

Response to IPART Tribunal request for comments on the Sydney Water Corporation letter dated 11th January 2012

14th February 2012

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1. Summary

We submit this report in response to the Tribunal's request to comment on the Sydney Water's letter of 11th January 2012. We set out the key points from our review under the same headings as the letter.

Experience and Methodology

- Our approach to assessing capital and operating efficiency is based on the hypothesis of a Frontier Company competing in an open market to deliver services to customers. This is consistent with Ofwat's review of efficiency to support determinations in 1999, 2004 and 2009. Our team has considerable experience in reviews of efficiency in utilities in Australia, the UK, and the Middle East.

Operating Expenditure

- The opex efficiency targets are challenging and broadly in line with those set by Ofwat in 2009. They are additional to the efficiencies proposed by the companies. The catch-up efficiency recognises the efficiencies proposed by Sydney Water and the main impact is in the latter part of the price period. The continuing efficiency is the same as used by Ofwat and is based on a study carried out for the regulator.

Capital Expenditure

- **Efficiencies:** The proposals are based on five areas where Sydney Water should be able to deliver material improvements through the development and application of processes including: improvements to investment planning; cost estimating and the management of contingencies; the impact of new procurement processes; and likely savings from more effective program management. A greater part of the efficiency savings are within the management of Sydney Water rather than market conditions. The average efficiency we have applied is around the upper quartile of the range of efficiency targets of other companies.
- **Growth in the current period:** Expenditure to meet growth from new customers forms 46% of total capex. In the current price control period, there was a shortfall in delivery of 150,000 new connections because the expected growth did not occur. Rather than ring-fencing this expenditure for a future price period or offering a reduction in charges to customers, Sydney Water funded additional corporate expenditure, mainly IT and property related. We have suggested to IPART that it considers what regulatory action might be appropriate to address this practice in the future.
- **Growth in the future period:** We have re-phased the growth capex to reflect the reducing certainty of expenditure over time, as we did for Hunter Water in 2008. This results in a 15% reduction although growth expenditure still remains significant. We have noted an inconsistency in the adjustment for 2016, although this has no material impact on prices.

Timing of Outputs

- **Water Mains Renewals:** Sydney Water proposed a step increase in activity and costs for asset renewals compared with the current price path. With a material reduction in mains burst rates, good performance and significant headroom against the Operational Licence standards, assets are in a stable or improving serviceability where it is difficult to justify such step increases in expenditure. Our proposals recognise the need for some additional expenditure to maintain assets which we have re-profiled over one or two price control periods. The impact is to defer the timing of some outputs and lead to a gradual change in

expenditure. Our adjustments refer to the margins of investment where the benefits of mains replacement are not material and have little impact on operating expenditure.

- Water Pumping Station Renewals: We noted inconsistency between our Report and expenditure tables and accept the need for some additional expenditure.
- Wet Weather Overflow Abatement: We have supported some 84% of the proposed program. We have questioned the effectiveness of some of this work and suggested that a review of the benefits being achieved. We have not seen evidence of surveys to determine customers' willingness to pay for achieve further environmental gains. If such expenditure can be demonstrated and is prudent, it can be logged up at the next Determination.
- System Reliability Water: We are supportive of this program which is currently at a preliminary planning stage with projects for funding have yet to be identified. There was therefore insufficient evidence of project identification and evaluation to justify the level of expenditure proposed. As a result, we have re-phased some expenditure from 2015 and 2016 into the next price path period.
- Priority Sewerage Program: Sydney Water comments on business efficiencies in our Report in isolation. We formed the view that efficiencies can be made on the PSP programme by considering alternative technologies, appropriate design, negotiation with the EPA regarding effluent discharges or innovative mitigation methods, allowing more time and resources for cost estimating during optioneering and placing less weight on residents preferences which are likely to lead to "gold plated" solutions.

