



Central Coast Council's response to IPART position paper - Special review of regulating water businesses

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Introduction

Central Coast Council's (Council) Water and Sewer Directorate provides water and sewer services to the Central Coast community. These services are considered natural monopolies and as such, consumer protection in relation to pricing and delivery of service is regulated by the Independent Pricing and Regulatory Tribunal (IPART). Regulation helps consumers by setting parameters which manage the potential risks of monopoly pricing (such as overcharging or poor service).

There are two main types of regulatory approaches to natural monopolies:

Cost of service regulation - prices are set to recover the business's actual expenditures (capital expenditure (CAPEX) and operational expenditure (OPEX)), including a return on investment.

Incentive regulation - where revenue or prices are capped prior to the beginning of the regulatory period, if the business reduces costs below the cap it can retain the savings for the remainder of that regulatory period.

The purpose of IPART's position paper is to determine if the existing framework is the right model and can it be improved.

There are many existing and emerging challenges for managing water and sewer infrastructure. For example, ongoing management of the supply/demand balance for water supply requires consideration of:

- growing population
- improving resilience and managing the impacts of existing climate variability and ongoing climate change
- maintaining, renewing and replacing ageing infrastructure
- reflecting changing community expectations and integrating with a circular economy whilst
- keeping services affordable for water customers and minimising costs to ratepayers.

The current IPART regulatory framework ensures:

1. Cost reflective pricing for the community
2. Community views are embedded into Council's pricing proposal
3. Investment in capital works aligns to mandatory standards, is efficient and prudent and
4. A level of operational efficiency is identified by the business.

Council welcomes IPART's review on its current regulatory framework and its invitation to respond to the three key areas of:

- Linking performance of the sector
- Encouraging innovation
- Promoting a customer focus.

Note: *Council at this stage does not have any input into the WACC review and would support a 12-month deferral if other industry members agree.*

It also recommends that any change to the existing framework should be an iterative process.

Background

Central Coast Council is unique in that its water and sewer services are legislated both by the Water Management Act (WMA) and the Local Government Act (LGA). It is a Water Supply Authority that resides with a Council. It is not a standalone business as most other water supply authorities in Australia.

Traditionally, customers view water and sewer as a Council delivered service rather than a separate Water Supply Authority. It is not a State-Owned Corporation (SOC) nor does it have an operating licence.

Hunter Water and Sydney Water are different in that they are standalone businesses and have operating licences that are governed by IPART to monitor performance. All internal services provided reside within the business.

For these water utilities governance is overseen by a board of directors that have industry experience and set the organisation's policies, management and performance. The Board sets the strategic direction and ensures both business and regulatory commitments are met.

Governance for Central Coast Council's water and sewer services is achieved by attaining "Best Practice" legislated by the Local Government Act (LGA) and reviewed by the Department of Primary Industry and Environment (DPIE). Councillors represent their ward and the people who live in it and provide a bridge between the community and the operational aspects of Council. This representation covers all delivered services and is not restricted to water and sewer, therefore their accountability is broad.

Scalability

IPART's regulatory framework for Water Businesses include:

- Hunter Water
- Sydney Water
- Essential Water
- Central Coast Council (water, sewer and stormwater drainage services)

The population density within these government areas varies significantly:

- Central Coast approx. 325,000
- Hunter Water approx. 630,000
- Sydney Water approx. 5,000,000
- Essential Water approx. 18,000

Whilst the population served varies, the regulatory requirements of the framework are the same. The current IPART process has become increasingly resource intensive for smaller utilities such as Council that do not have dedicated resources or required economic acumen to respond as the larger utilities do.

Capital Investment

Council's Water and Sewer Directorate typically determines its capital investment for its services using the drivers of mandatory standards, asset and service reliability, business

efficiency and servicing growth. Mandatory standards mean that the investment must comply with:

- Public health
- Environmental
- Licensing
- Legislation
- Risk

Asset and service reliability investments are asset infrastructure renewals intended to maintain and enhance customer service reliability. These investments align with Council's water and sewer asset management plans.

Business efficiency investments are new assets or asset upgrades intended to reduce operating expenditure.

Growth driven projects typically align with the prevailing Development Servicing Plans.

Investment outside of the above drivers is referred to as discretionary projects under IPART discretionary expenditure framework. This framework allows a business to recover efficient cost of delivery if the community is willing to pay for it.

Operational costs

Being a Water Supply Authority that resides within Council necessitates that internal services are shared. The business structure of Council sees business services such as finance, procurement, human resources, information management, customer service, communications, plant and fleet and legal, positioned outside of the Water and Sewer Directorate.

