

How IPART regulates the water businesses

WaterNSW response 17 February 2023



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Executive Summary

WaterNSW looks forward to implementing the new regulatory framework at its next pricing review and determination in 2024-25. We have set out our plan for WaterNSW's early engagement with IPART for your consideration.

We appreciate the guidance provided by IPART in the draft handbook but note that some aspects of the implementation remain unclear and we require further advice to fully deliver the benefits envisaged under the new framework.

WaterNSW recommends that further information and clarification be provided around:

- **Focus principles** – including the purpose of introducing focus principles without weighting their consideration in self-assessment gradings. How will focus principles be treated differently to 'non-focus' principles?
- **Streamlined ex-post capital expenditure reviews** and further refining the scenarios in which a more detailed ex-post review will occur.
- **Pre-review of processes and systems** – including the timeline for this pre-review to facilitate the greatest benefits for the business and customers.
- **“Base Step Trend” for operating expenditure** and how IPART will review operating expenditures differently using this method.
- **Cost share review** – including the ability of WaterNSW to ensure equitable trade-offs between benefits for customers and maintaining a commercial return to our shareholders.
- **Predictive modelling and benchmarking** – the use of predictive modelling and benchmarking should be introduced only when comparable input data is available for modelling and the models themselves are sufficiently robust.
- **50:50 sharing ratio for all non-regulatory income** including the consideration of the net revenues from multiple projects to ensure a proportionate level of administration and to optimise benefits/costs to customers and communities.
- **Nexus between regulating water businesses' operating licences and their pricing:** recognising the long-term nature of a water business's operations and the shorter-term nature of pricing periods.

1. Introduction

Our submissions throughout the engagement process for IPART's review of how it regulates the water businesses have stated our support for IPART's intent to ensure the regulatory framework leads to greater customer engagement, innovation and efficiency in the water sector.

WaterNSW endorses the introduction of IPART's proposed framework that aligns with and complements the WaterNSW strategic priorities.

We commend IPART in providing guidance to water utilities to promote a smooth transition to the new framework. The publication of the draft handbook provides some practical guidance as to how various aspects of the framework are intended to operate. However, we consider that there are some aspects that require further clarification before businesses can implement the framework and deliver the best outcomes to customers over the next determination period.

2. WaterNSW's key positions

2.1 Early Engagement Plan for WaterNSW

WaterNSW welcomes IPART's new regulatory framework and supports the more structured relationship between our organisations in the one to two years prior to submitting our pricing proposal. In its Handbook, IPART suggests that this early engagement:

...provides an opportunity for us to have a structured discussion with each business to identify potential concerns early on, and for IPART to understand how to best support the sector when implementing the 3Cs framework.¹

We understand that, while consultation with IPART as part of early engagement can be informative to the business, IPART does not intend for the engagement to produce binding decisions or to substitute IPART's pricing review processes.

¹ IPART draft handbook, page 30.

Under the 3Cs framework IPART commits to proactively engage with board directors, executive leadership and regulatory teams to ensure businesses understand the objectives and application of the framework. Similarly, WaterNSW sees considerable value in engaging early with IPART so that relevant issues are brought to the attention of the parties as early as possible and so that IPART is provided with relevant background on the specific circumstances of WaterNSW, our customers and our unique operating environment.

IPART has provided the following indicative meeting schedule for early engagement.

Table 3.1 Indicative meeting schedule between IPART and a business

Who	Regularity of meetings during early engagement
Tribunal and water business's Board (or equivalent)	Every 6 months
IPART and water business's executive leadership team	Every 3 months
IPART and water business's regulatory team	Every 2 months

To promote openness and transparency and reduce the risk of real or perceived regulatory capture, IPART indicates that meetings between the Tribunal and Boards (or board equivalents) and the purpose of these meetings will be published on IPART's web site every six months. IPART indicates that this is consistent with IPART's standard approach to proactive disclosure.

IPART has indicated that during the early engagement it expects businesses to:

- Explain customers' influence on outcomes and the link between outcomes and plans; and
- Propose and explain how the focus principles align with customer preferences.

WaterNSW's proposed early engagement plan

WaterNSW proposes the following plan for early engagement with IPART in the lead-up to the lodgement of our 2024 pricing proposal:

Who	Regularity of meetings during early engagement
Tribunal and the WaterNSW Board	Notionally every 6 months, starting April 2023
Strategic Leadership Group (SLG) – members of IPART and WaterNSW executive leadership teams (including CEOs) and senior regulatory staff	Every 3 months starting in April 2023
Regulatory Working Group (RWG)	Every 2 months starting in March 2023*

Note: we would expect the regulatory teams to meet more frequently than this but that the above would be formalised as part of the early engagement process.

