

How we regulate the water businesses

WaterNSW response 26 August 2022



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Executive Summary

WaterNSW's Corporate Strategic Plan was launched in 2021 to reflect the things that matter most to the customers and local communities we serve. It commits WaterNSW to ongoing improvement in the delivery of our core business and services to customers.

WaterNSW supports IPART's intent to ensure the regulatory framework leads to greater customer engagement, innovation and efficiency in the water sector that enables efficient outcomes that are in the long-term interests of customers.

The proposed framework supports the effective delivery of our Corporate Strategic Plan and provides the flexibility for WaterNSW to deliver those services valued by customers within a longer-term business planning timeframe.

While we support the delivery of benefits to customers at the earliest opportunity, WaterNSW proposes a number of improvements to the framework and its implementation that seek to enhance the anticipated outcomes across the broader range of water businesses across NSW.

To ensure an efficient and effective regulatory framework for the next round of IPART determinations, WaterNSW suggests the following enhancements be adopted:

- **Additional time** provided to water sector participants to engage with IPART on the detailed implementation of elements of the framework review findings.
- To ensure a regulatory framework that is fit-for-purpose, WaterNSW suggests that IPART's framework allows for **different gradings to be proposed for each of the unique services we provide** under currently separate determinations rather than a single over-arching grading for a combined proposal.
- **A streamlined framework should be applied to the services provided by WAMC** to reflect the nature of the services provided and to reduce the risk of introducing disproportionate regulatory burden.
- Each water utility should be able to **propose an alternative form of price control irrespective of a proposal's grading** to provide an effective tool to manage volume variations while ensuring a fair sharing of risk between the business and its customers.
- The **introduction of the CESS should be deferred to the subsequent regulatory period** to ensure it delivers the intended outcomes and operates as intended. Alternatively, the scheme could be initially introduced using a 'paper trial' with no financial incentives during the detailed investigation phase.
- A business with a standard grading should be able to **'opt in' to IPART's incentive schemes** to provide the appropriate expenditure incentives, provide experience with the schemes and deliver enhanced customer outcomes.
- Comments on IPART's suggested approach to several modelling considerations, including calculating **depreciation and sharing of unregulated income**, are discussed in Section 3.6 of this response.

Throughout the introduction of the framework we will continue to work collaboratively with IPART to ensure that its implementation harnesses the benefits planned and envisaged.

1. Introduction

WaterNSW's Corporate Strategic Plan was launched in 2021 to reflect the things that matter most to the customers and local communities we serve. It commits WaterNSW to ongoing improvement in the delivery of our core business and services to customers.

Managing water, dams and associated infrastructure in the context of climate change and extreme weather events is always challenging; however, the Corporate Strategic Plan, along with its priorities for the future, combined with a highly skilled and committed workforce, will enable a better future for our customers and local communities.

1.1 WaterNSW supports the introduction of the new framework

WaterNSW acknowledges and appreciates the collaborative approach that IPART has taken in reviewing the economic framework to ensure it remains fit-for-purpose. We support 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. In particular, WaterNSW supports a regulatory framework that encourages the embedding of customer preferences into business decisions and one that encourages efficient outcomes that are in the long-term interests of customers. Throughout the introduction of the framework we will continue to work collaboratively with IPART to ensure that its implementation harnesses the benefits planned and envisaged.

1.2 The benefits and outcomes

IPART's flexible, proposal-driven approach will allow WaterNSW to consolidate and articulate those areas of service delivery that are important to our customers. From this existing knowledge we can engage with customers and stakeholders in a more meaningful way and allow our business decisions to be informed and influenced by the feedback we receive.

Focusing our business planning around customer engagement, while balancing efficient costs to deliver the desired outcomes and meeting our duty of care obligations, will facilitate long-term sustainability of WaterNSW for the benefit of today's customers and into the future.

2. WaterNSW's operating environment

WaterNSW delivers services to a diverse range of customers. We supply bulk water to customers in the Greater Sydney drinking water catchment and in the state's regulated surface water systems. Across the state we deliver some of the water management functions on behalf of the Water Administration Ministerial Corporation (WAMC).

In Broken Hill we transport, store and deliver bulk water from the River Murray at Wentworth to Broken Hill and surrounding communities. We also service a small number of local pastoralists along the route of the pipeline who receive raw water through five offtakes in the pipeline installed close to their properties.

Our services are delivered in a rapidly changing natural environment. Across the state many areas are currently experiencing widespread flooding and before the recent deluge, many of our regions were experiencing the lowest rainfall and driest conditions in more than a century.

WaterNSW owns and operates 42 dams across New South Wales (NSW), as well as hundreds of weirs and regulators and a small number of pipelines. We supply and deliver water through our infrastructure and the state's river systems to our customers, including Sydney Water, environmental water holders, farmers, irrigators, regional towns and industry.

