●	●	○
Ex-post outcome incentives	○	●	○[2]	●	●
Ex-post expenditure incentives	○	●	○	●[3]	●
	● In the framework		○ Not in the framework		

[1] The AER is currently reviewing its regulatory framework to encourage better proposals.
[2] Outcomes from the previous review are assessed by the ESC alongside other forward-looking PREMO elements in assessing their return on equity. There are no standalone ex-post incentives on outcomes performance like for Ofwat (ODI) or the AER (STPIS) other than for failure to meet minimum standards (GSL).
[3] Ofwat currently uses a pseudo-totex approach to achieve some of the same objectives as IPART's proposed EBSS and CESS.

We think IPART needs to give more consideration to the likely impact of its proposed financial incentives on behaviour. It can do this by engaging with the companies to better understand their motivations and likely response. All companies are likely to have their own motivations based on a range of factors, including the ecosystem in which they operate. SOCs are in general likely to have a different balance of motivations relative to privately-owned companies. We can detect this in the ESC Victoria reforms, relative to the reforms introduced in environments in which more privately-owned companies are subject to regulation (Ofgem, Ofwat, AER).

Once there is a better understanding of the link between behaviour and incentives, IPART is better placed to consider how much funding to place at risk (that is, how much scope there should be for utility revenue to depart from utility costs). Financial risk exposure has a cost to both the company and therefore to the customers who are served by the company. So, the risk should be targeted to areas where the risk exposure motivates the company to respond, and where it is able to respond.

Exposing the company to risk it cannot manage (for example, exposure to water demand through price caps) is not a good use of the company's risk-bearing capacity. Similarly, introducing the company to many new risk exposures at once may not be in the company or customer interests. While we may want to respond to the full new set of incentives that we receive, it is likely to take time to learn how to do so. Particularly if the new regime coincides with a stressed operational environment (for instance, the onset of drought), the challenges of meeting our basic regulatory obligations, such as good environmental performance, may preoccupy management attention, as was the case in 2018-19.

Table 1-2 Indicative financial scenario ($ millions)

Ex post payouts per annum	Downside risk	Min payout as a percentage of ARR	Min payout as a percentage of Core opex
EBSS	-$26	-1%	-3%
CESS	-$26	-1%	-3%
ODIs	-$26	-1%	-3%
Total	-$78	-3%	-8%
Ex ante payouts per annum			
Proposal rating - standard business	-$26	-1%	-3%
Proposal rating - advanced or leading business	-$58	-2%	-6%
Total payouts per annum			
Standard business	-$103	-4%	-10%
Advanced or leading business	-$136	-5%	-14%
Total payouts for a four year determination			
Standard business	-$414	-4%	-10%
Advanced or leading business	-$543	-5%	-14%

Where the new incentives are complex and interact with each other in ways that can only be appreciated through experience, there is no particular reason to believe that the immediate customer outcome will be beneficial. Table 1-2 attempts to illustrate the maximum downside financial risk that Sydney Water could experience if we do not fare well against the various financial incentives that could apply to us. In a worst case we could forego 5% of our annual revenue on annualised basis or about $100 million per annum from our revenue of about $2.6 billion per annum.[6] As we are largely a fixed cost business, the impact of this loss would fall heavily either on operating expenditure and/or retained earnings.

In such a scenario, the financial outcome for Sydney Water may be deemed appropriate if it broadly reflects poor Sydney Water performance and if we had the same opportunity to earn the equivalent upside. However, there must be a significant chance that one or other of these outcomes arises mainly as a result of external factors outside of our control (for instance, network performance and leakage is heavily influenced in the short-term by soil conditions and rainfall patterns).

Alternatively, we may face organisational learning and capacity issues related to our speed of adaptation to the new financial parameters that we need to work to as a result of IPART's model. Without sufficient opportunity for testing and preparation in advance, prior to go-live in 2025, there must be a real possibility that this situation arises without a more incremental approach to reform.

In the light of these uncertainties, best practice in determining substantial policy change such as that proposed by IPART would suggest some form of cost-benefit analysis should be prepared before final decisions are taken. IPART needs to entertain the possibility that its proposed reforms may not have the effects that they presume will be the case.

In addition, this analysis highlights the importance of the financial caps at 1% of ARR, which are assumed to apply in Table 1-2. It is the behaviour change that IPART is seeking to motivate. It is not *per se* the financial transfers between shareholder and customer that are the main consideration. Lower-powered caps on ARR is another way to proceed to minimise financial risk.

Finally, we note that Sydney Water is currently losing about $70 million per annum as a result of a worst-case outcome from a revenue perspective based on the water demand forecast used to set our customer prices from 2020-24. Once the IPART determination is in place, we have no ability to manage this risk. If IPART plans to expose Sydney Water to more revenue at risk as a result of performance-based incentives in future, this illustrates why it is essential that we move to a revenue cap from 2025.

The presumption with incentive schemes is of course that Sydney Water does have at least *some* ability to control the performance outcome to seek to maximise its revenue. This is not case with price caps, which place control of our revenue outside of our control. If we were to continue with price caps, and to run the risk of a significant revenue exposure due to water demand between 2025-30, the cumulative impact of the total risk to our revenue will be another factor that limits the amount of revenue we can put at stake in performance incentives in the next cycle.

[6] Table1.2 shows a worst case of $136 million but we refer to $100 million for simplicity

1.2 We support strengthened engagement to tackle future challenges

IPART's proposed changes in the Discussion Paper largely focus on technical and process changes to its price review. We recommend IPART also consider how it can continue to strengthen enhanced engagement with other regulators and industry, to encourage cultural change by all parties, and to deepen its understanding of the challenges facing the water industry. This is another way for IPART to tackle the information asymmetry problem.

Seeking opportunities for more collaborative solutions between our economic and environmental regulation presents a key opportunity to promote higher value solutions for customers. We note IPART's proposal in its first Discussion Paper to establish a Regulatory Advisory Panel. We strongly support this idea. It is important for the regulatory framework to facilitate greater coordination across regulators – particularly IPART and the EPA – to ensure economic and environmental regulation work in partnership to encourage the identification of cost-effective solutions that deliver better environmental outcomes. We note that, in recognition of the different drivers they bring, Ofwat is working with the environment agency to promote better outcomes from investment in UK wastewater networks.[7] Each regulator brings its own skill-set and expertise to identify innovative and potentially lower-cost solutions, while also providing certainty from an environmental outcomes perspective.

Continuing the theme of certainty, improving the timing alignment between new or amended environmental obligations and our revenue re-set would assist us to effectively plan and cost the delivery of environmental outcomes. We understand this practice has been adopted in Victoria in the past, via the establishment of an MOU between the economic and environmental regulators.

As an example of the challenge we face, in our 2020 review, while we sought to agree an improvement level with the EPA for our Wet Weather Overflow Abatement Program with sufficient time to incorporate a robust cost forecast in our proposal, in the end we needed to make an assumption around costs (based on delivery of 40 improvement credits). We then had to propose adjusted cost forecasts after the EPA formally advised that 60 improvement credits would be required. If this decision had been made post-determination, we would not have had a chance to adjust our cost forecasts, while still being obliged to meet the tighter environmental conditions. Improved alignment of changes to our environmental obligations – or any other regulatory obligations – would help us to better plan for these costs, and not be potentially constrained by a lack of funding. This is also an example of an area where we are concerned that the introduction of financial incentives for opex and capex could discourage behaviours that are in the long-term interests of customers. If our environmental or other regulatory obligations change within period, we should not be penalised for spending above forecast to meet the new conditions.

We also invite IPART to continue to actively engage with us between reviews, particularly as we develop our long-term plans and conduct customer engagement. This is another way that IPART can build understanding and confidence in our processes and a deeper understanding of the key challenges that we face. We discuss this further in section 5.1.

[7] As noted by David Black, CEO of Ofwat, at the Sydney Water Innovation Festival on 18 October 2021. See: Sydney Water TV 2021, *Day 1: Sydney Water Innovation Festival* (online video), accessed 20/10/2021.

1.3 Structure of this submission

The rest of this submission provides more specific comments on the proposals outlined in IPART's Discussion Paper, as follows:

- Chapter 2: Encouraging good proposals
- Chapter 3: Expenditure and outcome delivery incentives
- Chapter 4: Streamlining the review process
- Chapter 5: Encouraging long-term planning
- Chapter 6: Encouraging innovation
- Chapter 7: Our response to IPART's questions.

2 Encouraging good proposals

Key messages

- We support encouraging high-quality proposals and providing guidance for how proposals will be assessed. It is important to have some clarity on what we all mean by a customer-centric business plan.
- However, in some areas IPART's guidance for customer principles is unhelpfully prescriptive. The more prescription provided by IPART, the higher the risk that IPART guidance conflicts with what customers say they value. This will weaken the incentive on the company to deliver a high-quality proposal that is in the long-term interests of customers. We want to be focused on meeting customer interests, not unduly focused on following the letter of IPART guidance.
- The company also has no means to appeal any decision by IPART to downgrade our rating based on subjective IPART interpretations of how detailed guidance should be interpreted in the context of our proposal.
- This is a compelling argument for simplicity in this type of guidance, a notable feature of the ESC's approach when they introduced this grading idea.
- IPART should also reflect on the respective roles of the Board and the regulator. IPART can comment on how our submission meets its requirements and how well we have justified our performance and expenditure. However, questions such as what level of ambition our plan should target from one period to the next are matters that our Board should determine, without the threat of cost deductions attached to those choices.
- IPART do not explain how the interaction between the proposed ex-ante and ex-post financial incentives will play out. IPART should explain why both sorts of incentives are necessary and proportionate, given the financial and regulatory complexity this creates. We are not aware of any regulator that applies both sorts of financial incentives.
- The only jurisdiction where the idea of a financial incentive based on plan quality is in place is Victoria, where there is a longstanding culture of competition by comparison between a large number of retail water businesses of similar size with a common owner. The ESC was therefore, through financial means, tapping into a reputational incentive.
- If IPART proceeds with a grading scheme for proposals, it should link the reward to a procedural incentive: fast-tracking or some form of lighter touch expenditure review.
- We are pleased that IPART has considered how it can streamline the expenditure review. But, so far, it has not been able to identify any measures that deliver the prospect of a streamlined review in the short term. The reward of a lighter or fast-tracked review is one means to address that gap.

2.1 We are open to the three Cs framework

2.1.1 Guidance should be simple, without directing how customer needs should be met

In our view, the role of the business is to deliver the services its customers value and to be held accountable for doing so. The regulator's role is to assess the effectiveness of the engagement with customers, as part of the package that the utility presents in demonstrating that it proposes to provide what customers want and at a price that they are prepared to pay.