Corporate

- Information Technology: While the Corporation states that any limitation on budget will prevent delivery of business strategies, Sydney Water did not demonstrate clearly the link between its investment in new IT capability and its effects on the overall operating cost efficiencies and customer service targets. For the next price path we found that there was a lack of robust evidence supporting its investment in new IT capability. On the basis of comparative IT costs for water agencies, we consider that the level of expenditure is sufficient to fund support by vendors for the critical business systems. It is not necessary to have the latest software versions and it should be possible to negotiate extended or reduced support in some cases;
- Water Meters: We welcome the acceptance of the proposed reduction in general water meter replacement expenditure, however we do not support the case for \$3.9 million capex to be restored for remote metering. Sydney Water states that the latter program is cost neutral therefore we would argue that the Corporation should meet the capital expenditure out of the savings on operational expenditure. Furthermore, the "unacceptable" level of customer service which Sydney Water has cited appears to be justified on the basis of the lack of customer co-operation, not as a result of any failure on the part of the Corporation.

The Sydney Water letter dated 11th January 2012 has provided no additional information to change the conclusions and proposals we presented in our Final Report 'Review of Sydney Water Corporation's Operating and Capital Expenditure' dated November 2012 except for two non-material adjustments which we detail.

2. Introduction

This report has been prepared at the request of the Tribunal to respond to the comments by Kevin Young, the Managing Director of Sydney Water Corporation, in his letter dated 11th January 2012. It has been structured to reflect the contents of the letter.

The purpose of the report is to provide further explanation and support to the conclusions and efficiency proposals we presented in our Final Report 'Review of Sydney Water Corporation's Operating and Capital Expenditure' dated November 2012.

3. Our Experience

Frontier methods for estimating efficiency are widely used in regulatory practice. In the water industry, this approach has been widely used in England and Wales, in Australia and in the Middle East. It is also utilised in many other industries and markets around the world.

The Atkins/Cardno team that we put forward for this assignment has worked on price reviews, regulatory regime design, efficiency analysis and benchmarking, network access and pricing, tariff and pricing strategy, due diligence and expert witness/dispute support around the world. We advise and carry out reviews for governments and regulators and have helped shape regulatory policy through our client work. The team has a wealth of experience in applying the methodology used in this review and we regularly audit water utilities of the size of Sydney Water Corporation and larger.

4. Our Methodology

Our review and assessment of capital and operating efficiency is based on the hypothesis of a Frontier Company competing in an open market to deliver services to customers. We use this approach to compare the business processes and systems with current practice and to identify the extent of catch-up that may be required over time to reach an efficient level of operation. This is consistent with the approach used by Ofwat in its 2009 Final Determination of prices, and previous Determinations, for water companies in England and Wales¹. We quote as follows:

When setting our price limits, we include incentives to companies to improve their efficiency over time. Our overall efficiency assumptions have two components:

- i. A catch-up improvement factor that challenges a company to make progress towards the top performing companies. For operating expenditure, this is explicit; for capital expenditure, our approach builds from the comparative efficiency challenge.*
- ii. A continuing improvement factor linked to the improvement that we could expect from leading or frontier companies. This applies to both operating and capital expenditure.*

We review the decision making processes for both operating and capital expenditure to test whether there is sufficient internal challenge and rigour to deliver total least cost solutions within the constrained capital program.

The efficiency frontier we use is based on our experience of the best performing water utilities with similar issues that Sydney Water faces and activities that it undertakes.

¹ Future Water and Sewerage Charges 2010 to 2015 Final Determination, Ofwat November 2009

This Frontier Company approach has also been applied to previous efficiency studies we have carried out for IPART on Sydney Water (2004), Hunter Water (2008) and State Water Corporation (2009).

5. Operating Expenditure

We agree that the opex efficiency targets are challenging. Our assessment is based on a continuing efficiency of 0.25% per annum, the same as applied by Ofwat in the 2009 Determination. Ofwat had applied catch-up efficiency in a range 0 to 2.9% per annum over and above efficiencies proposed by companies. For comparison, we applied an average 0.75% per annum above efficiencies proposed by Sydney Water. Thus the efficiencies we have applied are within the range of efficiencies applied to England and Wales water agencies. We have taken into account the level of efficiency savings that the Company has proposed so that our efficiency challenge is applied mainly to the latter two years of the price path.