In the regulated water management landscape in NSW, our purpose is to improve the availability of water resources that are essential for the people of NSW. Our main functions are:

- **Source water protection:** protection of the Greater Sydney drinking water catchment to ensure safe water is supplied to Sydney Water, local councils and other distributors for treatment and distribution to their customers;
- **Bulk water supply:** supplying water from our storages to customers in the Greater Sydney drinking water catchment and in the State's regulated surface water systems;
- **System operator:** efficient management of the State's surface and groundwater resources to maximise reliability for users through the operation of the state's river systems

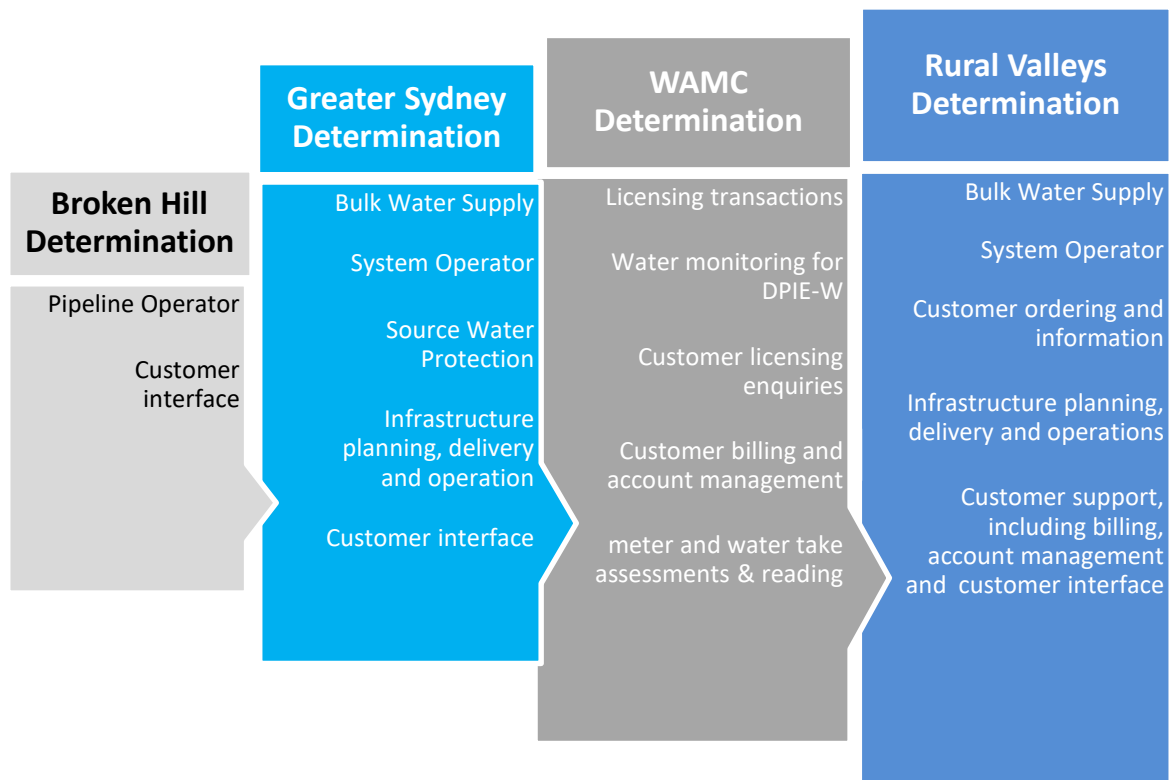
and bulk water supply systems, in collaboration with the MDBA which directs operations of the River Murray system;

- **Infrastructure planning, delivery and operation:** meeting customer-defined levels of service consistent with NSW Government policy and priorities to increase the security and reliability of water supplies to our customers and the communities of NSW; and
- **Customer water transaction and information services:** providing efficient and timely services to our customers for water licensing and approvals, water trades, billing and meet their water resource information needs for surface and groundwater quantity and quality.

We also own and operate the largest surface and groundwater monitoring network in the southern hemisphere and build, maintain and operate essential infrastructure.

Our regulated and non-regulated services

The regulated functions carried out by WaterNSW are set out in the figure below.



WaterNSW's monopoly services are the subject of four separate IPART price determinations:

- The maximum prices WaterNSW can charge for the water transportation services provided by the pipeline were set by IPART in the *Water NSW, Prices for water transportation services provided by the Murray River to Broken Hill Pipeline. BHP from 1 July 2019 – final Determination, May 2019 (currently under review)*;
- The services we supply to Sydney Water and some councils and minor customers in the Greater Sydney area are subject to the IPART Determination – *Maximum prices for Water NSW's Greater Sydney Services from 1 July 2020, June 2020*;
- The services we supply to irrigators, regional councils, mines, energy companies and environmental water holders in rural areas are subject to the IPART Determination – *WaterNSW, Maximum prices for rural bulk water services from 1 October 2021*; and
- The services we supply under our conferred WAMC functions are subject to the IPART Determination – *Water Administration Ministerial Corporation, Maximum prices for Water Management services from 1 October 2021*. We share this revenue with the Department of Planning and Environment (DPE) and with the Natural Resources Access Regulator (NRAR) which also provide WAMC services.

WaterNSW also supplies non-monopoly services such as leasing some of our facilities and certain commercial water monitoring services.