The regulator can helpfully set expectations to encourage the business to provide a great plan. We think IPART's 3Cs framework is an important step forward in this respect. However, there is a risk that the regulator can be too prescriptive and that, rather than simply encouraging good decision-making and governance processes, the regulator tries to impose its view on the nature of the service delivered. This is explicitly recognised as beyond the role of the regulator in other jurisdictions.[8]

When this happens, the regulatory framework risks focusing the utility on the requirements of the regulator, rather than of customers. Regulators are generally less well-placed than the companies to know what their customers want and value and how best to deliver them.

In some cases, IPART's proposed principles and grading rubric in Appendix B do look too prescriptive. For example:

- In Principle 5: Customer choice, IPART notes that to receive an advanced rating, a utility must offer standard add-on options to pricing, giving the example of carbon offsets. This type of tariff offering may not align with customer priorities and should not be a mandatory requirement for an advanced rating.[9] To continue pursuing these offers if customers express little interest in them would be inconsistent with a customer focus. Yet IPART's guidance would risk encouraging us to persist regardless. An appropriate principle regarding tariffs would be that utilities should engage with customers on potential tariff offerings. What the utility then proposes should be a matter for it to decide, considering customer preferences as well as balancing the value of additional complexity and administrative burden with customer benefit. Accordingly, we recommend that IPART remove or revise the guidance for Principle 5.
- In Principle 2: Customer engagement, IPART notes that it expects a leading business to "let go of the keys" when consulting with customers. It is not clear what this means in practice. This appears to be a reference to deep co-design and collaboration in some form, but it presumes that leading businesses should move towards a form of governance model specified by IPART. A better approach would be to expect the business to justify why its approach to engagement was appropriate given the challenge at hand and how it relates to their self-grading. IPART's role, as stated earlier, is to advise on the quality of a submission. If IPART wants to enter the world of conduct regulation more fully, where it

[8] See, for example, Ofwat (2017), Delivering Water 2020: Our final methodology for the 2019 price review, p. 25; ESC, Water pricing framework and approach: Implementing PREMO from 2018, October 2016, p. III.

[9] With regard to the example of carbon offsets, the draft Greater Sydney Water Strategy sets an expectation for the development of Net Zero Carbon Plan for water services delivered to all of Greater Sydney: DPIE, Draft Greater Sydney Water Strategy - Water for a resilient Sydney, September 2021, p. 79. It is unclear to what extent IPART has considered the role of government policy in suggesting this area as an example for opt-in tariffs.

makes financial decisions affecting the company on the basis of how the company develops the price submission, this requires more detailed consideration. The company's Board is much better placed to make these judgements about what is the right for the company at a particular time. It is not clear why financial rewards and penalties should be linked to these decisions made in good faith by company directors.

We request the opportunity to provide more detailed comments on IPART's proposed principles and rubric. We are happy to continue to work in parallel with IPART to identify any areas of concern.

2.1.2 We request clarity on where these principles sit in relation to other guidelines

We request further clarification on how the new principles and guidance will work in conjunction with IPART's existing submission guidelines and wider regulatory framework. At the moment, they appear to be in addition to existing requirements, which risks increasing the regulatory framework becoming increasingly administratively complex.

We also request that IPART provide more information to utilities about how our past proposals would have been graded, especially if IPART proceeds with financial rewards or penalties. An opportunity to engage with IPART individually on this matter will assist utilities to prepare for future price reviews and help guide future self-assessment of our proposal.

2.2 We support procedural incentives to encourage good proposals

IPART does not attempt to explain why a combination of both ex-ante and ex-post financial incentives is required. We are not aware of any other utility regulator that has concluded that both are necessary and proportionate to meet its objectives. The ESC is specifically focused on raising the ambitions of plans to deliver good performance, while AER, Ofgem and Ofwat rely on the power of expenditure and outcome incentives to encourage higher performance.

There is potential overlap between the ex-ante and ex-post incentives which IPART appears not to have considered. For instance, the ex-ante incentive discussion refers to the utility securing a higher grading through delivering a 5% improvement in customer value per year, measured in some way that is not entirely clear. This sounds like a performance criterion. Performance is already planned to be incentivised by the outcome and expenditure incentives, so it is not clear what additional value this 5% criterion is supposed to add. The discussion about the level of ambition in the outcome incentives will take place in that area, prior to IPART approving the outcomes in its determination.

From Sydney Water's perspective, we will always submit the highest quality plan that we can, given the importance of the IPART review to securing the funding that we require. Additional outcome incentives will clearly raise the financial stakes in our submission. Therefore, it is hard to see what additional motivation will be provided by an ex-ante financial incentive. We will already be highly motivated. We have always provided submissions that have met IPART's guidelines, and we expect to continue to do so in future.

In addition, IPART does not explain why an adjustment to the Annual Revenue Requirement (ARR), rather than return on equity, is a better approach. An adjustment to the ARR means IPART proposes to threaten to disallow costs that it would otherwise deem as efficient simply because its rating is lower than the utility's self-assessment. This will be hard to explain to customers who suffer poorer service as a result. Furthermore, a percentage of ARR is not necessarily a fair or practical metric to use. For instance, a large portion of our costs are uncontrollable, such as bulk water costs. In our view, it would not be sensible to threaten to deny funding for a percentage of these costs, given they are connected to our fundamental purpose to meet our legal and regulatory obligations.

By comparison, the ESC's focus on return on equity is more logical. Return on equity is a metric closely related to profitability. Movements in return on equity should send a signal to shareholders about business performance, and as such, it is a more intuitive metric to bring into play than ARR if the purpose is to simulate rewards in a competitive market.

If IPART still believes an incentive based on proposal quality is beneficial, we would support procedural incentives such as a commitment to a lighter-touch efficiency review process if our proposal is highly rated. We consider that reducing the administrative burden of reviews for higher quality proposals would deliver similar benefits to the inclusion of financial incentives. Furthermore, as a SOC, we strongly value our social licence to operate with our community and other stakeholders. The reputational effect of publicly scoring a good / poor proposal will also incentivise high-quality proposals.

These non-financial means are a more appropriate way forward than the threat of (dis)allowing a percentage of allowed revenue that IPART regards as efficient. When considered against the suite of changes IPART is proposing, it is unclear whether financial incentives simply pose unnecessary risks to customers and our shareholder.[10] In looking to other jurisdictions in Table 1-1, in light of the package IPART is proposing, we conclude that attaching financial incentives to the quality of regulatory proposals is not a priority reform area.

If IPART proceeds with financial incentives for grading, we request clarification on several areas:

- The Discussion Paper contains potentially confusing statements about the starting point for Sydney Water in the first round of the regime. Page 13 notes that all business proposals will be assessed from a starting point of standard, while page 15 includes comments about a "higher starting point" for Sydney Water and Hunter Water.[11] We understand from discussions with the Secretariat that all utilities would have an initial starting point of standard

[10] In principle, financial incentives could strengthen our incentive to put forward a better proposal. However, we are unaware of evidence that suggests the benefits of financial incentives will elicit a stronger response than what higher administrative and reputational incentives could achieve. If true, the financial reward or penalty to a business will come at a cost (a wealth transfer) to our customers or shareholder. This wealth transfer will be arbitrary; it is disconnected from the service customers receive and from additional benefit to the quality of proposals above administrative and reputational incentives. Putting customers' money – especially such a large amount of it – at risk without this evidence is contrary to the customer focus we are trying to achieve in the regulatory framework.

[11] IPART's Discussion Paper Encouraging Innovation, page 15 states that "We anticipate Sydney Water and Hunter Water would work to achieve a grading of advanced in their next pricing proposals, at a minimum. We propose this higher starting point for these 2 businesses given their size, services delivered and sophistication (based on our analysis during, and the outcomes of, recent expenditure reviews).

- Will the grading incentive be based on a percentage of total revenue across the regulatory period, or a percentage of the average annual revenue requirement? The Discussion Paper is ambiguous on this matter.
- How will IPART measure its proposed minimum threshold of 5% customer value per year (page 14)? And would this be measured cumulatively? If so, this would suggest delivery of a 30% change in customer value across IPART's proposed 6-year regulatory period, which appears to be an unfeasibly large change. And would a similar gain in value be needed in the next regulatory proposal in order to sustain the higher submission grading?

2.3 A revenue cap should be available to all businesses

IPART proposes that a revenue cap is available to businesses with a grading of advanced or leading. We consider that a revenue cap should be an option for all businesses, regardless of grading.

In general, we agree that regulation should be tailored to the scale and sophistication of the business. However, for the form of price control in particular, revenue and price cap regulation exist to ensure that businesses receive the revenue they require to operate efficiently. The question of which form of price regulation to adopt relates to how to best deal with volume risk. It should not be a reward for, for example, having better customer engagement.

For the reasons we laid out in our response to Discussion Paper 1,[12] a revenue cap provides the most appropriate form of price regulation in industries which rely heavily on fixed assets. This is the case for Sydney Water. We intend to propose a revenue cap at our next review.

[12] Sydney Water, Response to Discussion Paper 1 - Lifting performance in the sector, June 2021, pp. 21-23.

3 Expenditure and outcome delivery incentives

Key messages

- Strengthening incentives to perform well for customers is a key part of this reform package. In that context, we believe developing a set of outcome delivery incentives is the cornerstone of these reforms. These outcomes will require significant design and development, and a new commercial focus to ensure we mobilise to target delivery of outstanding performance.
- We recognise the case for reforming expenditure incentives, as well as for putting in place outcome delivery incentives. It is true that the incentives to save across regulatory periods can be strengthened, although we should also acknowledge that within period, we have strong incentives to save cost right now.
- Nonetheless we are happy to work with IPART to explore the introduction of EBSS. While IPART has already helped us to understand how it intends to apply EBSS, this needs much further consultation. Multi-period incentives are inherently more complex to manage than the status quo.
- There is a risk of unintended consequences unless IPART provides binding guidance on how it will operate the scheme across regulatory periods. If IPART can change the rules or operation of the EBSS at any time, clearly this will limit the scheme's positive incentive properties.
- We are concerned about the absence of complementary measures to manage cost risk and add unforeseen costs to the regulatory allowance. This risks penalising us for material increases in efficient costs within the regulatory period.
- We are less certain of the value of a capital expenditure sharing scheme. We would prefer to retain the status quo or for IPART to set up a trial or shadow scheme so we can better assess its likely effects. While we acknowledge there may be scope to encourage more efficiency in the management of our $1bn per annum capital program, it is well-understood from international experience that incentivising efficient delivery of capex without the risk of unintended consequences is a significant challenge.

3.1 The current model encourages us to make cost efficiencies

Before considering fundamental change to the expenditure incentives under which the company has operated since its creation as a SOC, it is useful to understand the current incentives that apply and govern our expenditure now.