The Water and Sewer Directorate funds the services provided through corporate overhead expense allocation however, the Water and Sewer Directorate does not have direct control of the percentage of corporate overheads allocated or direct control over these business processes to encourage efficiencies. Shared internal resources must be a best fit for all of Council's services, leaving the water business little ability to influence areas outside of its own directorate. A corporate overhead expense is allocated to the directorate. Efficiencies for these services are not managed by the Water and Sewer Directorate.

Lifting the performance of the sector

The performance of the sector is to encourage long term decision making enabling adaption to both climate change and growth. Investments should not be solely based on least cost but also reflect customer preferences, economic value and better demand management practices.

Lifting the performance of the sector as identified in IPART's position paper provides consideration of the following:

1. The regulatory environment and demands placed on business to comply with managing future water demand (Integrated Water Cycle Management).
2. Accountability for the business for the delivery of its outcomes to the community. This includes the sharing of risk (e.g. Council greenhouse emission targets and Climate Change Policy).
3. Understanding the businesses holistic regulatory obligations and their impacts to delivery and cost.
4. Engagement by IPART with Councillors to ensure understanding and support.
5. Flexibility in price setting. This could include revenue cap or weighted average price caps as opposed to price caps (with consideration to price volatility).
6. Introducing incentives in water conservation (leakage detection) by way of revenue adjustments at next pricing proposal equalling the value of the water saved and vice versa.
7. Refocusing capital expenditure, currently based on improvement of outcomes measures to one of delivery and meeting customer expectation (e.g. onsite electricity generation business efficiency projects); Council adopted reduction of CO₂.
8. Encouragement of offering a higher level of service to customers who opt in to projects that offer increased environmental performance.
9. Review of other regulatory models such as PREMO (performance, risk, engagement, management and outcomes/service standards)¹.

2. What mechanism can we put in place to ensure business are accountable for the process, series and outcomes they deliver to their customers and community

There is a myriad of regulatory and community outcomes that Council's Water and Sewer Directorate is obligated to deliver for its services. There are also risks associated with this delivery which are managed by the Water and Sewer Directorate in relation to the Australia Drinking Water Quality framework. These risks relate to volume risk – the risk from changes to volumes of supply or changes in consumption, as well as risks associated with the distribution and treatment of water in relation to:

- Structural characteristics
- Operating capacity

1. Using this model, it is not possible for the water business to prepare submissions without meaningful customer engagement with those concerns reflected as outcomes valued by their customers. Linking the rate of return to the ambition in the pricing proposal which should focus on delivering outcomes sought by customers. It also recommends that the business be accountable for discovering customer preferences and how they will be delivered. The PREMO method makes the customer not the regulator central to the submission.

- Topology
- Operating features
- Network elements associated with expected system demand
- Current and forecast demands
- System resilience
- Dam safety
- Water quality
- Security
- Discharges to the environment
- Algae blooms

In order to manage these risks and deliver on its regulatory and community outcomes, the existing regulatory framework is used to review expenses and provide revenue using the Building Block Model (BBM). The revenue provided assumes most of the risk is borne by the Water Supply Authority. Setting revenue too low impacts services, reduces outcomes, reduces investment and increases risk. Setting revenue too high can gold plate assets, over charge the community and influence efficiency.

Performance objectives defined in the SOCs operating licences feed into the prices set for the SOCs. In the absence of operating licence conditions, the link between prices and performance objectives is less direct and provides an opportunity for competing objectives from different regulators.

The PREMO model uses both reward and penalty as mechanisms to ensure accountability. The model rewards businesses that are leading and ambitious and penalise businesses where performance is determined as basic. The mechanism uses the level of return a business receives. For smaller water utilities, a lower rate of return (below market) could compromise the relationship between investment and risk.

Linking the delivery of community outcomes with the return on regulated equity is based on the premise of a standalone business with a board of directors having industry experience. PREMO places emphasis on the **M** for Management it asks if the business has provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes.

Council would be interested to understand how the model could be adapted to its structure and impacts on its rate of return.

Competition by comparison is a useful tool for reputational incentives, however it is not the only tool to be considered. Key mechanisms for accountability should also focus on delivery, outcomes to performance and efficiency.

- Delivery – adjustment to the regulated asset base, incentive to deliver
- Outcomes – linked to performance, delivery and risk management
- Efficiency – step changes, improved practices

3. How can we better coordinate with other stakeholders (including Government strategic water plans and the requirements of other regulators) to help lift the performance of the water sector.