The varying roles and functions that WaterNSW undertakes is not uniform across our operations, suggesting the importance of IPART applying a tailored approach to regulation to ensure that the regulatory arrangements are fit-for-purpose. For instance:

- **Greater Sydney** - a relatively small geographical area with a customer base consisting of one large customer (Sydney Water Corporation) that funds approximately 99 percent of the efficient costs Greater Sydney bulk water services. We also supply bulk water to three councils (Wingecarribee, Shoalhaven and Goulburn) and around 60 small raw water and unfiltered water customers.
- **Rural Valleys** – revenues and prices are set for each of thirteen valleys¹ comprising approximately 6,300 customers holding 12,500 billable licences across a vast

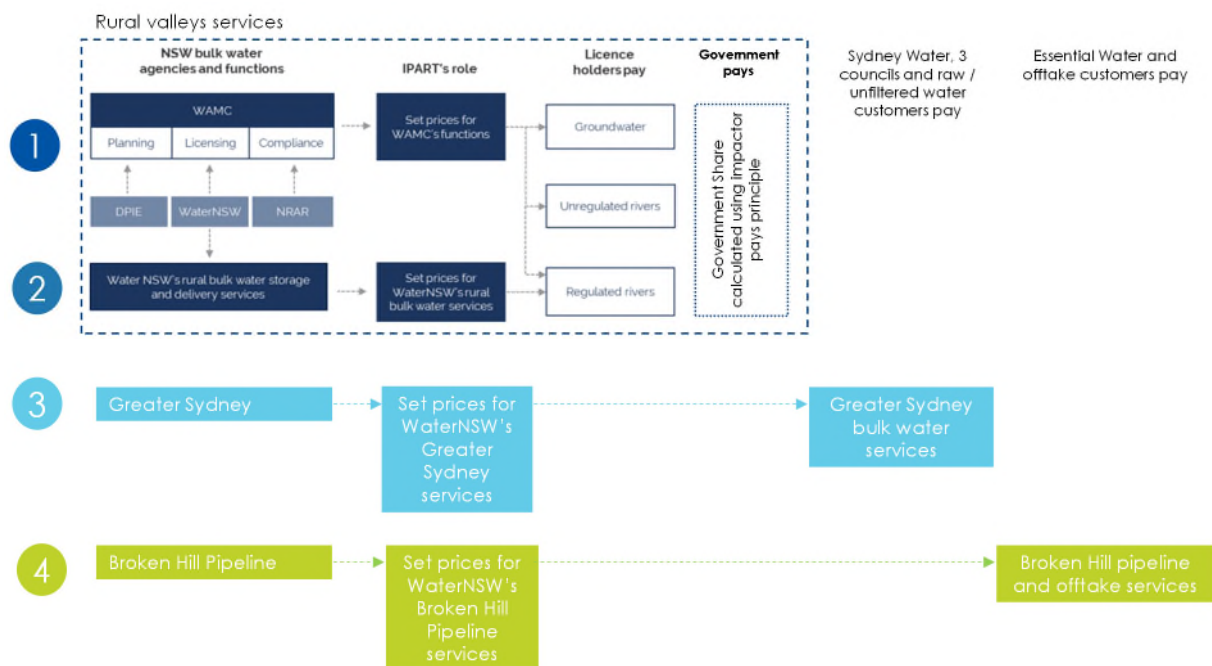
¹ The thirteen rural valleys regulated by IPART in its rural bulk water determination are Border, Gwydir, Namoi, Macquarie, Lachlan, Murray, Murrumbidgee, Hunter, Peel, Fish River, South Coast, North Coast and Lowbidgee.

geographical area. Each of the valleys has a unique operating environment and a diverse set of customer types. These include:

- o Private irrigators and Irrigation companies: irrigators use water for agricultural production while irrigation companies distribute water supplied by WaterNSW to their retail customers;
- o Environmental water holders: we release water for environmental purposes and environmental water holders are increasingly becoming a major customer segment for WaterNSW; and
- o Local Councils: council customers include Dubbo City Council, Albury City Council and Tamworth Regional Council.

We meet community needs by providing water for stock and domestic users. We are also responsible for delivering environmental flows on regulated rivers.

- **WAMC** – a single IPART determination is in place for WAMC services provided by DPE, NRAR and WaterNSW. WaterNSW provides billing and account management on behalf of each licence holding; licensing approval, administration and management, fee for service transaction services, including consent transaction and metering maintenance and reading charges; and water monitoring on behalf of DPE. WAMC water management charges are set for nearly 40,000 licences across 27 water sources - 11 regulated rivers, 12 unregulated rivers and 4 groundwater sources.
- **Broken Hill Pipeline** – We also provide water transportation services through the 270 km Broken Hill Pipeline that runs from the River Murray at Wentworth to Broken Hill, with charges to Essential Water and 5 offtake customers set by IPART. Virtually all the revenue is sourced via Essential Water charges as set by IPART.



Source: IPART and WaterNSW

Given the very different operating environments, customer numbers and composition and asset solutions used to provide regulated services, a 'one size fits all' regulatory framework for each of our current determinations moving forward would not reflect the different customer expectations and the level of stakeholder involvement desired. This could lead to ineffective and inefficient regulation with high compliance costs.