The current model encourages us to live within the operating allowance we are granted for each year of the period. If we spend less than our allowance within period, we keep 100% of the gain in that year. Likewise, if we overspend against it, as happened in the last period, our shareholder bears 100% of the additional cost. On capex, we are similarly only given the financing cost that corresponds to the capex allowance we are granted for the period. If we want to spend above that allowance, the shareholder bears the additional financing costs and any additional capex is subject to ex-post review by IPART.

This approach means we are encouraged to reveal our actual costs (to gain the efficiency reward, at least for the rest of the period). Revealed costs are used by the regulator to set the baseline for costs in the following regulatory period. There is no incentive on firms to increase costs so as to influence the assessment for next period's baseline, because of the likelihood of generating a large in-period loss, and the fact that IPART has scope to reset the baseline based on all relevant information (not just in one particular year).

In 2016, IPART introduced an Efficiency Carry-over Mechanism (ECM) designed to encourage us to make permanent reductions in operating expenditure, recognising that in theory our incentive to make savings declines towards the end of the period. We did not make an ECM claim in our 2020 proposal. We overspent our opex allowance for 2016-20 in response to the prevailing drought and because of our need to respond to our worsening environmental performance.

3.2 IPART proposes to strengthen incentives to find more efficiencies

IPART is proposing to introduce:

- an opex efficiency benefit sharing scheme (EBSS) and a capex expenditure sharing scheme (CESS). The objective of each scheme is to increase the incentive to find savings across regulatory periods and in the case of EBSS, to provide the process of setting the operating cost allowance more linked across periods.
- a service level incentive scheme, similar in design to Ofwat's outcome delivery incentives (ODIs). The ODIs would tie financial rewards and penalties to the customer performance outcomes that businesses propose that align with outcomes that are valued by customers.

IPART notes if we had service incentives without corresponding incentives to reduce costs, there is a risk a reputationally sensitive business would over-invest on performance. However, it is worth that in the current model since the shareholder would have to fund 100% this "over-investment", the incentive to do that is strongly mitigated if the company is spending close to its allowance.

IPART also argues that implementing incentive schemes in a piecemeal fashion with inconsistent incentive rates (both the sharing rates, and the timing of payouts) creates distorted incentives. To this end, IPART is proposing all mechanisms (EBSS, CESS, ODIs) have a flat 20% sharing rate between the business and its customers, calculated using a 'NPV' approach.

While this may be true in some theoretical sense, the importance of this alignment is overstated. As an example, performance under the ODIs will in many cases not be fully controllable. For instance, the onset of drought will make it more challenging to maintain leakage performance and work against achievement of an ODI leakage target. Management will be responding to these external factors to try to maintain and improve performance, with a limited number of levers available. The idea that we can in some sense "arbitrage" these targets presumes that in managing a physical network we have the real time information and perfect knowledge of a range of interventions and their cost effectiveness to make that calculation (even if we were motivated to do so). Interventions to improve performance do not in general have such simple, predictable impacts on actual performance in the way IPART imagines.

3.3 We support elements of IPART's proposal

We recognise there may be scope to strengthen incentives and we acknowledge EBSS appears to be well-accepted in the energy sector. However, introduction of EBSS would be a substantial change. We and IPART will both need to develop our skills and understanding of how to administer and work within the changing environment that an EBSS regime will bring. We do not want the effectiveness of new schemes to be undermined by inadequate preparation or a failure to identify upfront any unintended consequences. While the AER's experience is hugely informative, the way that the schemes work will be determined by the detailed rules, mechanics and forward put in place by IPART.

The key feature of these expenditure schemes is that expenditure in one year, relative to the IPART allowance for that year, has direct multi-period impacts on future expenditure allowances (both in the rest of the period and in future periods). This is unlike the current situation, where expenditure in any given year has no direct, mechanical impact on future year allowances. This may well have some positive benefits, but it is certainly more complex than the status quo from the point of the company planning its financial outlook.

With this introduction and as explored in the following sections, our preference is that IPART:

- focuses on the introduction of ODIs and EBSS scheme first.
- does not implement the CESS at this stage – instead we would prefer to retain the status quo or trial a shadow scheme.

3.3.1 We prefer to retain the status quo or trial a shadow scheme for capex

We see potential merit in each of IPART's proposed schemes. However, the schemes have not been fully developed or tested individually and as part of the suite of changes IPART has proposed.

It is conceptually challenging to find an effective mechanism for encouraging efficient capex. Capex poses the following challenges:

- only a small proportion of capex could be classed as recurrent expenditure
- by its very nature, it has long-term effects and the need for capex is challenging for regulators to establish without a very detailed understanding of the assets
- in general, capex is lumpy and forecasting quality (cost and timing) deteriorates as the time horizon increases.

The AER introduced its CESS in 2015 in an attempt to provide incentives to networks to reduce capex and provide equivalent incentives to those for opex reduction. As a result, there has only been one round of regulatory decisions that features CESS payments.

We understand stakeholders have expressed concerns the CESS provides incentives for regulated businesses to overestimate capex and subsequently receive a pay out when they come in under the allowance.

While there may be positives from encouraging a stronger focus on forecasting, the CESS appears to emphasise the importance of deviations from the year-on-year capex forecast included in the determination. This would be a significant change and may not incentivise desired behaviours. Such deviations occur for many reasons, including new information that we did not have when the forecasts were set, such as changes to the timing of government, developer or regulatory requirements. The proposed scheme also appears to be more penal than our current framework if we under-estimate our capex requirement, so we are less likely to be happy proposing a higher level of risk for ourselves regarding the capex proposed to be included in prices.

For example, in the past two price reviews, we have used a more conservative or risk-adjusted growth forecast than that provided by the Department of Planning, Industry & Environment (DPIE) in the capex forecast proposed to be included in prices. This was to ensure that customers do not fund upfront investments which may be deferred if growth slows down. Under this approach, if DPIE's forecast materialises, we are not funded up-front through prices, and we also would wear the financing costs for any required expenditure within the period. Under IPART's proposed CESS, we would be dis-incentivised from engaging in such behaviour. Rather, customers would wear more risk through prices.

Given the infancy of the CESS and the lack of evidence it drives the correct behaviours, we would prefer IPART retains the status quo or trial a shadow scheme at this time.

3.4 We request further detail on the design of the schemes

So far, IPART has worked closely with us to help us understand the schemes. However, we still have insufficient information to make a well-informed decision on their effectiveness. We request further consultation to understand the three schemes and their application in practice.

To appropriately evaluate these schemes, we consider there is a need for IPART to establish clear guidelines and methodologies on the aspects of the framework. Some further areas to clarify – as the schemes are developed in more detail – are outlined below.

3.4.1 Cost recovery schemes

IPART's EBSS requires the businesses to closely match expenditure with its proposal. We consider that complementary measures to manage cost risk and add unforeseen costs to the regulatory cost allowance are essential. We understand regulators such as the AER have more mature contingent cost mechanisms to address this. We explore this in our recommended adjustments to cost pass-through criteria in section 5.5. Without them, we would be concerned that businesses could be inefficiently rewarded or penalised (above the unders and overs in the current building block model) for material changes in efficient costs that are beyond the business' control to forecast at the time prices are set.

Without measures to manage cost risk, we would have been further penalised in 2016-20

2016-20 was a particularly challenging period for Sydney Water. We overspent our:

- opex allowance by $305 million (2019-20 dollars) responding to water quality issues due to bushfires, drought conditions and deteriorating environmental performance, the impact of which, was greatly exacerbated by extremely dry soil conditions.
- we overspent our 2016-20 capex allowance by $654 million (2019-20 dollars) responding to higher than determined growth.

The overspend was:

- unforecastable at the time we submitted our 2016-20 proposal, unless we had assumed our 'most likely' forecast was based on a relatively extreme set of unpredictable factors like weather. We do not forecast on this basis and do not believe IPART would not have accepted such a forecast in any event.
- uncontrollable, in that it drove a higher than expected workload.

As shown in:

- Figure 3-1, if IPART's EBSS was in place, the $305 million overspend in 2016-20, would have resulted in our 2020-24 revenue requirement being reduced by $338 million uncapped or per IPART's proposal, approx. $100 million capped.
- Figure 3-2, if IPART's CESS was in place, the $654 million overspend in 2016-20, would have resulted in our 2020-24 revenue requirement being reduced by $59 million.

That is, if an EBSS and CESS had been in place in 2016-20, not only would Sydney Water have borne the costs of the 2016-20 overspend, IPART would have reduced our 2020-24 revenue. We believe this revenue reduction would have been unreasonable, as the capex overspend was subsequently reviewed by IPART's efficiency reviewers and assessed as efficient. We believe our opex overspends were also efficient. In addition, shareholders bore the pain of the overspend.

IPART's EBSS and CESS would have given us a much stronger incentive to stick to the allowance, regardless of whether spending more was efficient. The threat of penalty would have further discouraged us from investing during 2016-20 despite it being in the best interest of our customers. Therefore, we question whether the proposed EBSS and CESS drives the correct behaviours when faced with unforecastable events that occur during a regulatory period. Rather, a possible outcome may be that the schemes strengthen the incentive for businesses to build large cost contingencies into their expenditure forecasts – to ensure they do not overspend. We hope this is not the case but would like to discuss these potential implications.