6. Capital Expenditure

The Sydney Water proposals for the future price path were for \$3007m. We have applied four principal adjustments:

- capital efficiency of \$142m
- rephasing of outputs \$184m
- re-profiling of growth expenditure \$109m
- corporate capital efficiency of \$38m

We discuss the adjustments in the following sections.

a. Efficiency

Our assessment of efficiency has been based on our review of the capital planning processes and analysis of sample projects. We have identified five areas where Sydney Water should be able to deliver material improvements through the development and application of processes including: improvements to investment planning, cost estimating and the management of contingencies, the impact of new procurement processes and likely savings from more effective program management. A greater part of the efficiency savings are within the management of Sydney Water rather than market conditions. The average efficiency target we have applied is 5.3% over the price path period which is around the upper quartile of efficiencies applied to England and Wales water agencies.

b. Growth

Growth expenditure forms 46% of total capital expenditure. We concluded that there were uncertainties in the timing of growth expenditure as these are dependent on developer plans which in turn reflect the demand for new housing. While the profile of growth expenditure is consistent with government growth forecasts the NSW Government submission² on the price review stated:

It is also important to ensure that all the proposed growth-related expenditure is in fact needed over the coming price path. Any reasonable deferral of growth-related capital

² NSW Government submission to IPART, October 2011

expenditure into future price periods will lead to a reduction in revenue requirements and this in turn will mitigate impacts on prices.

We noted that in the current price period, Sydney Water did not deliver 150,000 new connections because of the market forces outside its control. However, the expenditure allocated to growth was spent mainly on Corporate including its IT and property programs not included in the previous Determination. In effect, customers are now being asked to fund growth for a second time.

To address uncertainty in growth expenditure, we applied the approach we used for the Hunter Water efficiency review in 2008. At Hunter Water we re-phased expenditure based on the likelihood of projects progressing. We then applied a probability approach to growth expenditure where we have assumed that the timing of expenditure at the start of the period is more certain than later periods. The impact of this analysis is a slippage of seven months on the growth program. If it turns out that actual growth expenditure is greater than this revised profile then prudent expenditure can be logged up at the next Determination.

We agree that the growth adjustment in 2016 is overstated by \$11.8m although this does not have a material impact on prices.

c. Timing of Outputs

Sydney Water is seeking a significant increase in expenditure to maintain mandatory standards compared with the current price path. In the water service, proposed expenditure is \$731m compared with \$560m. Over the current price path, mains burst rates have reduced and performance is significantly better than the targets in the Operating Licence.

Our approach to capital expenditure to maintain mandatory standards has been to compare the historic level of expenditure with the performance measures in the Operating Licence. We noted that performance in the current price path against these measures was good with significant headroom between actual and target performance. It is apparent that the overall supply system has stable or even improving serviceability. The Company expresses concerns about the need for renewals. We believe that the post efficiency target expenditure is adequate, albeit with efficient and targeted renewals, as would be expected by a water company with efficient asset management.

These assets have long lives and significant changes in performance are unlikely in the short term. We therefore formed the view that, in seeking a significant increase in capital expenditure for the future period, Sydney Water was taking an unnecessarily low risk approach.

Our proposals are not cuts in expenditure but a phased and a gradual increase over the future price path. The pre-efficiency capex we proposed is a 10% increase on the current period. We found that, on current performance, the need for a step increase in expenditure is not justified. It would be appropriate to test the relationship between expenditure and performance to inform future price reviews.

Atkins / Cardno have commended Sydney Water on its asset management processes. The risk based approach to renewals prioritisation is considered well developed and to be leading edge. However, we are of the view that the bottom up approach provides outputs which then need to be further considered in the light of a capex constraint, financial impacts on customers and priority against other Sydney Water projects. We understand why Sydney Water takes a risk-averse approach, as it can become the focus of adverse media attention in the event of high profile asset failures, but this needs to be balanced against customer financial impacts and resource/ financial constraints. Financial analysis (including quantifying risk costs) is an important part of the process but just because the benefit cost ratio exceeds 1.0 should not mean that all projects need

to be implemented in the short term. For instance, a government treasury department would not fund every project because the benefit cost ratio exceeded 1.0.

We did not see any evidence of a process whereby all Sydney Water's programs/projects (including IT) were compared and prioritised using comparable criteria. This would allow Sydney Water management to make informed decisions on capital investment priorities across all programs.