2.1 How can the new framework benefit these operations?

The proposed framework provides a regulatory environment that focuses on the credible delivery of customer-centric services at efficient cost levels. The framework supports the effective delivery of our Corporate Strategy, Strategic Objectives and our annual Strategic Initiatives and provides the flexibility for WaterNSW to deliver those services valued by customers within a longer-term business planning timeframe.

A regulatory focus on the 'bigger picture' allows water businesses to speak to their customers in the way that addresses customers' needs and facilitates business planning suited to the delivery of services. This, in turn, results in more efficient delivery of the services required and reduced regulatory burden for businesses and regulators.

2.2 Unique aspects of WaterNSW's operating environment

WaterNSW's operating environment is unique when compared to other NSW water businesses, highlighting that a tailored approach to regulation is required rather than a 'one size fits all' approach.

Within our thirteen Rural Valleys we have widely varying customers with equally diverse opinions across and separate revenue and pricing arrangements between valleys. Our customers are geographically dispersed with differing preferences for communication styles. Whilst this environment is challenging it also offers an opportunity to use innovative engagement methods to develop a robust and in-depth image of our customers' key preferences.

Contributing to the uniqueness of our operating environment is the one-off nature of many of our assets. This is further complicated by varying asset lives and maintenance requirements and the legacies left by the complex history of the previous organisations that preceded the formation of WaterNSW. This provides challenges to forecasting costs accurately, but delivers opportunities to ensure our asset management and investment processes deliver the best outcomes for our customers.

3. WaterNSW's key positions

3.1 The timeframes for implementation are short

While we support the delivery of benefits to customers at the earliest opportunity, WaterNSW considers that additional time is required for the water sector to engage with IPART on the detailed implementation of elements of the framework review findings.

IPART has been conducting a series of workshops over the past few weeks that are designed to dive into the details of key implementation elements of IPART's proposed findings. While engagement on these elements is supported and encouraged, we believe that additional time is required to ensure effective consultation on several key matters.

In particular, additional time is required to consult on the introduction of IPART's various incentive mechanisms (as discussed further in Section 3.5) and the role and calculation of

long run marginal costing where an initial issues paper was released by IPART in July 2022 but intended to be considered in the current review (see Section 3.6.3).

A sufficiently long consultation period is required to provide the water sector with the opportunity to fully understand and assess the workings and implications of IPART's proposals on key issues including the introduction of benchmarking models to assess expenditures (yet to be advanced), potential modelling changes and the development and implementation of IPART's proposed incentive schemes.

Incentive mechanisms

Regarding the proposed incentive schemes, *prima facie*, there could be perverse outcomes created from their introduction if the impacts individually and in combination are not fully understood. For example, a grading of advanced or leading rewards a business through a financial incentive via a percentage increase in its annual revenue requirement if (in the case of the EBSS or CESS) the business's costs are lower than allowed by IPART.

In this scenario, the 'reward' to the business is additional revenues that *a priori* leads to higher customer bills in the short term. It is unlikely customers would welcome these increases.

We note IPART's view that providing financial incentives in the short term to encourage more efficient behaviour in the long term is in customers' long-term interests and that the long term 'gain' from the efficiencies outweighs the short term 'pain' from higher prices as a result of the incentive payments.

We suggest that IPART exercise caution when introducing new incentive schemes with financial rewards and penalties to ensure that the desired impacts, outcomes and incentives have been adequately consulted on to exude confidence from stakeholders that the schemes are likely to operate as IPART intended.

Furthermore, penalties arising from capital expenditure schemes may undermine the Board's risk appetite and the need to invest in otherwise non-discretionary projects resulting in inefficient expenditure profiles over the longer term.

WaterNSW therefore suggests that IPART's detailed implementation plan for the rollout of the new framework should be extended, noting that the development of the detailed workings of IPART's proposed changes may take six to twelve months after the final report is released to ensure effective consultation on key matters. This includes deferring the CESS to the subsequent determination.

We highlight that in the electricity network sector, the AER's consultation process on the development of its incentive schemes occurred over a twelve month period and that the AER is currently consulting on potential changes to its CESS that will take place over an eight-month period.² As IPART has largely adopted the AER's CESS, WaterNSW suggests that IPART not commence its consultation on the CESS until the AER's final position on the matter is decided in April 2023. This, combined with other limitations of the CESS in its current form as discussed in Section 3.5, suggests that there is insufficient time address the appropriate design of a CESS when considering its potential limitations. These limitations suggest that IPART should not introduce a CESS with financial incentives as part of the regulatory framework for the upcoming round of regulatory reviews.

Focus principles

WaterNSW also seeks to engage with IPART in the lead-up to and following the release of the final report on the proposed approach to identifying 'focus principles' (i.e. a subset of the full suite of principles) to be tailored for our business.

We look forward to early engagement with IPART on this matter to ensure that the grading of our proposal in the first round of reviews recognises realistic pathways to meeting the focus principles for our business.

