



WATER SERVICES
ASSOCIATION OF AUSTRALIA



**WSAA submission to
IPART Discussion Paper:
Lifting performance in
the water sector**

June 2021



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1.0 Introduction and overview

WSAA welcomes the release of IPART's discussion paper *Lifting performance in the water sector*.

We provided a submission to the initial Position Paper to this special review on how IPART regulates monopoly water businesses in NSW. We also presented to, and participated in, both workshops held to discuss lifting performance and customer engagement.

WSAA's overarching message in its submission and subsequent engagement is that the challenges facing the urban water sector will mean that utilities and regulators will have to evolve if they are to continue to meet the long-term interests of customers. We suggested that the key elements of the regulatory regime that need to evolve to support great customer outcomes are:

- clarity of objectives to promote the long-term interests of customers;
- customer engagement at the centre of the framework;
- incentives for efficiency and innovation

At the first workshop on Lifting Performance on 23 March 2021, presenters were asked to define what success looks like for the regulatory review. As a starting point we suggested that the regulatory framework should deliver:

A long-term price settlement that maintains affordability and preserves the best features of the current model

We consider that IPART's proposals are consistent with that success statement and WSAA supports the directions and preliminary positions set out in IPART's discussion paper. In particular we support:

- IPART's focus on the longer-term outlined in its proposal for longer price determinations.
- providing the option for businesses to propose different forms price controls (including revenue caps).

This submission expands briefly these points — particularly on implementing a long term view — and provides short supporting comments on the other proposals set out in the discussion paper.

2.0 Longer regulatory reviews

Customers prefer certainty and predictability in water bills over time, whether bills remain flat in real terms, or more likely, increase in the medium term. Price spikes, or large fluctuations in prices, are more difficult for customers to manage, budget for, and contribute to affordability pressures.

The current four-year determination period and the way prices are set may make it difficult to achieve a long-term predictable price and bill outcomes.

We therefore support the potential to move to longer determination periods. Certainly, five year determinations are common across regulated industries and some regulators are looking to expand this timeframe. As IPART notes, the ability for longer term determinations relies on utilities being able to provide credible long term business plans.

However, longer determinations are not the only way to achieve a longer-term price settlement, and by themselves may not be the whole answer. There are a range of mechanisms that could be used to ensure predictable price paths and price smoothing across determinations.

Specific mechanisms could be proposed by utilities or jointly developed with the regulator. Such mechanisms should work for customers and for utilities. The intention is not to ‘protect’ the revenue of utilities; rather they should be symmetric in how they operate (balanced between consumers and utilities). Relative to the status quo, over some determination periods utilities may recover less than they would otherwise, and in other periods they may recover more. Over time the outcome should be neutral.

WSAA believes that smoothing or adjustment mechanisms can support the long-term interests of customers. It does not believe they would involve arbitrarily building up reserves or an in-optimal capital expenditure profile. To take an illustrative example, regulatory depreciation could be used to smooth prices across determination periods. Regulatory depreciation is the Return of Capital in the building block model. It represents the rate at which invested capital is returned to the utility. If it were reduced in a determination period, revenue (and prices) would be lower than otherwise, benefiting customers in that period, yet the capital would remain in the Regulatory Asset Base earning a return. In contrast, regulatory depreciation could be increased in a determination to maintain real prices rather than have them decline. Increased regulatory depreciation would increase revenue in that period, but would reduce the Regulatory Asset Base providing a benefit to customers in all subsequent periods.

Adjusting regulatory depreciation is likely to be one of many approaches. We raise it not to suggest it is the best approach, but to simply illustrate that price smoothing need not involve arbitrary profits, or losses, or weakening of core elements of economic regulation such as the building block model.

Common to all approaches will be regulators and customers having sufficient and credible data to form a view of where costs, revenue and prices are headed in the long term — provision of which would remain the responsibility of utilities.

3.0 Different forms of price control

WSAA strongly supports IPART’s preliminary view to allow different forms of price control. IPART currently sets maximum prices a business can charge for water services. Among economic regulators, setting maximum prices is an exception, rather than the rule. Nationally and internationally, most regulators adopt forms revenue caps or weighted average price caps.

Moving to more flexible forms of price control is therefore not contentious and IPART has set out the benefits of revenue caps well. We agree that providing businesses with more flexibility to set prices would likely need to be accompanied by a set of pricing principles to provide assurance to the community that utilities are equitably applying prices within the cap.

The discussion paper suggests that implementing any significant change to the regulatory framework comes with an administrative burden for IPART and businesses. WSAA suggests any initial burden will be significantly outweighed by administrative savings, particularly for IPART in the medium term. The regulatory task of setting maximum prices for all services to recover efficient costs is significantly greater than the task of ensuring revenue is sufficient to cover efficient costs. Different forms of price control could free up regulatory resources for more critical tasks.

In relation to the potential burden on utilities of moving to different price controls, we draw attention to the point made in the discussion paper — ‘a lack of autonomy for the business to set prices potentially discourages them from taking ownership of their prices’. Beyond the economic and efficiency arguments for more flexibility, greater autonomy in price setting goes hand in hand with greater customer engagement and customer focus.

4.0 Customer choice pricing

WSAA supports IPART's proposal to introduce customer choice pricing in principle.

Traditionally the water industry has provided homogenous (high quality) water and wastewater services to all customers. This is supported by postage stamp pricing whereby all customers pay the same regardless of level of costs. Generally, these arrangements are strongly supported across the industry because water is an essential service.

Core service delivery is likely to remain the 'main game' for water utilities in the current environment. Nevertheless, customer choice pricing represents a pricing innovation that in time may lead to innovation in the delivery of services, particularly as utilities gain a greater understanding of customers' willingness to pay for new products.

One note of caution about the proposal is what is classed as discretionary offerings subject to customer choice and what should be funded as part of core services. IPART cites examples of water pressure, some environmental impacts and carbon offsets as potential candidates for customer choice. Depending on the individual proposal, arguments may also be made that these types of proposals could fall into the core service offering.

5.0 Shadow price for leakage

One of the themes in WSAA's initial submission to the Review is the need for greater incentives in the regulatory framework. We therefore support the use of incentives for water utilities for water conservation, including potentially a shadow price for leakage.

We certainly do not claim to have considered all the design issues for such a scheme. But as with all incentive schemes it will be important to get the design right to indeed send the right signals. An important variable would seem to be to get the target level right so as not to provide for windfall gains or losses (and to send the right signal for water efficiency).