A better coordinated approach with other stakeholders and regulators would be welcomed by Council. It would allow for greater transparency of regulatory demands placed on the water business. Included would be NSW Environment Protection Authority (EPA in respect to licencing and environmental performance) Department of Planning Industry and Environment (DPIE) in relation to Best Practice and delivery of IWCM, Bureau of Meteorology in respect to business performance and NSW Health with respect to public health outcomes. In the absence of an operating licence for Council's Water and Sewer business, the minimum performance requirements from the above regulators should be overlain and rationalised as an input to the Council's pricing proposal.

Part of the Council's pricing proposal should also specify regulatory costs, requirements and constraints to meet regulatory standards. A requirement for regulators to prepare a response to the pricing proposal would enable clarity and an understanding of Council's financial constraints and obligations. IPART being aware of all the regulatory priorities would also provide an understanding of business impacts on expenses.

Encouraging Innovation

The current regulatory framework uses the building block framework which reviews:

- Proposed expenses (reviewed for prudence and efficiency)
- Sets revenue requirements that a benchmark business would need to deliver its services
- Provided financial incentives for a business to reduce costs (Efficiency carryover mechanism)
- Long term planning
- Development of a discretionary framework (allowing the business to recover efficient costs of achieving an outcome above the regulated revenue)
- Customer surveys by IPART comparing performance and
- Provision of the WACC for the rate of return for efficient and innovative investment.

Currently proposed business investments are based on key projects in a bottom up approach. Often resulting in focus being placed on key projects rather than an aggregate approach which defines investment via envelopes of funding. This approach creates a culture within Council and its customers that IPART has approved or disallowed projects for the next determination period and creates additional challenges when preparing annual budgets within the next determination period.

4 Should we use a broader range of incentives to encourage innovation? If so what would these be? For example, competition by comparison.

Council agrees that there should be a broader range of incentives to encourage innovation and would support the concept of explicit funding for projects that would not otherwise occur under price controls. Competition by comparison should not be the only one considered. The capital works programs should not just be about least financial cost and meeting mandatory standards. It should also include incentives for innovation where the return on investment may not be realised in the short term but rather considers future water reuse and restorative solutions. A lack of investment now may incur increasing costs substantially over coming years. A business would need to show investment with solid business cases for innovation, to be granted explicit funding. This would also need to be linked to the Integrated Water Cycle Management which defines strategies for water security.

5 Does our discretionary expenditure framework create the right incentives for the business to pursue (and deliver) service outcomes above mandatory standards

It is understood that investment in innovation could be funded via the discretionary framework where communities "willingness to pay" is considered. Large investments in innovation needs to consider future generations where costs should be shared across the life of the asset.

The current discretionary expenditure framework poses some difficulties to the water business. Any projects/programs/initiatives that promote business efficiency or innovation generally need to demonstrate a return on investment within the determination period, where the funds were spent (to be assessed in the end of determination review).

The current propose, determine, review method makes it difficult for the water business to demonstrate longer term gains (financial or economical), when the business is being assessed in short periods (4yrs).

For example, if the business implements an efficiency project and can't realise those efficiencies within that determination, the business runs the risk of the expenditure being deemed inefficient disallowing the expenditure to be rolled into the RAB. This can act as a deterrent to businesses undertaking investment in new and innovative efficiency options.

Innovation based on explicit funding would be supported by Council's water business, it provides an avenue for investing in future circular water life cycle strategies in alignment with the circular economy. Agreed frameworks to assess and monetise benefits of investments outside of the water businesses asset base need to exist to provide certainty for developing business cases for projects that contribute to liveability and sustainability outcomes.

In addition, innovation should not be restricted to future asset augmentation. Council's Water and Sewer Directorate is a business within a Council. To change the profile of the internal structure requires an investment in both people and systems resulting in an increase in the operational expenses. Using the existing "base-step-trend" when setting operational expenses limits the ability for future efficiency gains in this area.

6 What changes should we make to our review of the business's actual and proposed expenditure? For example, what information should we require from businesses and where could we credibly incorporate more benchmarking into our expenditure review process?

Traditionally Council (for its operational expenses) within the regulatory framework uses a "Base-step-trend" approach. This reviews what operational expenses were used last time with a view to prudence and efficiency. This approach however can be restrictive especially for those costs that are a one off (COVID-19, flooding, bushfires) or costs that fall outside operational base expenses. This occurred in the last determination where funding for the tunnel inspections were disallowed and not considered part of base OPEX. Council's Water and Sewer Directorate, understanding the risks of failure and safety, covered these additional costs to mitigate risks.

The current method can assess a reduction in expenditure as an efficiency if service levels remain stable. The method doesn't allow for the long-term realisation of stopping or pausing a function. For example, low or minimal investment in maintenance sees no real service delivery impact to the customer in the short term, however it reduces the life of an asset and increases failure rates in future determinations leading to increases in expenditure.