3.2 Differential grading and a combined proposal

WaterNSW suggests that the grading framework should apply to services specified in existing determinations rather than the proposal as a whole and should take into account the diversity of the customer base. This may suggest separate gradings for different services (i.e. Greater Sydney, Rural Valleys and WAMC).

Differential grading for the different services provided by WaterNSW recognises that aspects of the business are at different levels of maturity with different expectations for service delivery. Applying differential grading, rather than a 'lowest common denominator' approach will provide incentives across the business to 'perform up' and deliver improved customer outcomes across the range of services over time.

² AER Review of incentives schemes: Options for the Capital Expenditure Sharing Scheme Position paper - August 2022.

<https://www.aer.gov.au/system/files/incentive%20review%20%20CESS%20position%20paper.pdf>

Grading the service based on the existing determinations rather than the proposal incentivises meaningful improvements to service delivery, and would be better understood by customers.

WaterNSW has been successfully engaging with its customers for many years and understands the complexities involved with effective customer engagement across our diverse customer base.

WaterNSW is planning to prepare a single regulatory proposal for the upcoming review that addresses our services across three current determinations reflecting the way our business operates and demonstrating to customers the economies of scale and scope delivered through those processes. There are some challenges in aligning this approach to the new timeline and requires thoughtful and extensive consultation with our customers and stakeholders. This may require substantial work to be undertaken (at significant expense) to present it in a way that meets the principles but we think that this approach aligns well with IPART's 3Cs approach that will ultimately result in benefits to customers, the business and IPART.

The benefits of a combined proposal (as well as aligning the timelines of the determinations more generally) include:

- Efficient proposal preparation and review processes, resulting in reduced regulatory costs for both WaterNSW and IPART.
- Improved accuracy for cost allocation of overheads within and between determinations and other cross-agency expenditure.
- Minimising the potential of 'consultation fatigue' that customers experience with the need to participate in frequent separate regulatory reviews when customers face many more significant issues, including responding to floods, drought and inflationary pressures.
- The ability to 'take stock' and review and improve our internal investment and asset management processes across all of our major activities to ensure they are best practice and deliver value for money for customers.
- Greater transparency for customers about the service outcomes we deliver and how costs are incurred and allocated.

WaterNSW is committed to investing the additional time and resources required to embed our customers' preferences in our future proposals as reflected in our Corporate Strategy.

However, this process is a journey that is unlikely to be fully implemented over the next two years as we prepare our pricing proposal for the upcoming review.

WaterNSW agrees with IPART that a key outcome from the review is to ensure the regulatory framework can be better tailored to the different customer bases, sizes and services provided by the businesses IPART regulates.

This is particularly true for WaterNSW, where we are currently subject to four IPART determinations for the monopoly services we provide, each with unique operating characteristics that makes it challenging to apply a 'one size fits all' approach to economic regulation.

The other water utilities regulated by IPART do not share the same degree of diversity of existing regulatory determinations and associated customer bases. Therefore, the need for a tailored approach to the regulatory framework applying to WaterNSW needs to consider the following:

- What constitutes effective customer engagement for WaterNSW needs to be tailored to the services we provide. For instance, the complexity of customer engagement for Greater Sydney and the Broken Hill pipeline (each characterised by one large customer and a handful of small customers) is vastly different to the complexity of engagement required for rural customers (bulk water and WAMC) given the valley-by-valley approach to rural bulk water (or water source in the case of WAMC) and the diverse customer base.
- This raises the proposition that a single grading may not be appropriate in our circumstances.
- To ensure a regulatory framework that is fit-for-purpose, WaterNSW suggests that the IPART's framework is sufficiently flexible to allow different gradings to be proposed for each of the unique services we provide rather than a single over-arching grading for a combined proposal.
- The ability to propose separate gradings is in the long-term interests of customers as it would provide the incentive for WaterNSW to progress from:

standard → advanced → leading

in a realistic timeframe that reflects the current maturity of each service and the associated customer base and operating environment.

- The option to propose separate gradings by service also avoids institutionalising the perverse incentive to propose a single grading based on the “lowest common denominator” (i.e. a standard grading) to avoid IPART penalties for an overly ambitious self-grading if each service, and the corresponding customer engagement requirement, vastly differs.
- For WaterNSW this could mean a different self-grading for our services in Greater Sydney (perhaps a more ambitious target) compared to rural bulk water services and WAMC.

3.3 Water Administration Ministerial Corporation

Due to the considerable differences in the operating model for services provided by WAMC (i.e. services delivered by three entities with revenues shared from customer charges and significant government funding), we consider a streamlined approach to implementing the framework should be implemented. The WAMC services that are partly paid for by bulk water customers provide a benefit to users and the rest of the community – these impacts and benefits are recognised by the current regulatory framework with the allocation of revenue requirement according to pre-defined user shares.

The societal nature of the services and the high proportion of costs allocated to the Government renders many principles of the new framework less applicable than to other types of water business.

These operational and regulatory differences mean that the evidence to demonstrate success in the new framework will be vastly different from that provided in support of WaterNSW's other services.