The above proposed engagement plan consists of approximately **20 meetings** prior to the lodgement of our pricing proposal in September 2024.

The meetings would be formalised in calendars and would be accompanied by agendas and papers (as relevant) with a summary of the meetings recorded as part of the early engagement process.

2.2 Focus principles

IPART's final report and handbook provide guidance on the 3Cs framework and guiding principles. WaterNSW is reflecting on the feedback from previous customer engagement to determine those priorities most important to our customers and the community. These preliminary focus principles will form the basis of future customer and stakeholder conversations and may evolve as a result of these conversations.

In the draft handbook IPART states the following regarding focus principles:

We will assess businesses' pricing proposals against the 12 principles in our 3Cs framework to grade the quality and ambition of a pricing proposal (see Appendix B). These are the same principles that the businesses will apply in making their self-

assessments, and our assessment will in effect act to affirm or challenge the businesses' self-assessments. **The businesses will identify focus principles which, if well justified, will be given greater emphasis in the assessments.** [emphasis added]

However, the businesses should not lose sight of non-focus principles and should self-assess against all 12 principles.²

To assist WaterNSW in engaging with our customers and communities on focus principles, we request that IPART clarify the purpose and value of focus principles and how they interact with non-focus principles during the upcoming review.

It is unclear what the role of focus principles is if they are not weighted in the self-assessment grading process. WaterNSW considers that, if these focus principles represent a higher level of engagement with customers and communities to reflect their priorities, then they should be given more credence in the 'calculation' of our self-assessed (and IPART's ultimate) grading.

If they are not, and water utilities are expected to equally address all 12 criteria in any case, we question whether focus principles should play a role in the upcoming review as it may lead to confusion and mis-guided expectations for our customers.

We request that IPART provide additional guidance on this matter in the Final Handbook.

2.3 Streamlined ex-post capital expenditure reviews

The handbook outlines a streamlined process for ex-post capital expenditure reviews but outlines the situations in which a targeted review will occur:

We conduct ex-post capital expenditure reviews by exception, rather than by default. Automatic ex-post reviews contradict the intent of the 3Cs framework for businesses. When we do review, we may target areas where:

- *the business has a significant capital project*
- *the business significantly overspends its allowed capital expenditure*
- *assets are repeatedly deferred and re-proposed*
- *evidence of underperformance exists, such as unmet service targets.*³

² IPART draft handbook, page 9.

³ IPART draft handbook, page 13.

These criteria appear to allow for a more detailed, targeted review in almost any scenario and does not provide any certainty or reassurance to businesses or customers as to how and when IPART may conduct reviews.

WaterNSW suggests that an approach using criteria closer to the National Electricity Rules (NER) whereby an ex-post review can only occur with a capital expenditure overspend and any resulting reduction in capital expenditure is restricted to the value of the overspend.⁴

Under the existing regulatory framework for electricity networks, the AER approves an ex-ante revenue allowance by scrutinising the prudence and efficiency of the forecast expenditure included in transmission network service providers' (TNSP) regulatory proposals. Once allowances are approved, the AER then relies on incentives, such as the CESS, to put downward pressure on a TNSP's actual expenditure. Under the incentive arrangements, TNSPs are rewarded or penalised based on their outturn performance against their revenue allowance.

Finally, if a TNSP's actual capex exceeds their approved allowance, the ex-post review process allows the AER to assess whether the overspend is prudent and efficient. The AER may exclude capex that does not meet this test from the RAB, under certain conditions. A primary condition is that an ex-post review may only occur with a capital expenditure overspend and that the value of any adjustment is restricted to the value of the overspend.

The nature of the ex-ante allowance and the availability of the CESS in both the AER and IPART regulatory frameworks results in incentives to invest efficiently that are similar. The availability of ex-post reviews with unfettered discretion by IPART (not part of the NER framework where the discretion is guided) leads to a higher risk of asset stranding for water utilities that is not compensated for elsewhere in the framework and that is inconsistent with relying on incentives to deliver efficient outcomes that reflect customers' preferences.

We suggest that IPART adopt the principles in the NER regarding ex-post expenditure reviews to balance the reliance on incentives in the regulatory framework with maintaining the ability to review expenditures above IPART's previous allowance.

This approach would more closely align IPART's intent for any such review of past capital expenditure to acknowledge the strong incentives already implicit in the regulatory framework to invest efficiently.

⁴ National Electricity Rules, clause S6.2.2.2A regarding reductions for inefficient past capital expenditure. <https://energy-rules.aemc.gov.au/ner/440/207113#6>

If there are concerns over capital underspends or deferrals, these would be more appropriately addressed through the ex-ante assessment of forward-looking revenues for the subsequent regulatory period rather than a stranding of assets via the ex-post review process.