Among other questions IPART seeks feedback about is whether the value of water used in the shadow price be based on short run marginal cost or a long run marginal cost of supplying water. The time when the most public focus will be on a shadow price for leakage is likely to be in drought and particularly when water restrictions are in place. At this time, the short run marginal cost (SRMC) of water would be very high because SRMC includes the opportunity costs associated with the value forgone from customers not being able to use water.

We are not sure whether this would have implications for the design of the scheme, but it would appear that the greatest incentive to reduce leakage should be sent during drought and water restrictions.

6.0 Establishing a Regulators Advisory Panel

In our presentation to IPART's workshop we drew attention to the increasing capital expenditure across the water sector. One of the areas of increase is capital expenditure to comply with regulatory requirements. We therefore support all moves for greater coordination among regulators to ensure that regulatory requirements are necessary and that the benefits outweigh the costs.

7.0 Performance standard setting

IPART raises two related issues regarding standard setting but has not formed a preliminary view on them. These are:

1. How best to align pricing decisions and performance standard setting to enable businesses to make trade-offs between the two
2. Whether to set performance standards at minimum levels or optimal levels to ensure ongoing performance by the business.

WSAA agrees that these are important issues, however, like IPART we do not have definitive views.

We would like to observe, however, that in our presentation to workshop two on customer trends across regulated industries, one of the key trends was that the scope of issues for customer engagement is expanding. Utilities are engaging with customers on a larger proportion of the bill. Areas that were once thought to be non-discretionary are now on the table for engagement.

Prima facie this would indicate that operating licences should set minimum standards to allow customers to input into trade-offs between price and service and the optimal level of service standards.

8.0 Next steps

WSAA thanks IPART for the opportunity to provide this relatively high-level submission. We would welcome the opportunity to discuss these issues further with you as the review progresses.

Adam Lovell, Executive Director, WSAA

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WSAA presentation to workshop on Lifting Performance

Stuart Wilson, Deputy Executive Director WSAA



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IPART regulatory review

Stuart Wilson
Deputy Executive Director



The last 6 years have been unique

The last six years have been:

- Good for customers
- Good for utilities
- Good for regulators
- Good for shareholders

But these benign conditions will not be repeated

Utilities and the regulatory system will need to evolve to handle the challenges

- More focus on customer
- More incentives for efficiency
- Especially innovation

Good for customers: bills stable

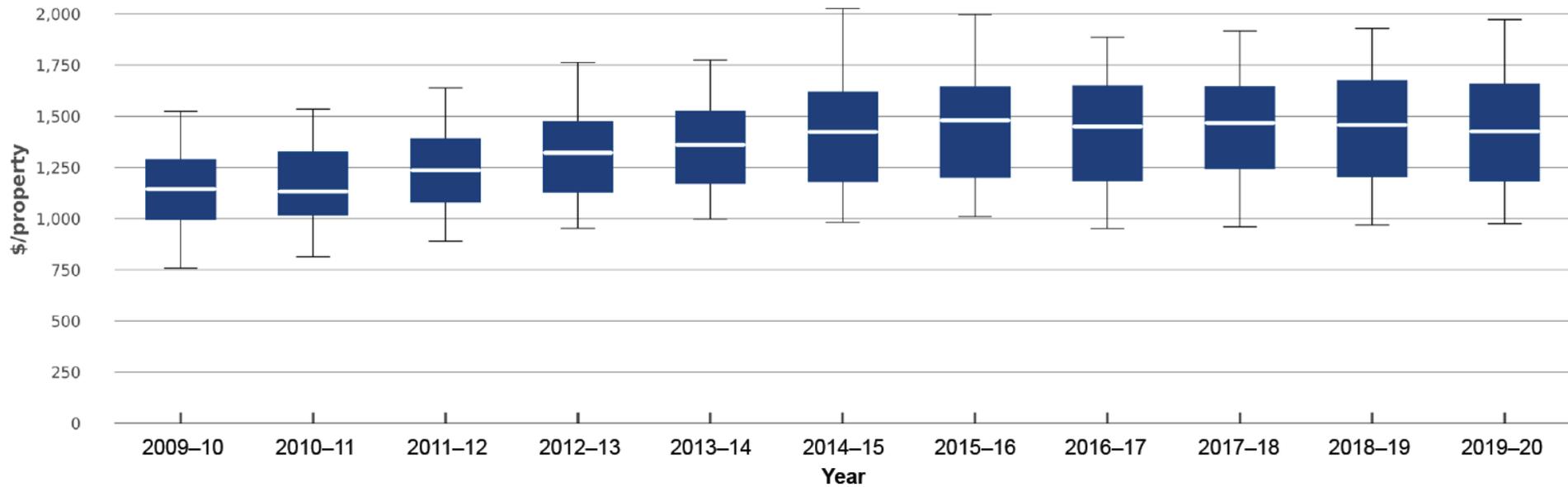
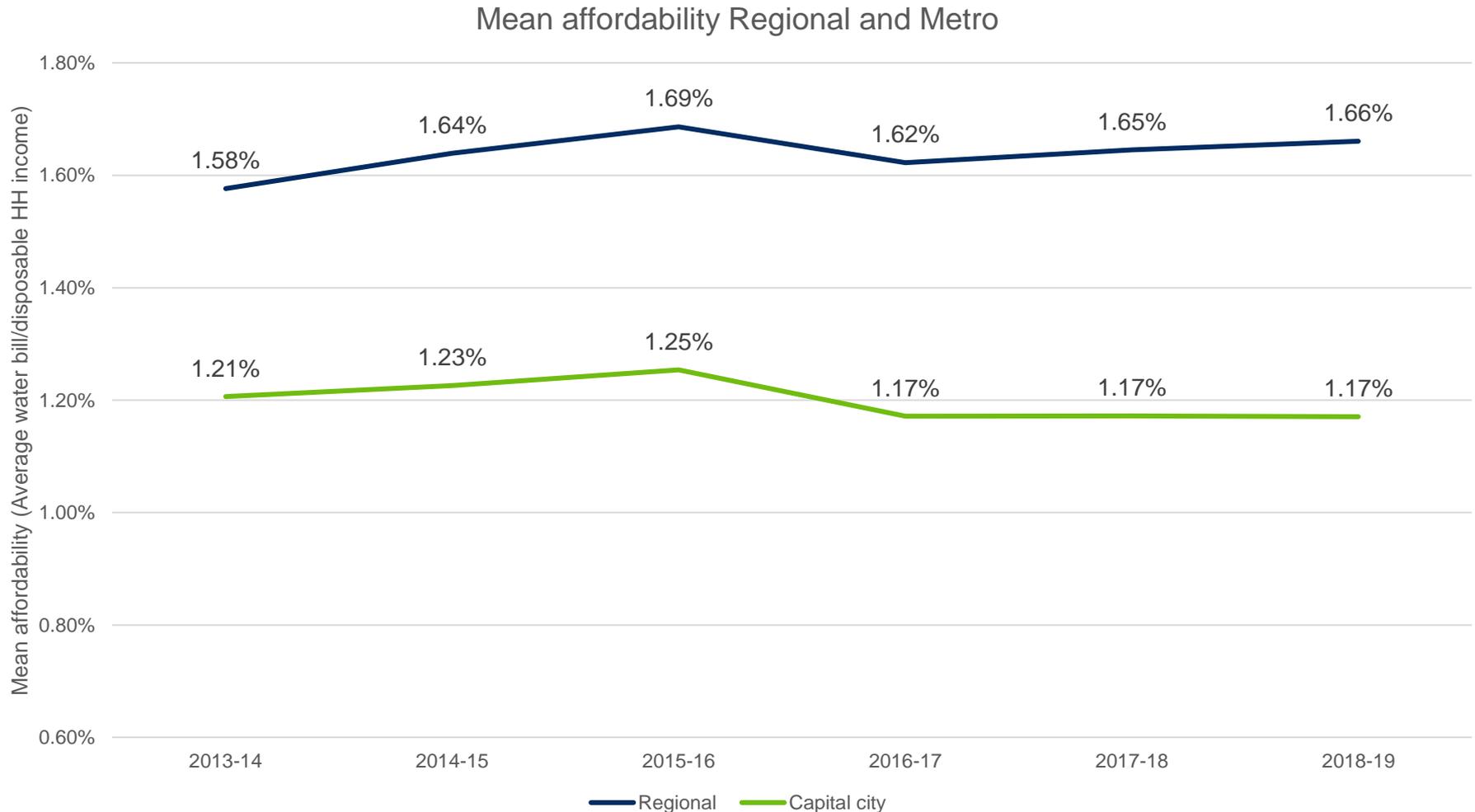