Critical Water Mains

In reviewing Sydney Water's submission we were of the opinion that a sudden increase in expenditure from \$32m in 11/12 to \$60m (87% increase) was not justified. We also formed the view that the sudden expenditure was due to the reclassification of 1800km of mains to be "critical water mains" bringing the total length of mains to 4800km which is 22% of the network. The failure rate for mains classified as critical (around 7.5 breaks/100km/yr which equates to 260 breaks per year) is much less than for the reticulation system (28.5 breaks/100km/yr which equates to 4600 breaks per year). Sydney Water applies the following risk strategies to their mains:

Risk Level	Condition Assessment	Renewal
Very high	Review/ Inspect immediately	Renew/ replace within 2 years
High A	Conduct condition assessment within 2 years	Renew/ replace within 5 years
High B	Conduct condition assessment within 5 years	Renewal based on cost-benefit analysis
Medium	Annual review of performance	Renewal based on cost-benefit analysis
Low	Annual review of performance	Renewal based on cost-benefit analysis

Based on the above criteria and Sydney Water's estimate of the percentage of inspected mains likely to be renewed we have fully allowed for all High Risk A renewals (risk is unacceptable to Sydney Water) and 50% of the High Risk B to be funded within the next price path. Sydney Water does not have mains rated as 'very high risk'. We estimate that that all the 'high risk A' mains will be addressed by mid-way through year 3 of the price path (pro-rata on cost) and meets the renewal criteria in the above Table. These mains are likely to be the ones that would cause the "extra high consequence" mentioned in Sydney Water's letter. Our proposed expenditure reduction is a reduction of 14km of mains not 16km as quoted by Sydney Water

The impact of our proposals should encourage Sydney Water to look more closely at the likelihood and consequence of critical mains failure. This should lead to the identification of a level of acceptable risk and help to identify those mains lengths at the edge of feasibility where the benefits are marginal and there is no significant impact on operating expenditure.

We do not disagree that deferring some of the expenditure will increase Sydney Water's risk exposure and related consequence costs. Our proposed expenditure profile would only increase this exposure from a risk averse position for a relatively short period.

We also note that there was a significant underspend on this project as indicated in the following Table. Reasons provided were that Sydney Water focused on smaller diameter mains; and the levels of renewals identified from risk and condition and assessment was less than planned.

	2008-12	2010-12
Average annual planned expenditure (\$m)	47.7	67.5
Average annual actual expenditure (\$m)	35.8	39.0

We also note that the unit rate for renewals of critical mains will increase from the current average \$3582/m to \$3895/m which is likely to reflect the renewal of larger diameter mains or work in more complex locations.

We agree with Sydney Water that the mains rated as 'high risk A' have an unacceptable risk rating and should be replaced. This by definition addresses mains with both a high likelihood and a high consequence of failure.

Our re-profiling of the replacement expenditure for the 'high risk B' mains over two price control periods allows Sydney Water to focus on those mains with the highest risk of failure within the price control period to 2016. This should allow the Company to complete inspections and analysis of the remaining 'high risk B' mains.

We are unable to replicate the costs that Sydney Water mentions. We would need further information to confirm these costs. Our view is that the level of expenditure allowed in the capital expenditure proposals is sufficient to manage the risks that the Company has identified.

Reticulation Water Mains

Sydney Water is proposing a similar level of expenditure as in the current price path period although 10% of mains have now been reclassified as critical. Sydney Water has been successful in reducing the level of main breaks and leaks/100km/yr from a peak of 50 in 2001/02 to 28.5 in 2009/10. Atkins / Cardno were of the opinion that Sydney Water's current mains break performance was reasonable.

Sydney Water initially identifies reticulation mains for renewal based on failure history. The Reticulation Main Renewal Decision Framework states that the decision to proceed with renewal is based on the NPV of maintenance exceeding the NPV of renewal that is the benefit cost ratio is greater than 1.0. The 2012-16 Business Case did not include any NPV analyses for the program. However, the 2008-12 Business Case showed the benefit cost ratios at varying discount rates. In our report we pointed out that at a discount rate close to the WACC the benefit cost ratio for the reticulation mains program was slightly over 1.1 which suggests that some of the projects within the program could be quite marginal.

We took the view that a marginal reduction in mains replacement activity would only exclude those mains lengths where the benefit cost ratio was marginal. As such the arguments presented by Sydney Water may represent the average benefits and costs but not those at the margin. Our view is that there would be no material impact in this modest rephrasing of the replacement program.