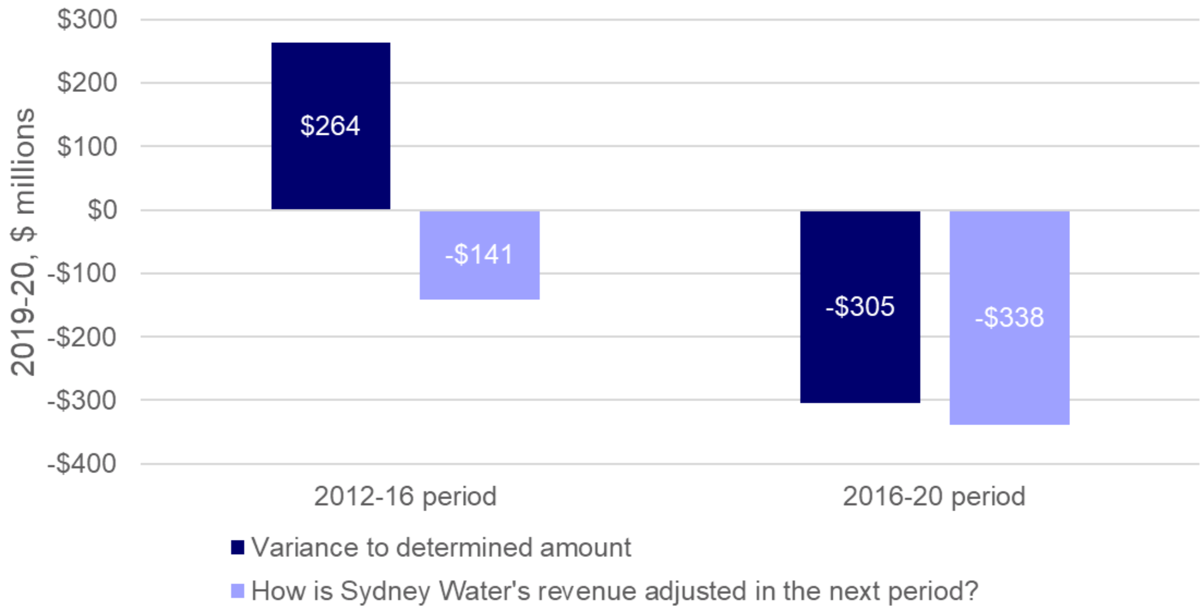

Figure 3-1 Sydney Water’s uncapped EBSS outcomes for 2012-16 and 2016-20

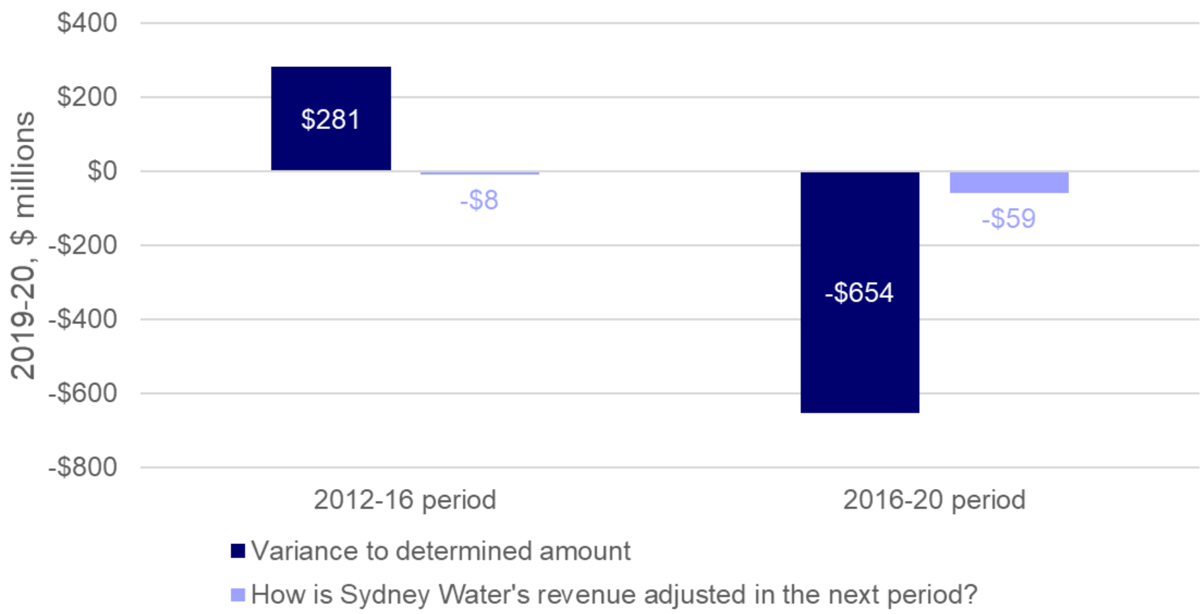

Figure 3-2 Sydney Water’s uncapped CESS outcomes for 2012-16 and 2016-20

3.4.2 Setting the opex allowance for future periods

The EBSS and CESS models provided by IPART have helped us understand IPART’s thinking to date. However, such models have limitations. The effectiveness of the EBSS and CESS will depend on the precise application of other aspects of the regulatory framework.

In this section, we focus on the EBSS, as we have additional concerns about capex (see section 3.3.1). In particular, the approach IPART will take in setting opex allowances for future regulatory periods will have a significant effect on the incentives we face from the EBSS.

We understand that IPART is proposing to have significant discretion in determining opex allowances, informed by base-step-trend analysis, benchmarking and the efficiency review. We would appreciate further consultation with IPART to understand the methodology through which IPART will set the opex allowance for future regulatory periods.

Consider a simple example. IPART sets an allowance of $100 per annum for the first regulatory period, and we incur a temporary overspend of $4 in the last year of that period. Using IPART's model, as shown in:

- Table 3-1, if IPART sets our opex allowance for the second regulatory period equal to the last year actual of the first regulatory period ($104), our net position is -$0.1. That is, in the first period, we bear the loss of the temporary overspend of $4 in year five per the current expenditure incentives. However, the EBSS also leads to a reduction in our revenue allowance for the second period of $16.8. As for the second period, if IPART uses last year actuals ($104) to set allowances, we would underspend by $4 in each year of the period ($20 over the 5-year period). This would result in an increase to our revenue allowance for the third period by $0.7 due to the EBSS. Over these three periods, our net position would be -$0.1.
- Table 3-2, if IPART sets our opex allowance for the second regulatory period to (say) $100 via an efficiency review process, our net position is -$20.8. In contrast to the above example, for the second period, by setting our opex allowance to $100, Sydney Water would not receive any in-period opex underspend benefit, nor any EBSS benefit in the third period flowing from that underspend. Over these three periods, our net position would be -$20.8.

This example shows IPART's decision on how it sets the opex allowance for the second regulatory period significantly affects the outcome. If IPART were to adopt the EBSS in the next period, we question which of the approaches sets the correct multi-period incentive for the business to seek efficiencies.

IPART needs to establish clear guidelines and methodologies before it implements its EBSS. The example in these tables helps to illustrate why the results the EBSS model produces are not simple to understand, rationalise and interpret. If we are not able to anticipate how our in-year expenditure affects our future allowances, then none of the positive incentive properties of the scheme will apply in practice. This particularly applies to understanding how the calculations and rules across *across* regulatory periods, when the expenditure allowances are completely reset.

Table 3-1 The effect of IPART setting baseline allowances using year 5 as baseline on the incentives given by the proposed EBSS

	Regulatory Period 1						Regulatory Period 2					
Year	**1**	**2**	**3**	**4**	**5**	**Total**	**6**	**7**	**8**	**9**	**10**	**Total**
Discount rate	4.0%	4.0%	4.0%	4.0%	4.0%		4.0%	4.0%	4.0%	4.0%	4.0%	
Opex allowance	100.0	100.0	100.0	100.0	100.0		104.0	104.0	104.0	104.0	104.0	
Actual opex	100.0	100.0	100.0	100.0	104.0		100.0	100.0	100.0	100.0	100.0	
In-period variance	0.0	0.0	0.0	0.0	-4.0	-4.0	4.0	4.0	4.0	4.0	4.0	20.0
EBSS adjustment to next period revenue allowance						-16.8						0.7
In-period net gain/loss						-20.8						20.7
Net gain/loss over both periods												-0.1

Period 2 allowance set to final year in period 1

Causes in-period underspend of $20m in period 2

No impact on Sydney Water after two periods

Table 3-2 The effect of IPART setting baseline allowances using other years as baseline on the incentives given by the proposed EBSS

	Regulatory Period 1						Regulatory Period 2					
Year	**1**	**2**	**3**	**4**	**5**	**Total**	**6**	**7**	**8**	**9**	**10**	**Total**
Discount rate	4.0%	4.0%	4.0%	4.0%	4.0%		4.0%	4.0%	4.0%	4.0%	4.0%	
Opex allowance	100.0	100.0	100.0	100.0	100.0		100.0	100.0	100.0	100.0	100.0	
Actual opex	100.0	100.0	100.0	100.0	104.0		100.0	100.0	100.0	100.0	100.0	
In-period variance	0.0	0.0	0.0	0.0	-4.0	-4.0	0.0	0.0	0.0	0.0	0.0	0.0
EBSS adjustment to next period revenue allowance						-16.8						0.0
In-period net gain/loss						-20.8						0.0
Net gain/loss over both periods												-20.8

Period 2 allowance set via efficiency review to (say) $100

No variance to allowance in Regulatory Period 2

Sydney Water loses $20.8, because of, temporary $4 overspend in one year

3.4.3 Calculation method and sharing rates

IPART has proposed a present value approach, where the business will retain 20% of the present value of the gain or loss per year in perpetuity. IPART states the:

- power of the scheme doesn't change over time as interest rates or the length of the regulatory period changes
- scheme addresses any 'edge' cases where the business may be able to 'game' incentive schemes
- 80% sharing ratio is appropriate because it:

- balances the need to incentivise behavioural change without creating an incentive for the business to inefficiently underspend.
- ensures the schemes provide benefit to consumers.
- is broadly consistent with the current real rates of return.

Noting the AER has chosen a calculation method whereby the business retains the gain or loss in a year for a fixed period of time, we are unsure whether IPART's proposal that customers benefit into perpetuity has been properly considered, tested and proven to be the most fit for purpose solution. While the outcome may be somewhat similar in NPV-terms depending on the discount rate, we query whether the AER approach is more appropriate.

3.4.4 Potential overlap between ex-ante and ex-post incentives

We would also like to clarify whether there is any overlap in the financial incentives created by the proposed ex-ante and ex-post schemes. We understand that the ex-ante incentives are generally intended to benefit utilities that propose ambitious targets for expenditure outcomes but are unable to achieve those targets (leading to an overspend) and vice versa. However, if a business' performance on cost outcomes in a previous period are used to inform the grading of the business in the next round, businesses may be rewarded or penalised twice. Has IPART considered how these incentive schemes will work together in practice?

3.5 We support greater focus on customer outcomes

We support the regulatory framework having a greater focus on customer engagement and outcomes. Public reporting of performance against these outcomes, measures and targets are important for businesses to be held accountable to their customers. We are also open to expenditure incentives aligned to outcomes proposed by the utility. Tying this performance to small financial rewards and penalties will help sharpen the attention of businesses to delivering these outcomes where they are in the best interests of customers.

We support a cap on all outcome incentives of 1% of the ARR, noting that Sydney Water will calibrate the proposed rewards and penalties on each individual outcome at subsequent price reviews.

However, we consider businesses should have the flexibility to propose when they receive the ODI rewards or penalties. Irrespective of IPART's proposed EBSS and CESS, if a business overspends during a period to prioritise service quality improvements, it bears the loss during those years. We see no increased incentive for businesses to inefficiently prioritise service quality improvements by allowing in-period payments. Rather, rewarding a business for improving service quality during the period will strengthen incentives to improve performance efficiently as it will immediately offset the higher costs of delivering that higher service quality. Also, from a customer perspective, where their experience fluctuates from a business' performance in-period, it makes sense that their bill reflects that level of service.[13]

3.5.1 Towards an outcomes-based price proposal

Moving to an outcomes-based price proposal will be a major cultural shift for both utilities and IPART, which we strongly support and are committed to. However, it will also require a multi-staged, iterative process to develop customer outcomes, measures and targets, which we anticipate will need significant time and resourcing.