Figure 1 Typical residential bill: water supply and sewerage (\$), 2009-10 to 2019-20.

Water is affordable

Water and wastewater services are affordable in aggregate. They are not at levels that cause policy makers concern. And they have remained relatively constant over the last 5 years. This is true of cities and regions.



Good for utilities: are able to invest

While bills are down expenditure is up significantly

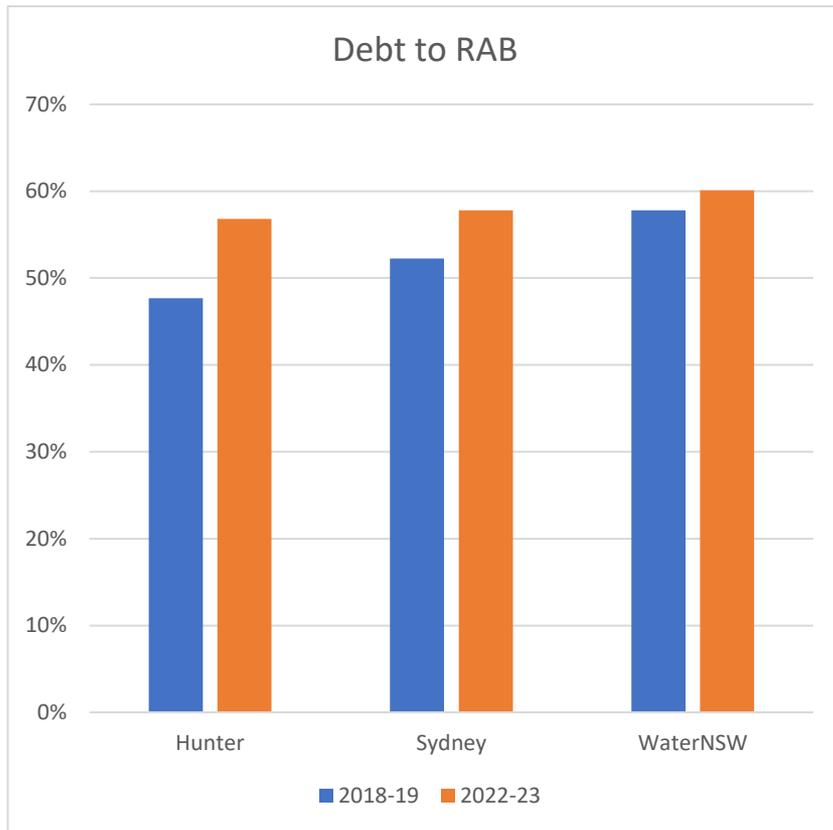
Table 1: Outcomes from regulatory determinations in 2020 (compared to expenditure over previous determination)

	Sydney Water	Hunter Water	SA Water	<u>WaterNSW</u>
CAPEX	Up 41%	Up 31.2%	Up 28%	Up 33.2%
OPEX	Up 1.4%	Up 5.9%	Up 2%	Up 1.4%*
Bill impacts	Down 7%	Down 4.3%	Down 10-15%	Down 8.3%