In our draft report we reduced the expenditure for this program by \$21.5m. Sydney Water's response was that the impact by the end of the price path would be an increase of 3 to 4 breaks and leaks/ 100 km/ year with an increase in operating costs of \$2 million to \$3 million. In response to Sydney Water's feedback we adjusted the reduction in expenditure to be \$13.1m. Even though we allowed a further \$8.4m in expenditure Sydney Water has responded in its letter that main breaks and leaks will increase to 3 to 4/100km/year and increase costs by \$3m a year. This is a similar response to the \$21.5m reduction which may suggest that Sydney Water has undertaken more detailed assessment or it may be just an indication of impacts.

Critical and Reticulation Water Mains

We have taken this opportunity to compare both water main renewal programs in the table below. In our Report, we allowed an increase of 11% over the expenditure in the previous price path. The table also shows that the expenditure as a percentage of total main current replacement is still higher than we see in other water agencies.

	Critical mains \$m	Retic mains \$m	Total \$m	Current replacement cost %
2008-12 Planned	190.5	247.8	438.3	0.95
2008-12 Actual	143.3	245.7	389.0	0.84
2013-16 SWC Planned	257.1	245.1	502.2	1.08
2013-16 Atkins Cardno Proposed	200.0	232.4	432.4	0.93

Sydney Water is proposing an increase in average unit rates for the next price path. The 9% increase in critical mains may be due to pipe diameter or location. The 17% increase in average unit costs for reticulation mains is because Sydney Water would be targeting smaller lengths of mains in more complex environments in the next price path period. We have taken these proposed variances in our analysis.

The resulting lengths of mains being renewed have decreased from the previous price path as shown in the table above. From this table it can be seen that the Cardno/Atkins proposed expenditure results in the percentage of mains programmed for renewal reducing to 0.39% of the total length of main.

We would be keen to further challenge Sydney Water on some of its assumptions and processes supporting their economic decision model should the opportunity arise. Based on service level criteria the proposed Atkins / Cardno expenditure is justified.

Water Pumping Station Renewals

This area of expenditure was not mentioned by Sydney Water when commenting on the draft report. We have reviewed this and noted an inconsistency between our comments on page 104 of the Atkins/ Cardno report, where we were generally content with the approach to renewals and in

Table 7.7 'Water Service: Summary of Efficient Capital Expenditure' where the capex adjustment should have been -\$2.9m not -\$7.9m.

Wet Weather Overflow Abatement

Sydney Water proposed an expenditure of \$184m in the next price path and we proposed a reduction to \$154m which consisted of reducing the "no deterioration" expenditure from \$36m to \$6m. We have supported nearly 84% of the proposed expenditure.

Our opinion was that the 'no deterioration' projects had yet to be identified thus the \$36m proposed could be considered as a contingency item.

While the program has been effective in reducing faecal coliforms in watercourses and beaches, the level continues to be above recommended guideline values after rainfall events due to the impact of stormwater, which is outside Sydney Water's control.

The environmental regulator, the Office of Environment and Heritage, had previously been responsive to Sydney Water's constraints through deferring the Northern Beaches project due to Sydney Water's priority requirement to construct the desalination plant.

Given that Sydney Water will have spent \$420m by the end of the next price path on committed projects it would be prudent to carry out a benefits realisation review.

We have allowed \$6m for 'no deterioration' in the price path as this would allow Sydney Water to undertake planning and detailed design to address areas of significant deterioration which could be addressed in the first year next price path.

We note that Sydney Water in its letter of the 11th January states that customers will not accept performance deterioration of systems. However, during our discussion with Sydney Water we were not provided with evidence which confirmed that there had been any recent surveys to determine customers' willingness to pay to achieve any further environmental gains. We did not have the opportunity to discuss the 'no deterioration' issue with the Office of Environment and Heritage.

We suggest that if it is demonstrated that an urgent need for additional expenditure on 'no deterioration' projects is identified and this expenditure is prudent then this expenditure can be logged up at the end of the next Determination.