In our preliminary view, developing an outcomes-based price proposal will involve several steps – some of which may take a couple of months to complete in themselves, as well as requiring a significant amount of pre-work internally (see Figure 3-3). For example, the business will need to form an understanding of customer priorities and preferences through robust and comprehensive customer engagement. The business will also need to develop key customer outcomes and define performance measures and targets under each outcome. Different delivery options, including key activities and expenditure, can then be explored to establish a plan for outcome delivery. Finally, performance should then be tracked throughout the regulatory period to ensure that progress is being made against customer outcomes and targets.

In practice, this process will involve iteration between steps and ongoing feedback loops. For example, early costings of delivery options may be used to inform willingness to pay. But we may then need to return to customers with updated costings, or to put options within the context of overall bill changes later in the process. These steps and iteration points will need to be worked out in more detail over time.

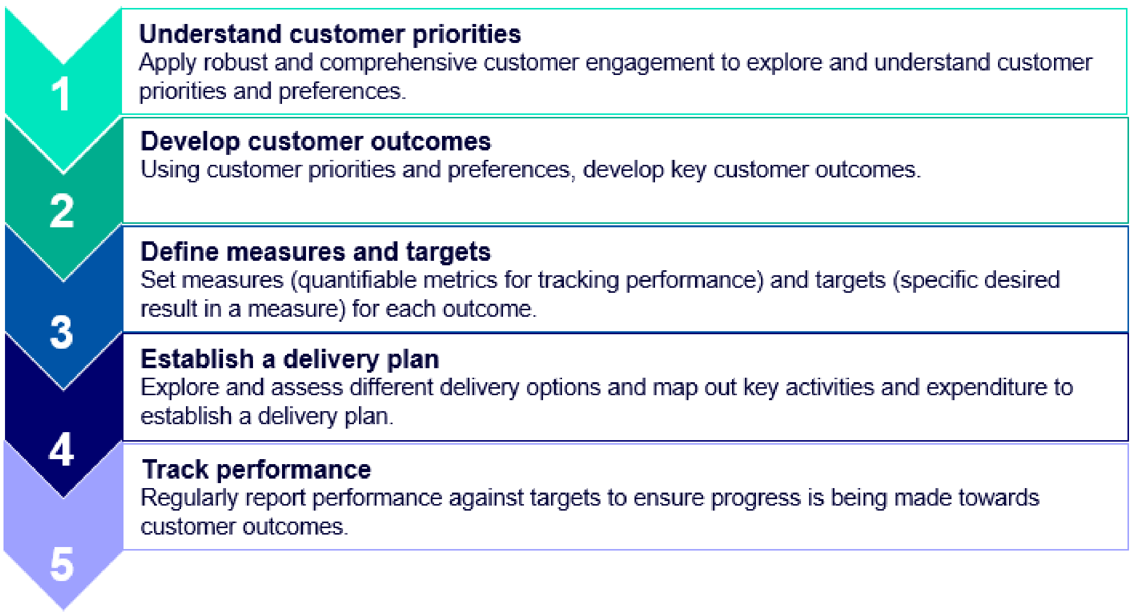

Figure 3-3 Indicative steps in developing an outcomes-based price proposal

[13] These are the reasons Ofwat adopted this approach in PR19: Ofwat (2019), PR19 final determinations: Delivering outcomes for customers policy appendix.

In other jurisdictions, utilities have followed a similar process in moving towards more outcomes-based price proposals. The experience of most Victorian utilities under the Performance, Risk, Engagement, Management and Outcomes (PREMO) framework, for example, has been to establish broad, deep customer engagement programs between one to two years to understand and define key customer outcomes, before determining levels of service and key activities for outcome delivery and defining measures and targets to track performance. In the UK, utilities have similarly developed outcomes and performance commitments to establish ODIs, through extensive and iterative customer engagement programs and research.

4 Streamlining the review process

Key messages

- We welcome IPART's initiative to streamline the review process to reduce the regulatory and administrative burden on utilities.
- However, at least in the short-term, IPART's proposals appear to result in very little streamlining. Rather, the proposals largely seem to require work that will be additional to current requirements. When combined with the rest of the IPART package, IPART is proposing a significant increase in the amount and complexity of regulation to which Sydney Water will be subject.
- IPART's logic appears to be that it can only justify lighter touch expenditure reviews if it has hard data (models and benchmarking) as a basis to make decisions. An alternative approach is to engage more with our governance processes (such as our review of our long-term plan) as one input for IPART to establish confidence in our processes, and that they consider all relevant data and apply robust scrutiny and challenge.
- We are happy to work with IPART on benchmarking studies and predictive models, where it is within our capacity to do so. We currently use predictive models to forecast some of our capital expenditure, such as renewals. Benchmarked data may have some specific uses in regulatory reviews, but cross-jurisdictional comparisons generally need to be considered with great care.
- Given the need to always consider the local context, it is probably an illusion that such models could be developed to the point that IPART could primarily rely on them to demonstrate the efficiency of Sydney Water's plan in its entirety. Without sufficient comparators, over-reliance on benchmarking poses a significant risk of drawing the wrong conclusions and distorting the regulatory process. Sydney Water does not have peers where local conditions, size and scope are sufficiently similar to provide a sufficiently large, relevant and comparative dataset.
- We are generally supportive of using a base-step-trend approach for operating expenditure, noting that this does not appear to significantly differ from IPART's current approach.

4.1 We support further streamlining to the review process

IPART proposes to undertake a review of systems and processes, which we expect to focus on capital and asset management and planning, around two years before a proposal is due. A review of our systems and processes currently occurs within the first day or two of the efficiency review.

We are happy to support the proposal to separate a review of systems and processes. This is a sound move that would assist IPART move towards a lighter touch form of regulation, where justified.

IPART's proposed review of systems and processes occurs at the same time as IPART's proposed mid-point check in. This timing suggests that a utility will be in some form of review cycle for almost half of its determination length (preparing for or participating in a review process).

We believe the review process could benefit from being streamlined in other ways. As discussed in chapter 5, our proposal is to have a default five-year determination with no mid-point check in and for the system and processes review to also cover a review of our long-term plan. If IPART is assured of the robustness of our systems, processes and long-term planning, and finds the utility's proposal is of a high quality, this could then lead to a procedural incentive of a lighter-touch or fast-tracked efficiency review. This provides a more immediate reward than IPART's suggestion that a positive finding from the systems and processes review could lead to a narrower systems and processes review in the future.[14]

Under our proposal, the review of systems, processes and long-term plan would occur one year out from a price proposal, rather than two years. We consider this provides sufficient time to resolve any issues raised in the review, while not extending the length of the review cycle too far across the regulatory period.

We provide a diagram of our alternative approach in section 5.3.

4.2 Benchmarking should be used with caution

As a longer-term initiative, IPART has proposed developing benchmarking models to streamline the efficiency review process. Benchmarking can help measure and compare the financial and service performance of different water utilities. This can help utilities identify opportunities for business improvement and efficiency gains. It can also provide regulators and policy makers with data to inform decisions.

However, benchmarking should not be used as a deterministic tool to make important regulatory process decisions. As the Australian Productivity Commission has noted on the use of benchmarking in the energy sector:

> *There is a large literature on estimating the comparative costs of businesses, with much of that literature concentrating on using the 'right' techniques. However, it is equally important to be clear about how to interpret benchmarking results for policy purposes because the misuse of good technical analysis can result in adverse outcomes for consumers and businesses. In particular, comparing the costs between businesses in different jurisdictions without accounting for factors outside the control of the business could provide misleading indicators of managerial efficiency. If used in incentive regulation, this could lead to underinvestment or unwarranted transfers from consumers to the businesses.*[15]

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[14] IPART, Encouraging innovation in the water sector - Discussion Paper 3, August 2021, p. 26.
[15] Australian Productivity Commission 2013, Electricity Network Regulatory Frameworks: Productivity Commission Inquiry Report Volume 1, pp. 169-175.

Benchmarking requires a robust dataset from a sufficiently large number of businesses that are relatively comparable.[16] As IPART acknowledges, it regulates a small number of heterogenous water businesses and benchmarking its regulated businesses will always be limited by a lack of comparators.[17] An option being explored by IPART is cross-jurisdictional benchmarking. There are, however, few water utilities in Australia that share sufficiently similar characteristics with Sydney Water (see Figure 4-1).

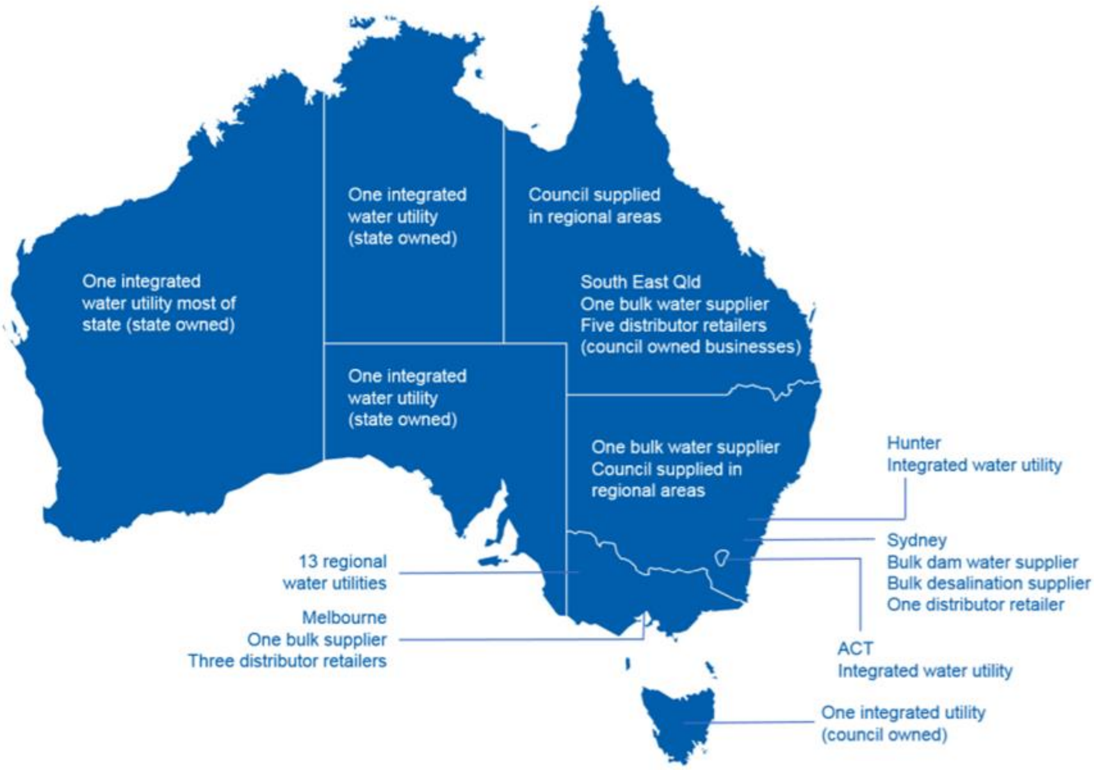

Figure 4-1 Water utilities across Australia

Source: Water Services Association of Australia 2018, "Urban water governance in Australia: Submission to NZ Three Waters Review", p. 19.