Using the average expenditure over the determination period as a base line as opposed to a single financial year (penultimate year approach) would create a more realistic paradigm of the business's expenditure requirements especially in areas where costs can fluctuate (weather).

The "base-step-trend-approach" needs to consider intermittent costs and sharing the revenue risk with customers in order to maintain the assets and provide the expected outcomes.

In relation to capital investment, an envelope approach would be welcomed where investment is determined using a top down approach. Using this approach, expenditure would be at the discretion of the business with consideration to consumer preferences, changes in regulatory requirements and ongoing asset risk prioritisation, consistent with Asset Management Plans and Business Strategies.

In relation to incorporating more benchmarking into the review, Council would welcome benchmarking based on size and scale and unit cost benchmarking based on defined metrics with like for like businesses. Currently there is inconsistency in relation to pricing outcomes by comparison to other larger water utilities. It is understood that the pricing is directly reflective of the required revenue to service the business. However, Council does not have the same internal structures for the delivery of said services and its expenses are influenced by costs beyond its control.

The PREMO model promotes under performance and over performance payments. Over performance payments are set by frontier shifting performance. In relation to scalability and structure of Council's water and sewer business, would this create inequity in relation to standalone water utilities where total control over all aspects of the business are managed?

7 What changes to our approach would enhance efficient new entry and competition in the supply of water and wastewater services?

No comment on this question.

Promoting a customer focus

The current framework replicates as far as possible outcomes within a competitive market. These outcomes are predominantly driven by customer preference and the business to delivery on those preferences. The exception being the difference between short term and long term investments which may require a balance between the business and IPART.

Council is improving its customer engagement and understanding that it is cornerstone to the proposal in reflecting prudence and reflecting what the customer preferences in aspects of the delivery. The outcomes focus on:

1. Price
2. Price structure
3. Asset performance
4. Minimisation of outages
5. Expenditure performance improvements

Council listens to the community views and ensures the outcomes are reflected in delivery of service and service standards. Council agrees that customer engagement should be embedded into business as usual so information can be collected and reviewed each year to ascertain community changing values and preferences.

Council's Water and Sewer business, being a "Water Supply Authority" within a Council, participates in Council's corporate community strategic plan. This plan also provides extensive engagement with the community during its preparation and implementation over its development. The plan is in place for 10 years and covers the high-level engagement on what the community needs and wants for its region.

8 What level and type of engagement are customers looking for from water businesses?

It is expected that the local community has a say in the pricing proposal. This is especially important to cost, service, reliability, security, willingness to pay and value for money. Community engagement should be embedded in business as usual and at a minimum occur annually. Consultation should be open and transparent. Council has a Corporate Engagement Framework that must be used in the development of all community engagement programs. This is aligned with the IAP2 Framework Public Participation Spectrum which includes:

1. Inform
2. Consult
3. Involve
4. Collaborate
5. Empower as well as
6. Educate

9 How do we provide the right incentive for the businesses to genuinely engage with their customers, understand what they want and incorporate this into the heart of their operations?

Water price regulation as seen in the UK, is moving from frameworks that focus on incentivising cost efficiency and efficient pricing structures, to better engagement with

customers about their values and priorities and using financial and reputational incentives to improve performance.

Under the PREMO model there are no satisfactory outcomes for a water business which fails to work closely with its customers and show it engaged with its customers' concerns and interests. The framework rewards businesses that:

- focus on delivering outcomes sought by their customers
- accept risks on behalf of their communities
- deliver services as efficiently as possible, and
- financially penalises businesses that underperform in the areas of Performance, Risks, Engagement, Management and Outcomes.

An assessment tool rates each area to determine if the rating is basic, standard, ambitious or leading. There is an expectation that the minimum rating would be standard (not basic) The PREMO model uses the rate of return a business will get based on its proposal and by reflecting the community outcomes in its proposal.

If the rate of return was considered as an incentive to perform community engagement and reflect the outcomes in the proposal, then additional costs and controls would need to be considered. Again, consideration given to both scalability and structure.

10 Who is best placed to undertake customer engagement? Is it the business, IPART or another independent third party?

It is noted that some regulators are outsourcing community engagement, however it is considered that the utility understands its own community best and as a water business residing within a Council, the engagement model with the community is expected to have a holistic approach.

The business should have the responsibility to undertake community engagement.

Proposing a standalone WACC

Council Water and Sewer Directorate at this stage does not have any input into the Weighted Average Cost of Capital (WACC) review and would support a 12-month deferral if other industry members agree.