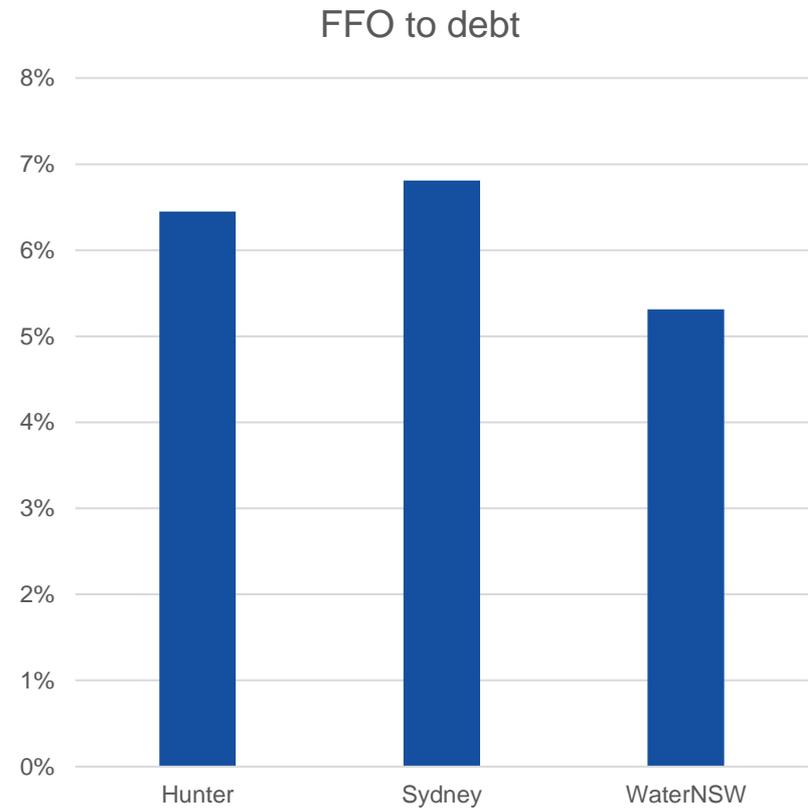
*estimate

Good for shareholders

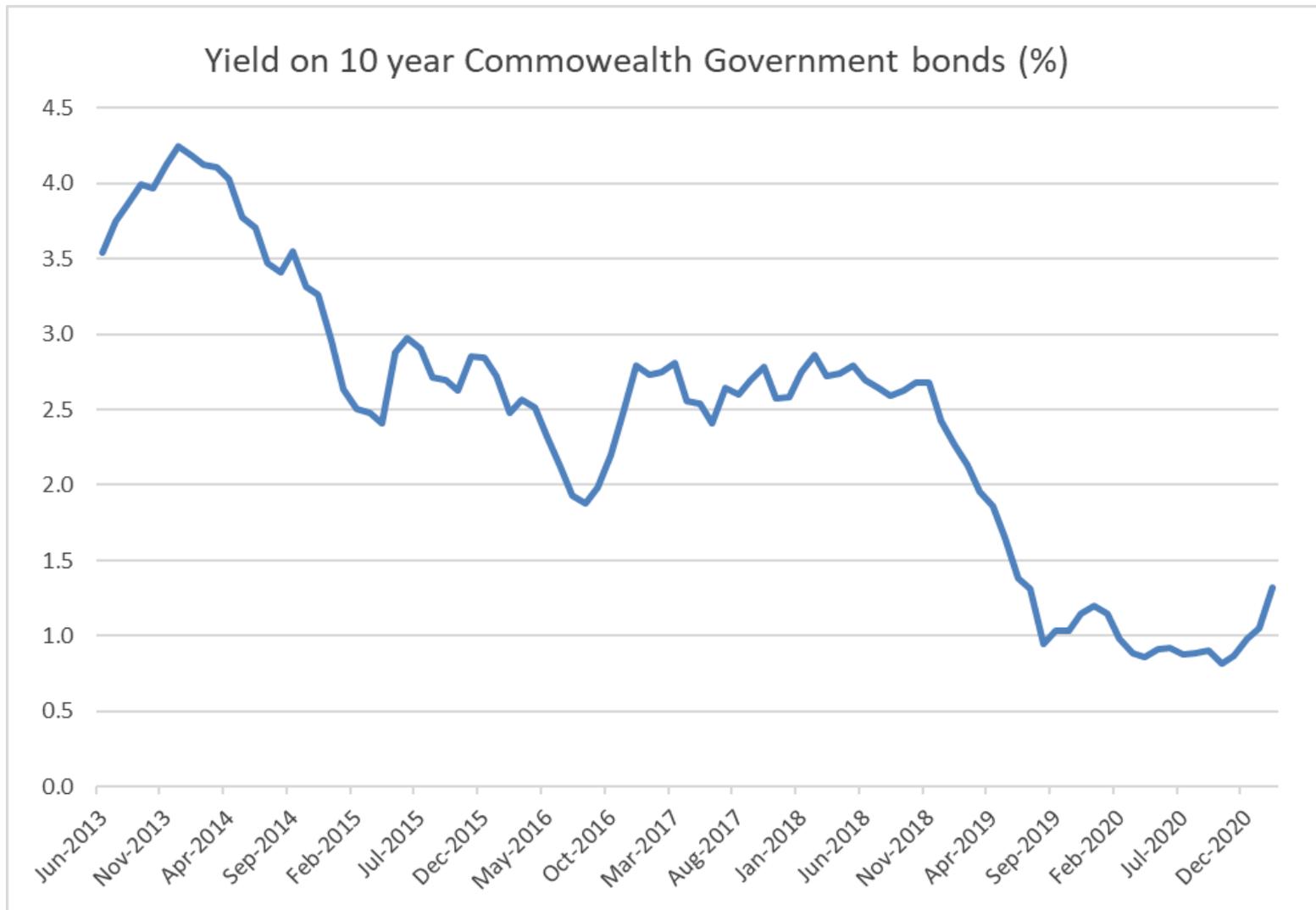
Capital structures have been optimised at close to the WACC benchmark