System Reliability Water

We were supportive of this program to improve water system resilience. However during our discussions with Sydney Water, it appeared that the program was in the preliminary planning stages, the projects to be funded had yet to be identified and there had been little opportunity for detailed options analysis and reliable cost estimating. While Sydney Water claimed that 24 projects had been identified with an estimated cost of \$170m, we felt that given the level of project development, that the program should be rephased to include \$38.1m of the proposed \$70.5m expenditure in the next price path. There will be an opportunity at the next price review for more robust projects to be included.

Priority Sewerage Program

We consider that efficiencies can be made on the PSP programme by considering alternative technologies, applying appropriate levels of design which differ from the large projects Sydney Water is used to manage, negotiation with the EPA regarding effluent discharges or innovative

mitigation methods, allowing more time and resources for cost estimating during optioneering and placing less weight on residents preferences which tend to lead to “gold plated” solutions. We note that reducing costs in this way (better optioneering, slower but more efficient procurement) may not be popular with residents or their elected representatives, but it is in the interests of the wider customer base. We also note that in the event that costs do overrun despite efficient management, Sydney Water should be able to log up any additional prudent costs in the next price submission.

d. Corporate

Information Technology (IT)

Sydney Water raised four key issues relating to the proposed reduction in Corporate Information Technology capital budget, which we have responded to below.

We are unable to comment upon Sydney Water's statement about the major under-investment in IT between 2000 and 2006 as our review did not consider this timeframe and the relevance or impact of the activity, or lack of, during this period was not cited by the Corporation at any time during our review.

With respect to Sydney Water's statement about the unacceptable risk and constraint of removing its discretion to reassign capital funds, we concur that some discretion and flexibility in any business is crucial and the Corporation should manage this. Our view is that this discretion should be responsibly applied. Our main concern related to the material under-delivery of the growth output, where we argue that the funding should either be logged down (ring fenced) or charges to customers reduced. As it is, customers are being asked to pay for growth for the second time as this expenditure was reassigned to IT for the 2008–2012 period.

We concur that it is appropriate to ensure that software for most critical systems is supported by vendors and we believe, within the budget allocated, that this has been allowed for. There are various options open to Sydney Water to manage the support from software vendors and its approach to managing this issue relates to the Corporation's risk appetite. It is not necessary to have the latest software versions and it should be possible to negotiate extended or reduced support in some cases.

While the Corporation states that any limitation on budget will prevent delivery of business strategies, Sydney Water did not demonstrate clearly the link between its investment in new IT capability and the effects on the overall operating cost efficiencies and customer service targets. Overall, we identified for the next price path that there was a lack of robust documentation supporting its investment in this area. We would expect the justification in new IT capability to address the need and scope of the projects, the planned project budget, program and outputs, the options considered in the appraisal and the appropriate prioritisation and timing for the scheme. We would also expect to see the assessment of the project outcomes and contribution to Sydney Water's capital program drivers. As highlighted by the Corporation, a significant proportion of IT expenditure falls under business efficiency, but there is relatively little developed about how these projects will contribute to efficiency. Where large projects are being initiated, we have encouraged the Corporation to consider quantifying, to as great an extent as possible, not only the benefits for the business, but the eventual benefits for the customer in order to justify investment. In many cases, we were presented with 'one pagers' to justify a new project; the presentation of more structured business cases would have strengthened the Corporation's justification for investment.

Water Meters

We welcome Sydney Water's acceptance of the proposed reduction in general water meter replacement expenditure.

We do not support Sydney Water's case that \$3.9 million be restored to enable 12,000 existing properties to have remotely readable meters fitted. If, as is stated by Sydney Water, this program is cost neutral, we would argue that the Corporation should therefore meet the capital expenditure out of the savings on its operational expenditure.

We do not accept the basis of the Corporation's case that it is providing poor customer service and is not meeting customer expectations. The Company indicates that it is making reasonable efforts to access and read meters. We believe that it is not an unreasonable expectation that customers take some responsibility for the level of customer service they receive. The "unacceptable" level of customer service which Sydney Water has cited appears to be justified on the basis of lack of customer co-operation.

We do not believe that the case has been justified for a remote metering program on the grounds of the level of complaints received. We have seen no evidence to support the assertion that customer complaints would be reduced by such a large number. Furthermore, IPART confirmed that it has not considered regulating the level of actual versus estimated meter reads in the future price path.