Whilst WAMC services are undertaken by three organisations, those provided by WaterNSW are delivered under the same customer relationships, core investment and businesses processes that will be reviewed and tested as part of the upcoming bulk water determination(s) and should give IPART confidence in reviewing efficient expenditures for licensing and water management functions that the underlying processes are efficient and effective. This should provide confidence to IPART to adopt a more targeted review of WAMC costs and prices.

The extent to which the new framework applies to WAMC should recognise the risk of increased regulatory administration costs to meet the new grading requirements that are not reflective of the WAMC service arrangements provided by the three organisations. For instance, the individual grading for the services provided by each of the three entities may

differ and attempting to combine to a single grading may lock in a standard grading for the 2025 determination.

3.4 Risk mitigation and financial stability

IPART currently sets maximum prices for water businesses, and it proposes continuing this approach for businesses with a proposal graded as 'standard'. Under this framework a high risk to WaterNSW's financial stability is the lack of appropriate mechanisms to manage volume risk in the rural valleys.

However, IPART indicates it would expect advanced or leading businesses to explore and propose the most appropriate form of price control, which could be a revenue cap or a weighted-average price cap. IPART states that these businesses would need to demonstrate they understand what tariff structure provides the best balance of risk between customers and the business, particularly over the longer-term, while ensuring they are implementable and easy to audit.³

Under IPART's proposed framework, the form of price control appears to be treated as an incentive since it would only be available to advanced or leading firms.

While a water business should engage with its customers on this matter, WaterNSW considers that the form of price control should be considered in the wider context of managing volume and revenue volatility to enable a business to recover its efficient costs, while providing opportunities to encourage greater tariff offerings for customers.

WaterNSW considers that the decision on the appropriate form of price control should not be linked to a firm's 'grading'. The Essential Services Commission in Victoria (ESC) uses its PREMO (performance, risk, engagement, management and outcomes) water pricing framework. This framework asserts that demand and supply risks should be allocated to the party best able to control or manage the risk and incentivises the party to reduce the risk or manage it effectively. The PREMO framework recognises the form of price control is an important tool for ensuring water businesses achieve sustainable revenue streams over the regulatory period.

This option is available to all water businesses that can demonstrate that customers have been consulted and that the proposed form of price control can be easily understood,

³ IPART Discussion Paper 3 – encouraging innovation, page 16.

manages risks effectively for the business, delivers price stability and sends appropriate price signals to customers. For example, under this framework Goulburn Murray Water's 2016 determination allowed 100 per cent fixed charge under revenue cap.

WaterNSW is contemplating the use of alternative forms of price control, including revenue caps or unders-and-overs mechanisms in our future reviews that we believe are in the long-term interests of our customers. We have engaged with our customers in previous reviews on pricing-related matters, including the form of price control, and propose to continue this dialogue with customers in the leadup to our next pricing proposal.

The appropriate form of price control is a topic of interest to our customers and we suggest that, should IPART deem WaterNSW to have a standard grading, discussions would be marginalised as the outcomes from the engagement could not be implemented in any case under IPART's current proposal.

Discussions on the form of price control should not be restricted by our self-assessment (or IPART's ultimate assessment) as to whether our services are graded as 'standard', 'advanced' or 'leading'. We suggest that alternative forms of price control should be available to all firms irrespective of grading to manage volume variations and to ensure a fair sharing of risk with customers.

3.5 Incentive mechanisms

The proposed framework proposes a number of incentive mechanisms including an operating expenditure benefits sharing scheme (EBSS), a capital expenditure sharing scheme (CESS) and a customer outcomes delivery incentive scheme (ODI). These mechanisms are available to all advanced or leading proposals. WaterNSW considers that more time should be taken to design these mechanisms to ensure that they incentivise the intended business outcomes. For example, the AER is currently reviewing its CESS and EBSS and has a review timeline of almost 12 months for the review of these mechanisms only.

In advance of a more targeted consultation period WaterNSW makes the following high-level comments in relation to the suite of incentive mechanisms:

- The introduction of a CESS is complex and, if not implemented correctly or combined with mis-matching incentive mechanisms can introduce perverse outcomes:

- Businesses can be rewarded (and customers pay extra) for reductions in capital expenditure due to previous forecasting errors, rather than genuine efficiency gains.
 - Incentives to reduce capital expenditure may come at the expense of reduced asset condition, resulting in increased expenditure in future years.
- To implement the suite of mechanisms correctly WaterNSW suggests the following:
 - The implementation of the CESS be deferred to subsequent regulatory period or be implemented using a 'paper trial' at the 2025 determinations with no financial incentives.
 - Consideration of whether exclusions (such as for growth or other legislative requirements, e.g. environmental reviews) should apply and whether CESS should look at recurrent expenditure only. The latter would ensure that market tested and benchmarked estimates (as relevant) are available for forecasting and would exclude the one-off, 'lumpy' expenditures that are typical of large capital expenditure programs.
- IPART's concerns relating to the allocation of costs between operating expenditure and capital expenditure if the incentive schemes are introduced at different times should be mitigated by:
 - IPART signalling that a CESS will be introduced, which sends a strong message to businesses that any unexplained movements between operating and capital expenditure in the interim would be investigated by IPART.
 - The recognition that the current efficiency carryover mechanism (ECM) has operated since its introduction without a capital incentive mechanism and we are not aware of any specific instances of cost shifting between capital and operating expenditure that this has caused.
- "Getting it right" and taking the time necessary to implement the CESS effectively is more important than rushing the introduction of a scheme that has not been thoroughly investigated to ensure it is fit-for-purpose in the NSW context.