With not much further room to move

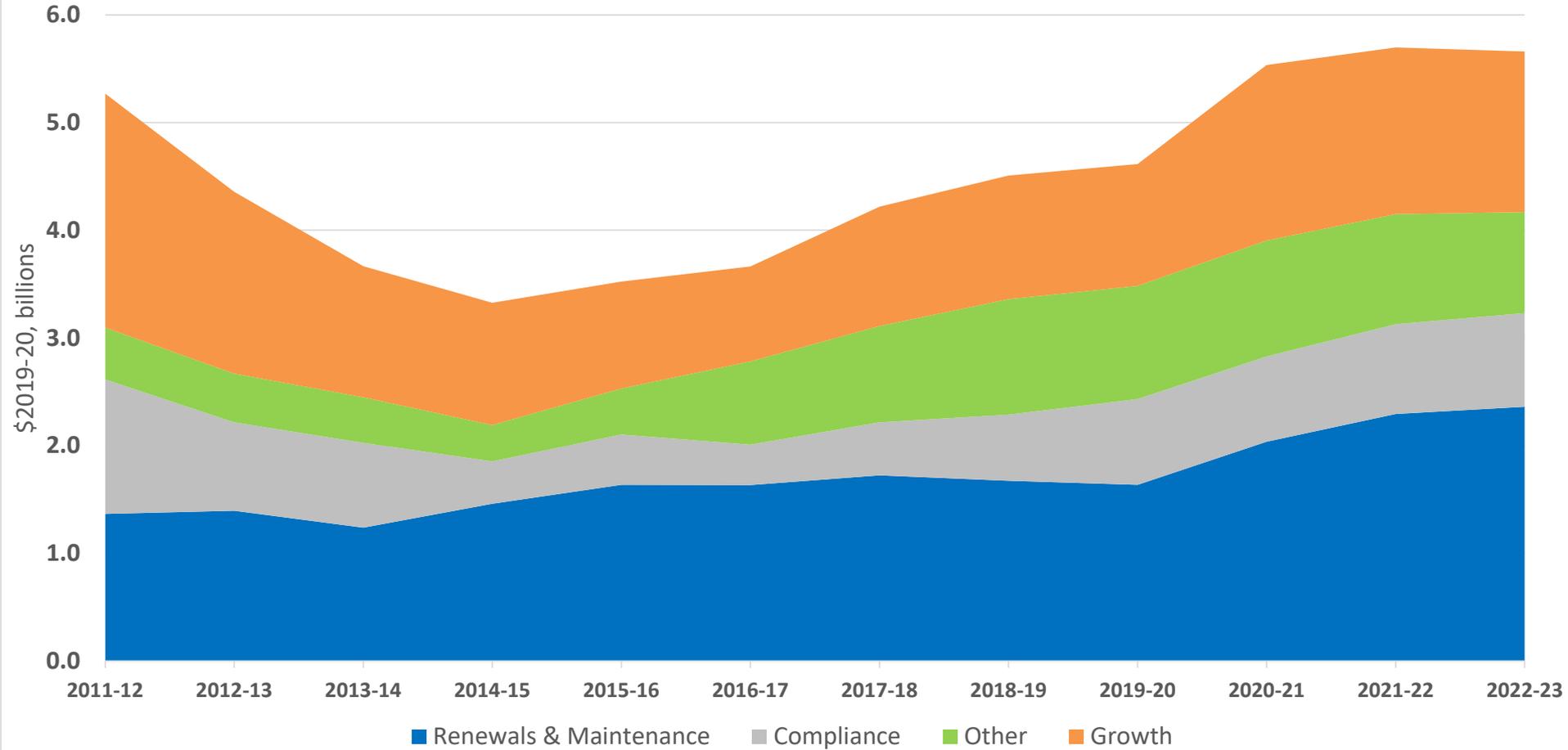


Falling interest rates have been the key



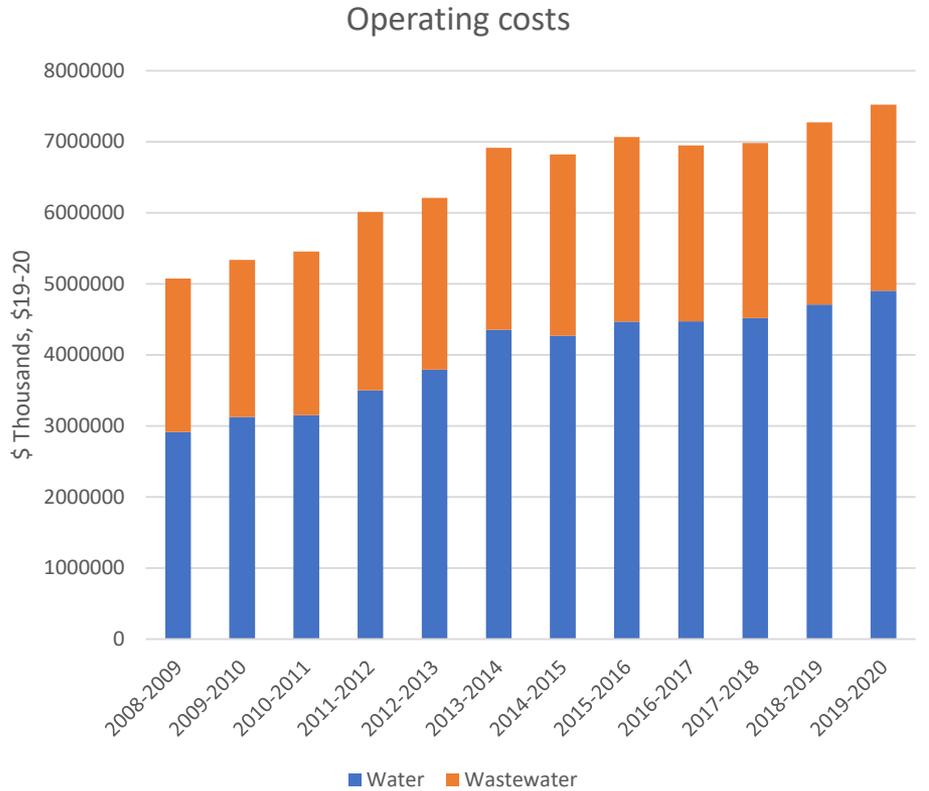
The future is already here!

Capital expenditure - actual & forecast
(\$2019-20, 17 utilities)