Without sufficiently similar comparators, the effect of certain characteristics (such as size of networks, climate, geographic location, regulatory requirements, labour costs, etc) may lead to benchmarking outcomes that are inaccurate and/or misleading. This poses a risk of a high probability of error if benchmarking is used as a basis for regulatory decisions.

Even where there is a robust dataset, we note that benchmarking results need to be carefully interpreted and used. This includes having regard to the broader operating context, such as differences in environment, policy settings across jurisdictions and other exogenous factors, which may not be able to be captured in the analysis. For example, a utility with above-average capital expenditure, which has performed poorly in benchmarking compared to others, may not necessarily be inefficient, but simply at a different stage of its asset lifecycle.

[16] Frontier Economics, Improving economic regulation of urban water: A report prepared for the Water Services Association of Australia, August 2014, pp. 70-74.
[17] IPART, Encouraging innovation in the water sector - Discussion Paper 3, August 2021, p. 29.

Therefore, while we recognise IPART's proposal is well-intentioned, it is not helpful to link benchmarking to future possibilities for streamlining. For the same reasons, it should also not be a requirement for utilities to use benchmarking (across the board) to receive an advanced or leading grading, as suggested by IPART's guidance for Principle 6: Confidence in costs. Benchmarking may be useful to help demonstrate a particular business case or the efficiency of a particular cost but is unlikely to provide data that demonstrates the efficiency of Sydney Water's plan in its entirety.

4.3 We ask IPART to involve us when developing cost categories

We are open to updating cost categories for operating and capital expenditure to be similar to those used by the Victorian ESC. We note our concerns with the use of these cost categories to move towards long-term benchmarking to set efficient costs (see section 4.2).

We note that a transition period may be required to implement new cost categories as this may require updating internal systems. We have just implemented a new internal cost system, BxP, that was developed using IPART's current cost categories.

We request to work with IPART, other utilities and stakeholders to define any new cost categories, and to ensure that our data collection and reporting aligns with the new cost categories once introduced. An early understanding of the specific changes being proposed would be appreciated in case time is needed to make system changes.

4.4 We generally support a base-step-trend approach for opex

We generally support moving towards a base-step-trend approach for reviewing and setting operating expenditure, as applied by other regulators such as the AER and the ESC in Victoria. IPART notes that this approach is not dissimilar to its current approach. However, as for the EBSS, we would appreciate more detail about how IPART would use this approach in practice. For example, how would IPART choose an appropriate starting 'base' year.

As noted in chapter 3, we would also appreciate greater clarity on how the base-step-trend approach would work in conjunction with an EBSS. The outcomes from the application of opex incentives will be affected by how changes in expenditure are reflected in the cost allowance as a whole for the next period.

4.5 Predictive modelling is not appropriate for all capex

IPART has also proposed asking businesses to develop predictive models of longer-term capital expenditure needs, particularly for renewals and growth capital expenditure, to establish an efficient level of baseline expenditure and move to a lighter-touch efficiency review over time. We request that IPART work with businesses to identify appropriate areas that could be defined as 'recurring' capital expenditure and be appropriately informed by predictive modelling. It is likely that recurring capex will be a small percentage of total capex.

We already use predictive models to forecast some of our capital expenditure requirements. For example, we forecast the timing of renewals based on remaining asset life, which is in turn determined by the application of a set of simple rules dependent on asset condition. We are also exploring the use of deterioration models and optimisers for our linear asset classes, which we expect to be ready to implement in several years' time.

While predictive modelling may be appropriate for some forms of recurrent capital expenditure, we believe it is not appropriate for other types of capital expenditure. In particular, growth expenditure (used as an example of recurrent expenditure in IPART's Discussion Paper) is by nature 'lumpy' and highly variable due to location. We would be concerned with an approach to forecasting growth expenditure based on, say, a single unit cost per forecast dwelling. In addition, forecasting dwelling growth with accuracy is difficult and highly dependent on external factors. The farther out the forecast, the more challenging it is to accurately forecast new dwellings.

IPART's proposal to review historical capital expenditure by exception, targeted to areas of significant overspend, where assets are repeatedly deferred and re-proposed and the business spends that money in other ways, or where evidence of underperformance exists appears reasonable. This should help reduce the scope of the efficiency review. It would be helpful to get an indication of what IPART would regard as a "significant" overspend.

4.6 We question some other aspects of IPART's proposed review

IPART proposes a range of other changes to satisfy it that proposed expenditure is efficient:

- For efficiency reviewers to set a range of efficient expenditure, rather than a specific figure (IPART would then recommend a specific figure)
- For utilities to propose their own ongoing efficiency factor
- For utilities to list achieved and forecast efficiency improvements.

The first point above has the stated objective of deterring businesses from second-guessing the outcomes of the efficiency reviewer and over-inflating forecasts. This is not our experience, and, if it was, it is unclear how adding a second decision layer deters this. In addition, it is unclear how IPART is better qualified than an efficiency reviewer to make this judgement.

On efficiency, we think a better approach is to expect the utility to explain how it has considered how it will become more cost efficient over time and how this is reflected in its proposal. Clearly, this will need to be translated into the financial plan that it represents. Cost efficiency can be delivered through a range of strategies that will deliver benefit to customers over time. An expectation to explain its plan for future efficiency would be a more useful requirement than requiring utilities to stipulate an efficiency factor.

5 Encouraging long-term planning

Key messages

- As our industry faces growing expenditure requirements and challenges such as drought and climate change, customer bills are likely to experience upwards pressure. This makes it imperative that the regulatory process facilitates a conversation between the company, its customers and the regulators about the long-term outlook for service and customer bills, and how that relates to the short-term plans under discussion.
- In particular, long-term costs and intergenerational equity issues should be actively considered when setting short-term revenue and prices, as a part of a progressive, modernised approach to regulation.
- This would extend consideration of bill volatility to include an interest in medium- and long-term customer bill volatility between periods, and what steps might be appropriate to mitigate that (if required), as well as considering average customer bill volatility within the regulatory period.
- Supporting long-term business planning will promote IPART's objectives. To engage with customers effectively on strategic issues, we will need to present alternative scenarios of the future our customers face. The big service choices they face are medium and long-term issues. Engaging more with our long-term planning will help IPART build confidence in our governance and business processes and increase IPART's understanding of our key challenges when the next revenue re-set occurs.
- IPART has proposed a 3-3-6 model with the stated aim of encouraging long-term planning. However, we do not agree that it will meet this objective. In heavy infrastructure industries where assets get renewed and replaced over decades, 'long-term' means 20 to 30 years. In addressing net zero, for example, we are focused on targets in 2050.
- We recommend a simple 5-year default determination length, with a greater focus on long-term planning as part of IPART's review.

5.1 What do we mean by a long-term approach?

As our industry faces growing expenditure requirements from challenges such as maintaining ageing assets and responding to climate change, customer bills are likely to experience upwards pressure. This will particularly be the case if expenditure increases occur in conjunction with increases to the cost of capital. A key opportunity for a regulatory reform will be to adopt a long-term approach when setting prices, to ensure that customer bills remain fair and affordable.

As outlined in our response to IPART's Discussion Paper Lifting performance in the sector,[18] we propose shifting the regulatory framework to a long-term focus, so the long-term outlook is

[18] Sydney Water, Response to Discussion Paper 1 - Lifting performance in the sector, June 2021, pp. 5, 12-16.

fundamental to informing the short-term plan. We are a long-lived, asset-based industry dominated by sunk costs for which customers pay over decades. It is in the long-term interests of customers to consider the extent to which they may face future liabilities that are not immediately transparent in the regulatory process.

We provided a supplementary submission to our response to Discussion Paper 1 to IPART on 9 September 2021.[19] This provided more detail on a long-term approach with three key features:

1. A review of the company's long-term plan is incorporated as part of the regulatory review
2. Prices are set considering the long-term price trajectory and customer insight
3. The long-term plan and the price review focus on efficiency and innovation.

Under this approach, a review of our long-term plan prior to the price review will provide an opportunity to consult on the long-term outlook for customers with IPART and other stakeholders, particularly government and customers. This will draw on the best information available about how our investment requirement is likely to evolve and what this could mean for customer bills over time, capturing material cost drivers, such as new investment requirements, and anticipating scope for productivity improvements and changes in financing costs. While future costs are always uncertain, we can develop scenarios and present a range of possible future outcomes for customer bills. We can then propose a shorter-term revenue requirement that has regard to the long-term outlook, and seek to target a long-term customer bill trajectory, as part of a conversation about intergenerational equity, taking into account customer preferences.

The recent draft Greater Sydney Water Strategy has highlighted the long-term challenges faced by the water industry and the need for utilities, government and IPART to work together to smooth future price increases in the interests of customers. In particular, the NSW Government has stated:

- Sydney Water also faces potentially higher costs in the future, over and above maintenance of the existing network. For example, some ageing assets will need to be replaced and others will need to be upgraded to meet the environmental and water quality standards expected by regulators and the community.
- These investments will secure Greater Sydney's water supply and maintain the high level of service and water quality enjoyed by water customers in the region. However, they are expected to lead to higher water bills over the next 20 to 30 years as the costs of those investments will be incurred by Sydney Water but ultimately paid for by customers.
- The NSW Government will identify a number of approaches to smooth price increases, working together with water utilities (including Sydney Water) and IPART. This includes improving long-term planning in the water sector, implementing lower-cost operational changes as quickly as possible and spreading larger-scale investment over a longer period (to avoid any sharp increases in bills).[20]

[19] Sydney Water, *Sydney Water's response to IPART's comment on our consultation response*, 9 September 2021.
[20] DPIE, Draft Greater Sydney Water Strategy - Water for a resilient Sydney, September 2021, p. 122.