Regarding the EBSS, where the incentive mechanisms are mandatory for advanced and leading proposals, but not available for a standard proposal, WaterNSW suggests that standard businesses should be able to 'opt in' to provide the appropriate expenditure incentives and delivering enhanced customer outcomes.

The details around potentially lower sharing percentages or different caps and the combined incentive payments could be considered as part of an extended consultation process.

3.6 Other considerations

3.6.1 Modelling simplifications – Fewer RAB categories

In the draft report, IPART states that the cost building block models it uses to set prices have become increasingly complex over time. IPART proposes a number of modelling simplifications that it considers would not compromise the overall integrity of the prices it sets (or the incentives it provides to promote better outcomes).

One modelling area that IPART proposes to simplify is reducing the number of regulatory asset base (RAB) categories per service and providing more flexibility to water businesses to propose appropriate asset lives.⁴ IPART notes that the main benefit, and indeed the purpose, of having multiple asset base categories for each service is to estimate depreciation with a degree of accuracy. IPART further notes that grouping assets with similar lives provides a benefit that once established, asset lives tend to become “fairly uncontentious” during a review because the businesses and IPART can calculate the remaining lives at the end of a determination with some degree of accuracy.⁵

WaterNSW agrees with the benefits of the current approach.

IPART, however, outlines that while the current approach has advantages, it results in:

- Large and complex models and information requests;
- Multiple sets of allocations, as all capital expenditure, RAB adjustments disposals and other factors must be separated by asset category; and
- Potential for ‘spurious’ accuracy, as calculating remaining lives in asset categories inevitably requires a degree of inaccuracy.

IPART considers that the above limitations of the current approach justifies moving to two asset categories per service – one for all depreciating assets and the other for non-

⁴ IPART draft technical report, page 62.

⁵ Ibid, page 62.

depreciating assets. Under this approach, IPART and the businesses would no longer calculate remaining asset lives, and instead the business would propose:

- The remaining life of existing assets based on evidence of economic lives, for example its asset register;
- The expected life of capital expenditure for each year. The weighted average asset lives will likely vary from year-to-year depending on the mix of items in the capital expenditure program.

IPART considers that the proposed approach could lead to depreciation rates that reflect the actual 'consumption' of assets more accurately than under the current approach.

WaterNSW does not support a mandated move away from the current approach of identifying multiple RAB categories at each review to IPART's proposed approach. This is due to the following:

- The modelling effort and inputs required to calculate a weighted average depreciation profile is the same as is required under the current RAB category approach, thereby negating any perceived benefit of the move;
- IPART's proposed approach would be a retrograde step away from achieving greater transparency and cost recovery of the RAB;
- The proposed approach to varying depreciation rates does nothing to address IPART's perception of the 'spurious' accuracy of the existing RAB category approach.

We also note that in recent determinations, WaterNSW has proposed, and IPART has largely accepted, additional (rather than fewer) RAB categories to improve the cost reflectivity and transparency of the depreciation calculations.

For instance, in our 2021 Rural Valleys determination, IPART noted the following:

In our Draft Report, we suggested Water NSW consider disaggregating the RAB for each valley into 2 or 3 categories based on their asset lives to better estimate depreciation for the next determination period.

Water NSW agreed and considers disaggregating the RAB into a short-lived and a long-lived RAB would more accurately align costs and revenues. It suggested retaining the existing RAB and separating new assets into short-lived and long-lived RABs...

We maintained our draft decision to calculate regulatory depreciation for new assets using the weighted average life of assets by valleys, without disaggregation into short- or long-lived RABs. We prefer to maintain our approach until we review our WACC method, which would allow suitable stakeholder consultation on this matter. We generally support the approach to disaggregate the RAB and are aware it would put upward pressure on prices.⁶

In its 2020 determination for bulk water charges in Greater Sydney, IPART stated the following:

However, we can more accurately calculate depreciation on capital expenditure by using the individual asset life for each asset category. While using an average asset life means that Water NSW will recover the full cost of the capital expenditure over the (weighted) average life of that capital expenditure, using disaggregated asset lives provides a more accurate year-by-year depreciation profile.

On 10 March 2020, Water NSW submitted a proposal to disaggregate capital expenditure into a number of asset categories. In its response to our Draft Report, Water NSW re-iterated its view that a disaggregated approach better reflected its actual year-by-year depreciation profile. Water NSW also indicated its intention to disaggregate its existing RAB for the next determination period (2024).⁷

The extracts from recent IPART determinations highlights that WaterNSW has embarked on a process to improve the cost reflectivity of the depreciation calculation – that IPART has largely accepted - by using the individual asset life for each asset category, and that this necessarily results in greater, rather than fewer, categories in many cases. We suggest the current approach is fit-for-purpose and wholesale change is not required for the depreciation calculation.