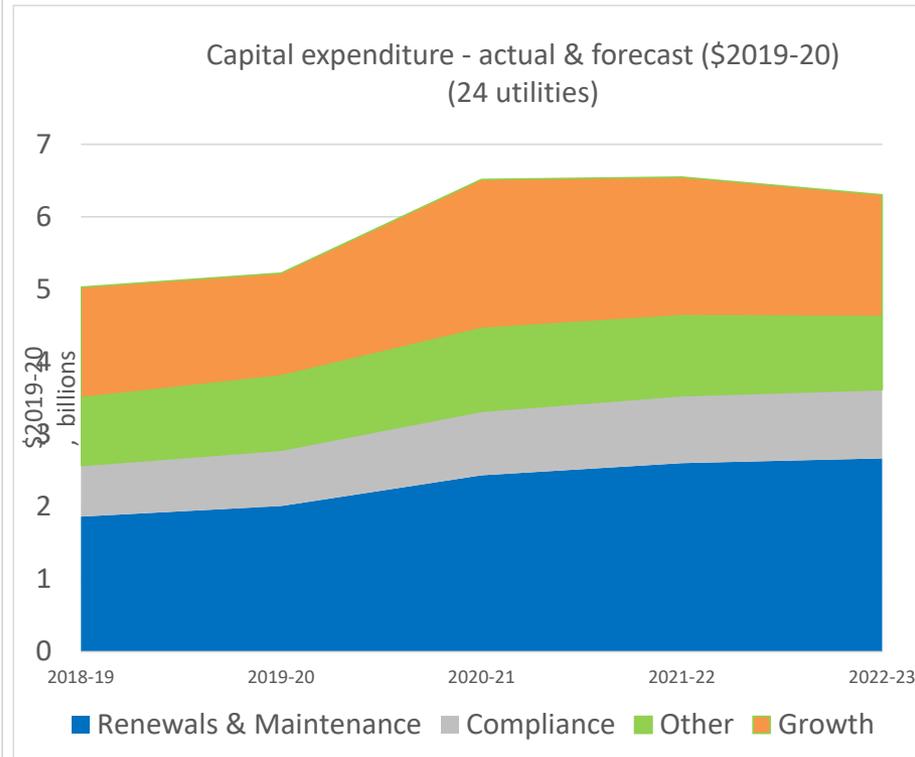
All trends the same direction

1. Over 3% growth rate in OPEX



NPR data, major and large utilities

2. Capital expenditure has increased from \$3.7 billion in 2014-15 to over \$6 billion



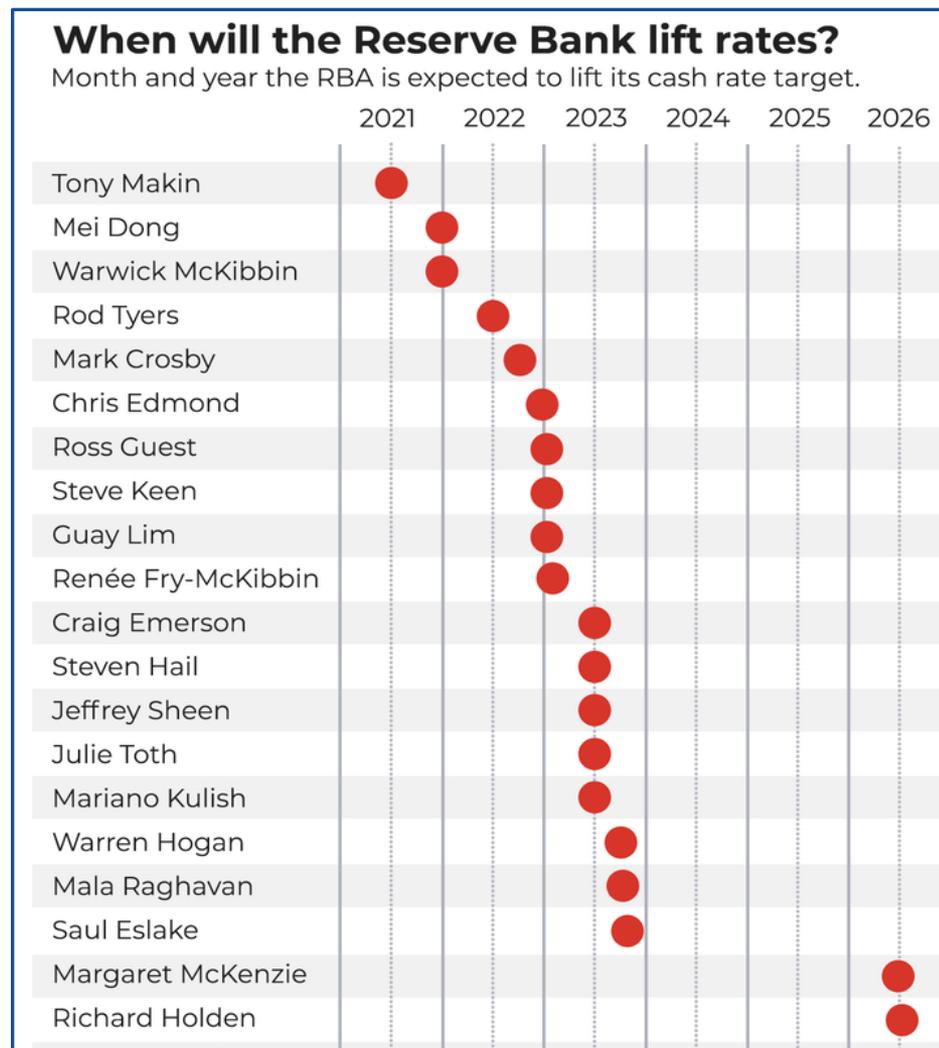
3. Interest Rates

A one percent increase in interest rates increase prices by around 8 percent + when it fully flows though the WACC

The future will be characterised by

- Higher expenditure for ageing assets
- Higher growth expenditure in NSW
- Increasing operating costs notwithstanding efficiencies
- Rapidly growing RABs
- Higher interest rates (sometime)
- Little ability to absorb shocks on balance sheets

- Higher medium term prices are inevitable



source: The Conversation

The challenges are significant

Can the current framework deliver a settlement that is in the long-term interests of customers?

- **Impact will not be uniform across utilities**
- **The prime responsibility lies with utilities**
- **But the role of economic regulation is also critical, and there needs to be strong alignment**
- **Congratulations for reviewing the framework**
- **Now is not the time for incrementalism in IPART's approach**

What does success look like?

- **A long term price settlement that maintains affordability and preserves the best features of the current model**

WSAA presentation to workshop on Customer Engagement

Evelyn Rodrigues, Manager Customer and Community, WSAA



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Frontiers of Customer Engagement IPART workshop 2

Evelyn Rodrigues



1 Owning the customer relationship

The utility has the relationship with the customer rather than the regulator taking full responsibility for the interests of the customer



2 Multiple dimensions to engagement

Engagement is happening earlier (and it's broader and deeper)