2.4 Pre-review of processes and systems

WaterNSW sees merit in using pre-reviews of processes and systems to verify that a business has effective systems, processes, data and long-term planning in place. These advance reviews will facilitate more streamlined expenditure reviews during the pricing review.

We note that there will be an optimal time to undertake this type of review to allow businesses to make most use of the findings and implement business process improvements in time for the next pricing review. For most benefit we recommend that the pre-reviews occur mid-determination period. That is, around two years prior to the next review.

2.5 “Base Step Trend” for operating expenditure

WaterNSW forecasts its operating expenditure annually using a bottom-up approach. This method ensures that budget managers consider their resource requirements frequently and facilitates a regular 'check-in' with the leadership team.

That said, the base step trend methodology appears to be similar to the approach previously adopted by IPART and its consultants in the review of efficient operating expenditure. WaterNSW seeks clarification of the changes to IPART's assessment processes with the introduction of the base step trend methodology.

WaterNSW is willing to update its methodology for forecasting operating expenditure and will review its budgeting processes to ensure this can be done accurately.

2.6 Cost share review

IPART's handbook identifies that “...*In future proposals, WAMC and WaterNSW should detail their proposed cost shares, and should explain how these are consistent with IPART's cost sharing framework and principles...*”

WaterNSW agrees that customers, the community and the Shareholder should all have a voice in identifying the appropriate cost sharing arrangements for the upcoming rural

determinations and that the decisions reached and the processes to achieve those decisions need to be considered fair and independent.

We suggest the best way to demonstrate transparency, fairness and independence for a review of cost shares is for IPART to conduct a separate 'limited' cost shares review. The review should be a limited review rather than fulsome one, with the specific cost shares for investigation to be identified through our engagement activities or IPART's usual public consultation process as undertaken in prior reviews.

Previously IPART has undertaken its cost share reviews as a separate process to the pricing review. We suggest this process is continued but is focussed only on issues identified by stakeholders, with candidate issues assessed by IPART as requiring review.

WaterNSW is responsible for delivering services that customers and the community value and for contributing to the NSW Government earning a fair return on their investment in water infrastructure. WaterNSW considers that the best way to ensure that these potentially conflicting objectives are achieved in a manner that is seen as transparent, fair and independent by stakeholders is for IPART to undertake a separate 'limited' review.

2.7 Predictive modelling and benchmarking

Throughout its review of how it regulates the water businesses IPART has acknowledged that many activities of the Water Administration Ministerial Corporation (WAMC) and WaterNSW are unique. We consider that it is not appropriate to introduce predictive modelling or benchmarking for WaterNSW's forecast capital expenditure for the upcoming review and we recommend that we work with IPART to develop a mutually acceptable methodology for top-down expenditure forecast checking.

WaterNSW foresees that over time it may be possible to develop models in which we can have the necessary confidence for regulated revenue and price setting and that these can be used for future reviews, noting the relative absence of comparable firms to WaterNSW on which to draw meaningful conclusions for benchmarking purposes.

2.8 50:50 sharing ratio for all non-regulatory income

Our submission to IPART's draft report noted that the main consideration in applying rules around the use of regulated assets should be one that results in:

- The incentive to pursue greater utilisation of infrastructure assets by society; and

- Customers not facing any incremental costs associated the use of regulated assets for non-regulated purposes.

We noted that in some cases where the non-regulated revenues are relatively small, it may be a pragmatic approach to apply a 50:50 sharing of revenues as the administrative costs of a more detailed analysis of the incremental costs may not be warranted. For larger projects, however, IPART's proposed 50:50 sharing of profits may result in many otherwise viable projects not meeting the required commercial hurdles. This would be to the detriment of customers and the community.

WaterNSW therefore suggests that IPART apply a 50:50 sharing of revenues as a default position for small projects. We support, for larger projects where IPART's sharing of profits would apply, IPART's approach of providing flexibility is provided within the framework for the business to propose a different sharing arrangement on a case-by-case basis, balancing the commercial requirements of the business (including using the net revenues from a collection of projects where appropriate) with customer objectives to reduce bills.

3. Summary

WaterNSW supports the introduction of IPART's new regulatory framework and will continue to work with other water businesses and IPART to clarify the processes required to ensure the successful implementation of the framework.

In particular, WaterNSW recommends that further information and clarification be provided around:

- **Focus principles** – including the purpose of introducing focus principles without weighting their consideration in self-assessment gradings. How will focus principles be treated differently to 'non-focus' principles?
- **Streamlined ex-post capital expenditure reviews** and further refining the scenarios in which a more detailed ex-post review will occur.
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