In other jurisdictions, the importance of a long-term focus has been recognised in regulatory frameworks and regulators have sought to support utilities to improve long-term planning and ensure it is aligned with shorter-term investment plans. For example, the Water Industry Commission for Scotland (WICS) has worked with Scottish Water to develop an understanding of Scottish Water's capital and operating expenditure requirements over the next 20 years and set prices based on a long-term trajectory with bill smoothing.[21] In South Australia, the Essential Services Commission of South Australia (ESCOSA) has explicitly required SA Water to form an understanding of its long-term investment needs and planning across regulatory periods, and to link its four-year investment proposals within its Regulatory Business Proposal to those long-term investment needs.[22] And, in the UK, there have been calls for Ofwat to be more explicit in its review methodology on how it will trade off short and long-term factors. For example, the UK Consumer Council for Water recommended that:[23]

> *Ofwat's framework for PR24 should encourage companies to produce business plans that are considered in the context of a longer-term strategic plan. This long-term strategy should address future challenges such as asset resilience and the effects of climate change on delivering the service customers expect. This will mean future price controls are more clearly seen as part of a longer-term strategy.*
>
> *Ofwat also needs to be more explicit in how it will trade off short and long-term resilience in service performance, affordability and investment needs in the PR24 methodology.*

5.2 The role of long-term planning in setting short-term prices

IPART has proposed a 3-3-6 model based on a 6-year determination period with a formal check-in at three years, with the stated objective to promote better long-term planning. IPART observes, "In the most obvious sense, [the 3-3-6 model] encourages long-term planning because it sets prices for longer (i.e. 6 years rather than 4 years), and businesses need to develop forecasts for a longer period to generate their proposals".[24] However, an additional a year or two on a price review forecast does not indicate that a utility has successfully conquered long-term planning.

When we refer to long-term planning, we are referring to an outlook longer than ten years. For example, the long-term capital and operational plan we are developing in line with our Operating Licence requirement will have an outlook of 20 years.[25]

We acknowledge that there are some indications that IPART has considered these issues in the detail of its Discussion Paper. For instance, IPART has proposed grading guidance under Principle 9: Equitable and efficient cost recovery, indicating that an advanced utility would "Provide analysis that shows its proposed prices…balance efficiency and intergenerational equity" and that a leading utility would propose "Longer-term pricing paths supported by reliable (but ambitious) long-term

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[21] Water Industry Commission for Scotland, *Final Determination: Strategic Review of Charges 2021-27*, December 2020.
[22] Essential Services Commission of South Australia, *SA Water Regulatory Determination 2024 - Final framework and approach*, September 2021, pp. 5-6.
[23] UK Consumer Council for Water *Lessons learnt from the 2019 Price Review: A report by the Consumer Council for Water*, 2020, p. 23.
[24] IPART, *Encouraging innovation in the water sector - Discussion Paper 3*, August 2021, p. 36.
[25] Under clause 3.2.1 of our current Operating Licence 2019-2023, we are required to develop and submit to the Minister a long-term capital and operational plan. See: Sydney Water 2019, *Operating Licence 2019-2023*, p. 9.

cost estimates". This appears to be supporting Sydney Water's requests for the regulatory framework to consider longer-term price trajectories when setting shorter-term revenue and price proposals. However, we request that options available to consider intergenerational equity and longer-term pricing paths be made more explicit in IPART's draft and final reports. The strongest signal IPART can send is to embrace our proposal for IPART to participate in our long-term plan review with stakeholder and customers.

5.3 We support a five-year default with no mid-point check in

Under IPART's proposed 3-3-6 model, utilities face a mid-point check in, a review of systems and processes and the possibility of an additional price review all within a 6-year determination period.[26] This undermines the benefits of a longer length for the determination, which should be to allow the utility to focus on the execution of its business plan and deliver performance and efficiency improvements. The 3-3-6 model further introduces uncertainty for utilities. If IPART wants Sydney Water to be motivated to act on the stronger incentives provided under the new framework, we must be confident the rules of the game are not subject to change. A stable regulatory cadence will help to provide the right climate for performance improvement, efficiency and innovation.

We propose to retain the ability for utilities to propose their determination length, but with a commitment to move to a five-year default. We consider a five-year determination would:

- reduce complexity and uncertainty in the new framework
- allow greater focus on delivery of outcomes and working on strategic issues between reviews, while balancing risk related to the accuracy of forecasting
- allow for better alignment with operating licence terms (allowing reviews to occur before each price review) and with the planned updated of our long-term plan.

Staggering pricing and licensing reviews is important to us, given that new or amended licence conditions can affect a utility's costs. While there are pros and cons for different timing options, a two-year gap between the conclusion of the operating licence review and start of the price review allows for licence requirements to be established up-front, to ensure appropriate funding can be secured at the upcoming price determination. Staggering reviews would also help to smooth resourcing burdens.

We provide a comparison of the current review process, IPART's proposed changes and our alternative proposal in figures 5.1 to 5.3.

[26] The mid-point health check also overlaps with the split efficiency review. It is unclear if this is intentional.

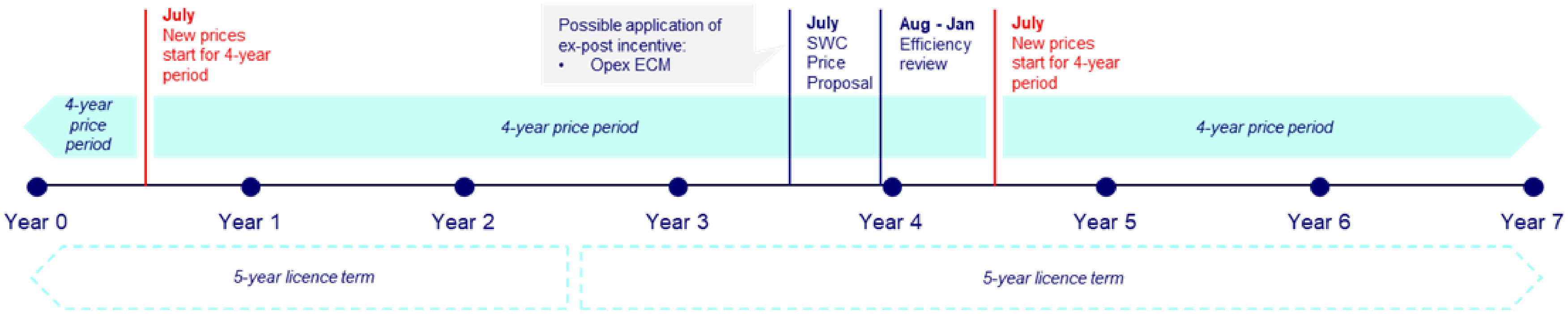

Figure 5-1 Current IPART review process

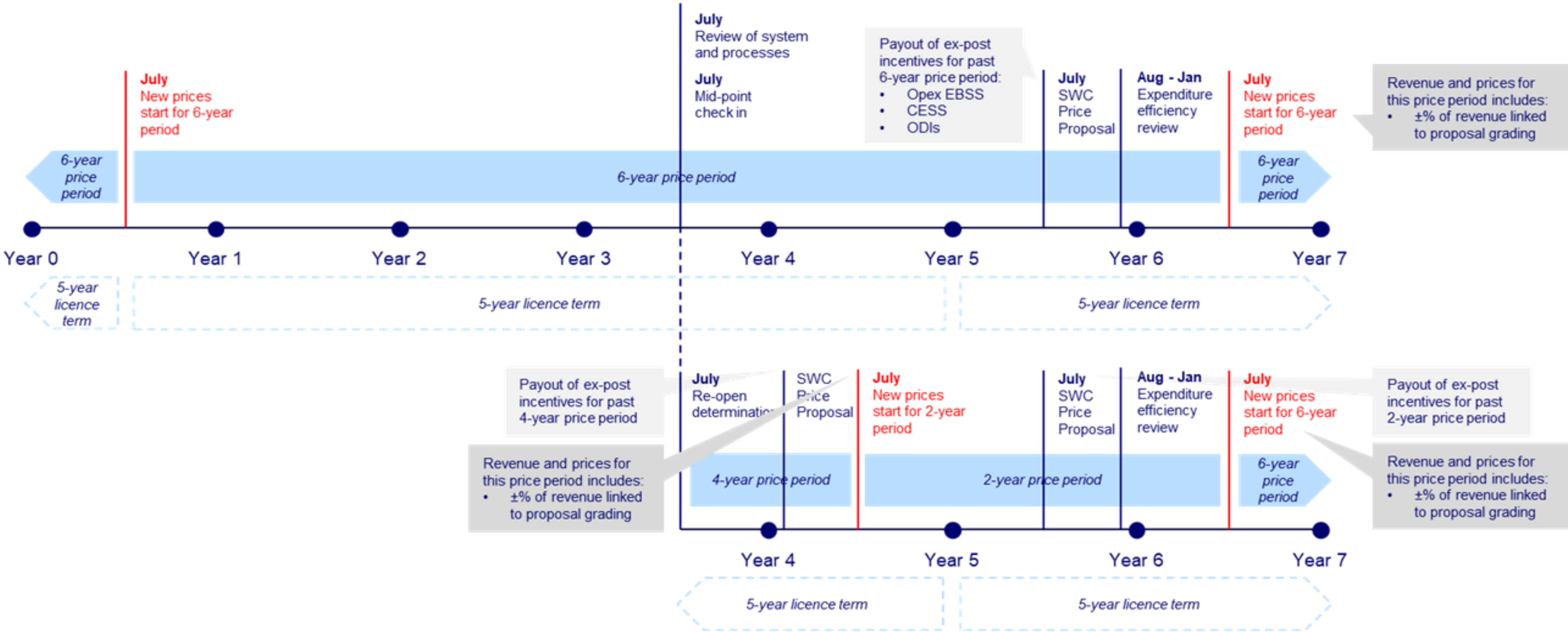

Figure 5-2 IPART proposed review process

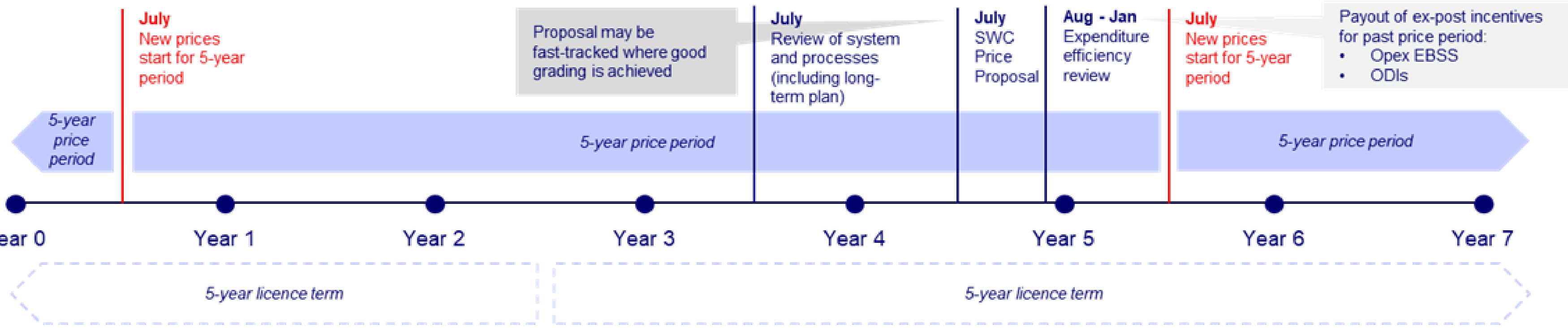

Figure 5-3 Sydney Water proposed review process

5.4 We recommend operating licence reviews by exception

We still strongly support IPART considering a reduction of regulatory burden by reviewing the operating licence ‘by exception’. This means that operating licence reviews would be targeted to focus on areas of greatest value and make the best use of available resources, rather than revisiting every clause at each review.