More techniques used through out the program

We are heading towards the 'Empower' end of the IAP2 framework

There is the expectation of universal and inclusive engagement



3. Triangulate and Iterate

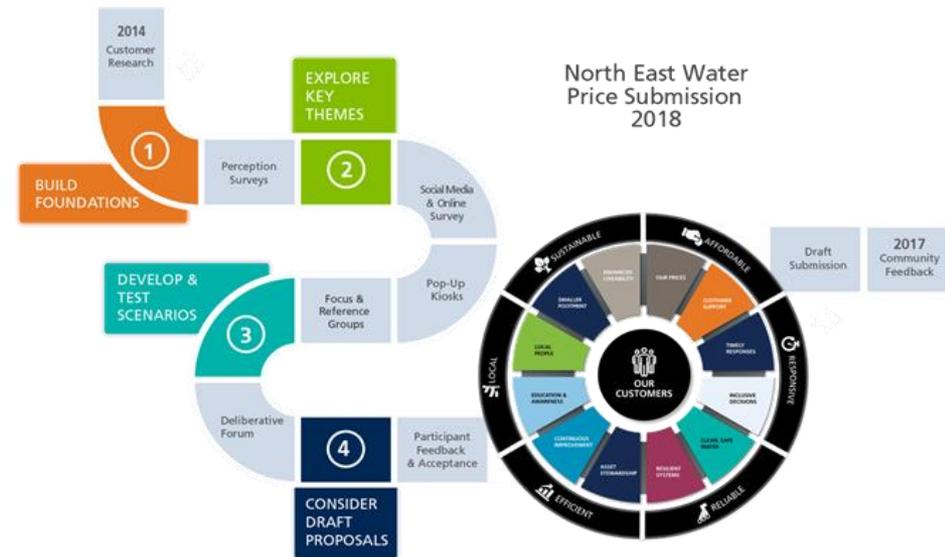
Regulators expect to see more than one source of truth – particularly for WtP studies

Check in with your customers regularly throughout the process to ensure your insights have been appropriately interpreted.

Be flexible and review and refine as you go.

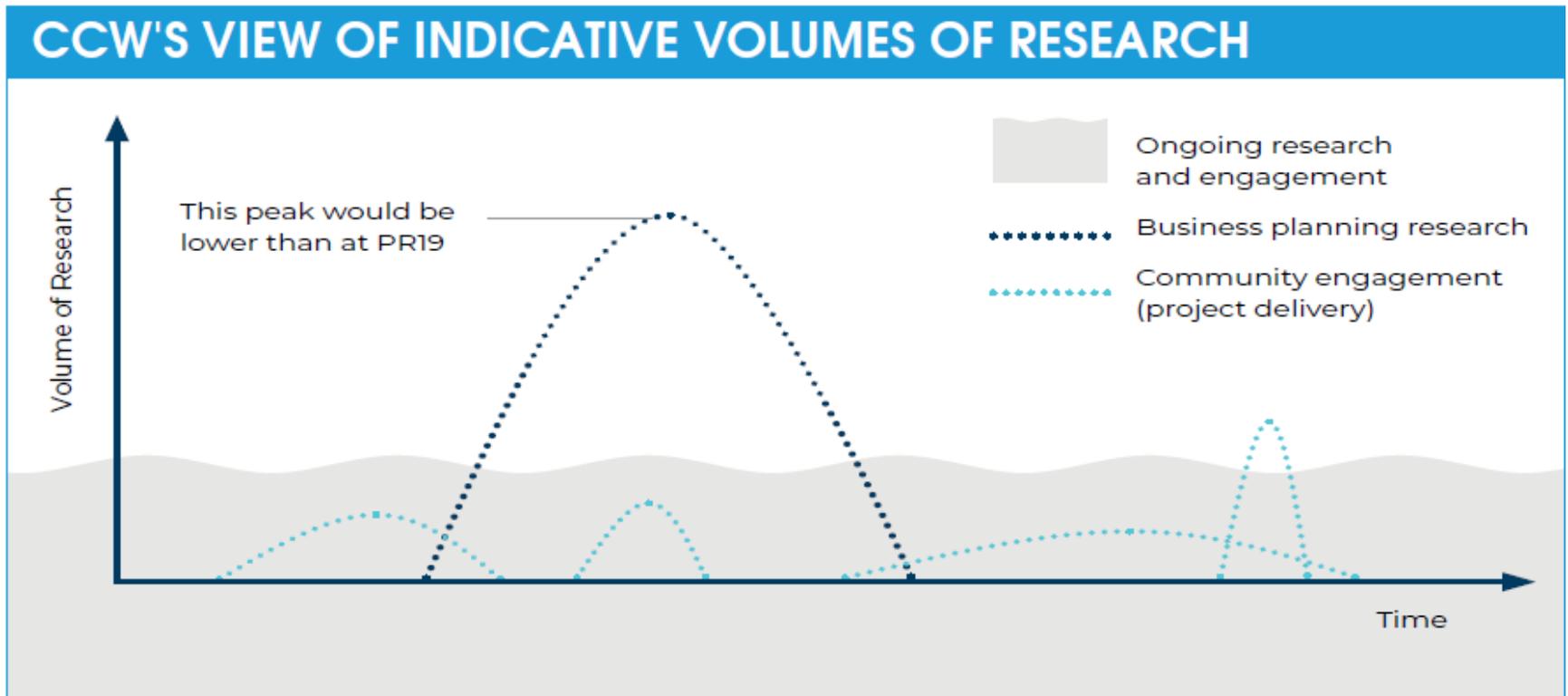
Check acceptability of the draft plan.

Be clear where changes have been made as a result of engagement.



4. Engagement is ongoing

This doesn't mean that the amount of engagement for a pricing submission will increase but it does mean linking it to existing engagement and customer research.