Finally, WaterNSW has been calculating depreciation based on multiple RAB categories for many years and determinations, noting it is a relatively minor administrative task for the business and IPART to undertake.

In summary, WaterNSW does not support IPART's proposed change to the depreciation calculation based on fewer RAB categories and weighted average asset lives. We request that IPART not mandate its proposed change and instead allow each business to assess whether the current or proposed approach to calculating depreciation better meets the

⁶ IPART 2021 *Final Report on Review of WaterNSW's rural bulk water prices*. Page 96.

⁷ IPART Review of prices for WaterNSW Greater Sydney from 1 July 2020, page 151

long-term interests of customers when taking into consideration the business's unique circumstances.

3.6.2 50:50 sharing ratio for all non-regulatory income

Non-regulatory income is income from unregulated services using regulated assets. Non-regulatory income from all sources is generally a very small (e.g. less than 0.5 per cent) proportion of the net revenue requirement.

IPART states that businesses are concerned about the incentive effects of sharing ratios, which has led to very detailed information requirements, modelling and proposals in pricing submissions. The businesses and IPART spend a disproportionate amount of time and effort for a small impact on prices.

IPART therefore proposes applying a 50:50 sharing ratio for all non-regulatory income. IPART notes that a 50:50 ratio has always been its default position for non-regulatory income and that this approach provides adequate incentives to provide the service and will avoid distraction from more important and material matters.

WaterNSW notes 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.

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, a 50:50 sharing of revenue may result in many otherwise viable projects not meeting the required commercial metrics to proceed due to the high sharing requirements. This would be to the detriment of the community.

WaterNSW therefore supports IPART's approach of applying a 50:50 sharing mechanism as a default position for small projects, but recommends that 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 with customer objectives to reduce bills.

3.6.3 Estimating Long Run Marginal Cost

WaterNSW notes IPART's Information Paper A *more accurate way to estimate LRMC* that forms part of the review into how water businesses are regulated. Submissions are due 30 September 2022.

As discussed earlier in this response, WaterNSW seeks to ensure appropriate consultation occurs on matters that have the potential to significantly impact a business's costs or prices.

The IPART LRMC Information Paper was released near the end of a two-year consultation process (released in July 2022) and consultation with us had not occurred prior to the paper's release. We therefore request that IPART provides stakeholders with a period to respond to this paper over the next six to twelve months. As LRMC does not play a direct role in our regulatory arrangements, it will take some time to assess the content and relevance of the paper to our circumstances and how it fits within IPART's framework review.

4. Summary

To ensure an efficient and effective regulatory framework for the next round of IPART determinations, WaterNSW proposes the following:

- **Additional time to engage with IPART on the detailed implementation of the framework review findings should be provided to the water sector.** IPART has been conducting a series of workshops over the past few weeks that are designed to dive into the details of key implementation elements of IPART's proposed findings. While this engagement is supported and encouraged, the current rollout of the workshops is insufficient to ensure effective consultation on key matters and detailed consultation may need to take place up to 6-12 months after the final report is released to ensure appropriate consultation on these key topics. In particular we suggest that deferring the introduction of the CESS to the subsequent determination to ensure that the combination of incentive mechanisms operate as IPART intends.
- To ensure a regulatory framework that is fit-for-purpose, WaterNSW suggests that IPART's framework allows for **different gradings to be proposed for each of the unique services we provide** (distinguished by the current independent determinations) rather than a single over-arching grading for a combined proposal. The ability to propose separate gradings would provide the incentive for WaterNSW to progress from

"standard to advanced to leading" in a realistic timeframe that reflects the current maturity of each service and the associated customer base and operating environment while avoiding the perverse incentive to propose a single grading based on the "lowest common denominator".

- **A streamlined framework should be applied to the services provided by WAMC** to reflect the nature of the services provided and to reduce the risk of introducing disproportionate regulatory burden to a largely government funded business providing significant community benefits.
- **Each water utility should be able to propose an alternative form of price control irrespective of a proposal's grading.** This is to reflect that the form of price control (including a revenue cap, an "unders and overs" mechanism or a weighted average price cap) is a key risk management tool to address volume risks while ensuring a fair sharing of risks between a business and its customers. Alternative forms of price control should not be considered on a similar basis to financial incentives for improved performance that are available only to 'advanced' or 'leading' proposals.
- To ensure the incentive scheme delivers the intended outcomes and operates as intended, the **CESS implementation should be deferred to the subsequent regulatory period** or be implemented using a 'paper trial' at the 2025 determinations with no financial incentives.
- A business with a standard proposal should be able to **'opt in' to IPART's incentive schemes** to provide the appropriate expenditure incentives and deliver enhanced customer outcomes. The details around lower sharing percentages or different caps and the combined incentive payments could be considered as part of the extended consultation.
- The current approach to calculating depreciation is superior to the proposal to base calculations on fewer RAB categories and weighted average asset lives. Where there are no defined benefits of changing methodologies business should be allowed to nominate to continue with the current approach to calculating depreciation.
- Support for the introduction of default positions for unregulated income for small projects but proposes flexibility to propose alternative sharing arrangements for more significant projects on a case-by-case-basis