As discussed in our response to IPART’s Discussion Paper 1,[27] we believe the operating licence should reflect minimum standards to protect customers, with performance above those standards being agreed with customers via the price review. This would allow trade-offs between service levels and prices and the impact of other cost drivers on customer bills, such as changes in environmental standards or water quality guidelines, or the need for future supply augmentation, to be considered simultaneously.

We see IPART’s proposals around outcome delivery incentives as a vehicle for doing this. We also may propose outcomes that are valued by customers that do not easily fit an outcome incentive.

5.5 We recommend further flexibility for cost pass-throughs

We support IPART’s proposed changes to its cost pass-through criteria. In addition, we propose that IPART further amend its guidelines to enable cost pass-throughs to be identified and allowed within a regulatory period.

This change is particularly important if IPART introduces incentive schemes for operating and capital expenditure, to mitigate the additional risks to businesses and customers from those schemes. In our view, it would be unfair for a utility to be additionally penalised for cost increases within a regulatory period caused by external factors or an unforeseeable event, beyond having to fund those costs within the regulatory period.

Specifically, IPART proposes that:

- there must be a trigger event for cost pass-throughs which can be clearly defined in the price determination
- businesses should not be allowed to pass through costs related to unforeseen events where there is no way of estimating the impact ahead of time (such as a government tax change)
- businesses should not be allowed to pass through costs where there is an event with a known outcome for the business but whose costs would be difficult to estimate (such as a change to EPA requirements unknown at the time of the price proposal).[28]

Yet, for each of the event categories noted above, passing through changes in costs is efficient.[29]

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[27] Sydney Water, *Response to Discussion Paper 1 - Lifting performance in the sector*, June 2021, pp. 17-18.
[28] IPART, *Encouraging innovation in the water sector - Discussion Paper 3*, August 2021, p. 38.
[29] In a competitive market, each of these changes would have a direct effect on the marginal cost of supply once they occurred. Suppliers would pass on the higher costs to customers immediately. Failure to do so would imply they were earning negative economic profit, a violation of perfect market competition.

IPART states that they should not pass them through because allowing costs that are so unknown to be passed through unconditionally would create poor incentives for the business.[30] However, because of the new criterion requiring the business to demonstrate the proposed cost pass-through is the most efficient and equitable way of dealing with the event, the incentives on the business will remain unaffected. In our view, a proposal for a cost pass-through under this guideline will form the basis of discussion between a utility, the regulator and customers – it will not allow pass-throughs unconditionally.[31]

In not allowing for these types of events to be dealt with via cost pass-throughs, IPART appears to be concerned with the trade-off between in-period bill volatility and efficiency. We agree this trade-off should be considered for each proposal by a utility. However, this is also satisfied by the efficiency and equity requirement. We see no reason why this trade-off consideration cannot validly occur outside of a price review for unforeseeable increases in costs.

We consider our proposal is in line with the cost recovery and reflectivity pricing principles of the National Water Initiative. Without these changes, we are concerned that IPART is sending a message to utilities to build large cost contingencies into our forecasts in case of unforeseeable events (that customers will pay for even if those events do not occur).

[30] IPART, *Encouraging innovation in the water sector - Discussion Paper 3*, August 2021, pp. 37- 38.
[31] IPART also states almost all events are within some level of control of the business over a long enough time period, giving the example of an expansion of the Sydney Desalination Plant (SDP). We do not agree that an expansion to the SDP could necessarily be avoided by Sydney Water. While we participate and provide advice on urban water planning policy, it is ultimately a decision of government whether to mandate particular supply augmentation options. In our view, there are many examples where this may be the case.

6 Encouraging innovation

Key messages

- As we have set out in previous responses, and as recognised by regulators including Ofgem, Ofwat, the AER and regulators in other sectors (eg, financial services), there are systemic problems in developing a culture that sufficiently promotes innovation in highly regulated environments.
- IPART says it recognises that R&D spend is low, but it needs to be convinced targeted innovation support would have management attention. We guarantee this would be the case. We would like to establish a small fund consisting of shareholder funds, customer support and any third-party support that we can secure.
- The whole purpose of this funding would be to direct it to activities that are early stage, and which need dedicated support to move forward. There would need to be tests applied to provide confidence that the money is well-invested, even if – as is always the case with innovation – future benefits are uncertain.
- This is a low-risk way for IPART to demonstrate its support for promoting value and innovation, as well as cost reduction. IPART will expect customers to experience the benefits of innovations that we develop, so it is normal that they contribute to the costs.

Innovation is key to achieving better outcomes for our customers. We are striving to build a more innovative culture so that we can deliver services that our customers value at the least cost over the long-term. In October 2021, we held the inaugural Sydney Water Innovation Festival celebrating some of our innovative solutions to critical challenges and exploring how we can better promote innovation in the water sector. We thank IPART for contributing to the debate.

We are already seeing benefits, such as partnering opportunities from industry participants. Some private sector business partners have stepped forward and have offered to provide funding and prizes to support our innovation pipeline of activities.

IPART's Discussion Paper considers innovation funds and competitions and notes the difficulty assessing the quality of innovation ex post, given that projects sometimes fail and notes that it needs to be convinced that "there would be appropriate management attention to the innovative projects".[32] It raises a number of concerns, which we address in turn below:

- "It is difficult to assess the quality of innovation ex post"

This is no different to the tests that apply now on all our expenditure. Where IPART wants comfort, it can do ex-post reviews, as it does now. Even if we compare innovation spending to, for instance, putting a wastewater pipe in the ground, IPART is not able to assess that all our capex is efficiently spent in practice. It relies to a large extent on good governance and process. Innovation is no different. It means building new technologies and intellectual capital that turns into future efficiency

[32] IPART, *Encouraging innovation in the water sector - Discussion Paper 3*, August 2021, p. 41.

improvement in the long run. There is nothing inherently different to assessing innovation spend than assessing the efficiency of anything that IPART approves now.

- "…it is not clear a commensurate investment in effort has accompanied the innovation funding"

There is no reason that this has to be the case. IPART can use expenditure review consultants just as it does now to perform any audits it thinks are appropriate.

- "We are not sure de-risking regulated businesses through the innovation fund would encourage greater innovation or discipline in ensuring project success"

We have not said that innovation funding should be de-risked. IPART can require any form of competition or test to apply as a condition of funding. If the tests are not met, IPART need not pay out any funding. Indeed, it is important to attempt to recreate the competitive tension that exists naturally in competitive markets. We need tests to be applied to encourage only high-quality projects to come forward.

However, we also need to change the culture of the sector. We believe IPART needs to be part of that change. The need for a special focus on innovation recognises the limitations of the regulatory model that we have. The regulatory framework should be adapted so we can experiment to try to overcome these limitations. It is hard to see how IPART can expect the sector to start on this journey of transformation, unless IPART is prepared to play its part in it.

The NSW Productivity Commission has recently released a white paper recommending a range of policy and regulatory reforms designed to lift NSW's productivity. Recognising the benefits that innovation can deliver to society, innovation is a key focus area of the paper.[33]

[33] NSW Productivity Commission, *White Paper 2021 – Rebooting the economy*, May 2021, p. 21.

7 Our responses to IPART's questions

1. **What are your overarching comments about our proposed approach?**

   We largely support many elements of IPART's proposed direction. However, we have reservations about the pace and scope of change and how well IPART's proposed incentives align with encouraging the right behaviours and outcomes. For our overarching comments please refer to our executive summary.

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?**

   We support a mechanism that provides the right incentives for us to innovate. Regulators in other jurisdictions have recognised that regulation biases investment towards traditional servicing solutions and have implemented regulatory mechanisms to promote innovation, including funding or competitions. See section 6.

Specific questions 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?**
   In general, we are open to most of IPART's proposed principles. In some cases, these principles, although marked guidance, are overly prescriptive. In our view, matters of what utilities should propose and how we should propose it should be for our Board to decide, not the regulator. It is also unclear how the principles will interact within IPARTs existing policy and regulatory framework. See section 2.

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

   The regulator can helpfully set expectations to encourage the business to provide a great plan. We think IPART's 3Cs framework is an important step forward in this respect. However, we will always submit the highest quality plan that we can, regardless of IPART's proposed grades and grading rubric. See section 2.

   In our view, the long-term interests of customers will be best served when prices are set with reference to long-term costs. See section 5.

3. **How should an incentive matrix be structured to ensure water businesses provide maximum customer value for least cost?**
   Our preference is for any reward for good proposals to be provided through reputational and administrative incentives. Introducing financial incentives attached to the quality of regulatory proposals is not a priority reform area for us and could pose unnecessary risks to customers and our shareholder. See section 2.

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 do not support financial rewards and penalties being tied to a business' grading. Instead, we prefer greater use of non-financial incentives. We understand, and support, all utilities being assessed from a starting point of 'standard' in the first round of the new regime. See section 2.

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?**
   We support streamlining the review process where justified. Businesses should be free to propose suitable regulatory mechanisms in their submission, regardless of their overall grading. For example, the option of a revenue cap should be open to all businesses. See section 2.3.

6. **Do you support a tiered use of ex post incentives to advanced and leading businesses?**
   We support balanced and symmetric incentives. If the ex-post incentives appropriately incentivise the correct behaviours, we see no reason why they should not apply to standard businesses as well. See section 3.

7. **How effectively would our proposed use of ex post incentive schemes encourage cost reductions and improvements to service quality?**
   In our view, IPART's proposed ex-post service-level incentive schemes will encourage efficient improvements to service quality. Further analysis must be conducted on the expenditure incentives to understand how well they encourage cost reductions in practice. See section 3.

8. **Given the new 3-3-6 model, should we make changes to the way pricing and licensing reviews align?**
   We have proposed a default period of five years for price reviews. This is simpler, removes the uncertainty of a potential re-opener, and better aligns with licensing reviews and long-term planning updates. See section 4.

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

   We support IPART's proposed changes to its cost pass-through criteria. In addition, we consider it would be in the long-term interests of customers to allow cost pass-throughs for efficient costs to be identified and allowed within a regulatory period. See section 5.5.

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