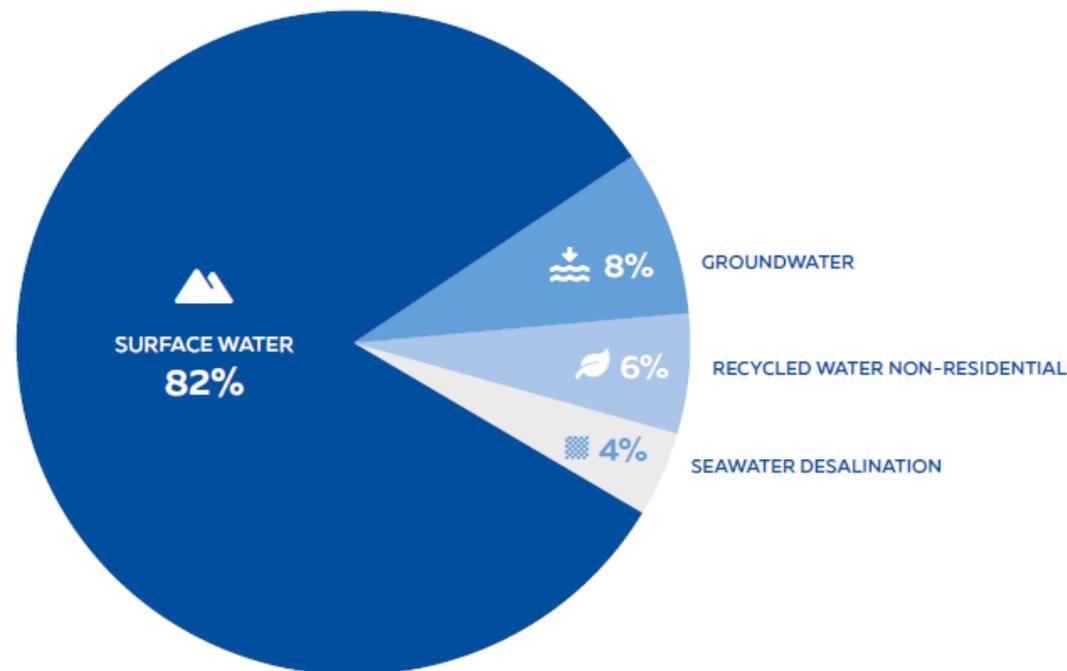


5. Consider long-term affordability

The challenge is adapting regulatory models to address long-term issues such as climate change, reducing emissions, water security etc. These need to be planned for over several pricing submissions if we are to ensure water bills stay affordable in the future.

WICS, the Scottish water regulator incorporated this in the latest determination for Scottish Water where based on customer engagement incorporated a 2% real price increase not just for this price path but at least the next one.

FIGURE 2 Existing sources of urban water in Australia 2018-19 (BOM, 2020)



6. Engage as customers and citizens

“What, if any, could the role of the price review be in encouraging or incentivizing companies to better deliver public value?”

Ofwat, Jan2021 in a paper on how customer preferences can better inform the price review process

Engagement is moving beyond just cost versus service trade-offs. We are also engaging on how our services can deliver social and environmental benefits (beyond compliance requirements).

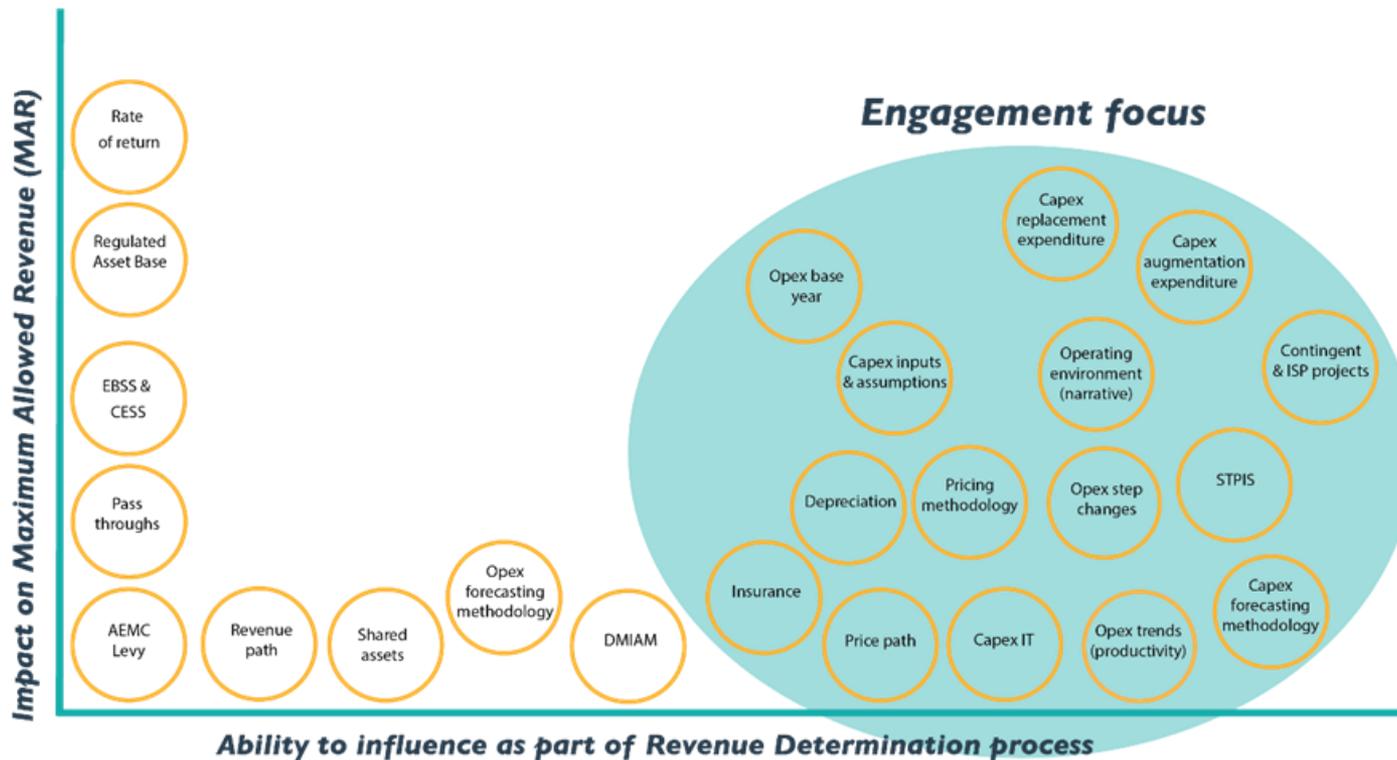


7. More things are on the table

We are now engaging on a larger proportion of the bill

Things we previously thought of as non-discretionary are up for engagement

Early engagement leads to customers making the decisions about what aspects are important



Outcomes of co-design process, Powerlink 2021

Greater engagement is here to stay

- 1. The water utility owns the relationship with the customer and regulatory models are recognising this.**
- 2. Engagement is strategic process made up of multiple parts.**
- 3. Customers have more input into price submissions. Regulators expect to see this reflected in a robust way.**
- 4. Incorporate all sources of customer data and intel into your engagement program**
- 5. The consideration of affordability beyond the price path**
- 6. Customers have expectations to engage on public value, not just on service levels and costs**
- 7. The topics for engagement are influenced by the customer – not just the utility or the regulator**