



October 2020



Regulating Water Businesses

Response to IPART's Position Paper

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KEY MESSAGES

- Hunter Water welcomes and supports IPART's special review and the engagement with stakeholders on ways of improving the regulatory framework.
- In our view, many aspects of IPART's current approach, underpinned by the building block model, work well and provide a sound basis for decision-making.
- It is important that the regulatory framework continues to evolve. This requires periodic assessment of how IPART can best provide autonomy, guidance and incentives to promote business accountability and responsibility.
- IPART is looking to make changes to the regulatory model that make the people of NSW better off – not just today, but also in the future. We suggest that IPART could formalise this intent by testing changes against the objective of promoting the long-term interests of customers, as applied by other economic regulators. This would ensure that the regulatory model is fit-for-purpose and consistent with principles of good regulatory design.
- We endorse IPART's three focus areas for this review: promoting a customer focus, lifting the performance of the sector and encouraging innovation.
- The customer voice should be heard and form an integral part of our business decision-making. This is not about improving engagement for its own sake – it is about better outcomes for customers and tangible improvements in customer satisfaction.
- Hunter Water incorporates customer engagement into day-to-day planning, operational and retailing activities. We recognise that this has benefits for customers, as well as creating a positive feedback loop that benefits our business.
- Service levels are not just about water interruptions or wastewater overflows – there is a myriad of ways we impact, interact, communicate and transact with customers.
- We agree with IPART that performance assessment should focus on outcomes rather than inputs. The regulatory framework should drive the water businesses to identify, understand and deliver the outcomes and levels of service that customers want.
- IPART's current approach to incentive regulation is largely about encouraging businesses to spend less than the operating cost allowance. We see a role for complementary incentive mechanisms – process, reputational, financial – that reward Hunter Water for delivering outcomes that customers want and penalise us if we under-perform.
- Hunter Water can see merit in a revenue cap model, most importantly in the way it allows us to pursue water efficiency measures with residential and business customers.
- IPART's Position Paper includes a long list of suggested changes and ideas from other economic regulators. Hunter Water is keen to work with IPART on an integrated package of measures based around core elements: genuine customer engagement, measuring and tracking performance and service levels, and incentive mechanisms that drive the right outcomes.
- We suggest that IPART consider forming a stakeholder reference group – including water businesses, NSW government agencies, consumer groups. The reference groups would be helpful, particularly in the next phase of the review, in canvassing the key priority areas and the framework for the review, before exploring the detail of specific measures.

1 INTRODUCTION

Hunter Water welcomes the opportunity to respond to IPART's Position Paper *Water Pricing and Licensing, Regulating Water Businesses, Special Review*, September 2020 (Position Paper).

1.1 We support this timely review

We strongly support IPART's initiative in undertaking this in-depth review of the framework for economic regulation of the urban water sector in NSW.

In our view, many aspects of the current regulatory framework work well and provide a sound basis for decision-making. There is an inevitable tension between long-term bill affordability and long-term financial resilience given significant cost pressures, challenges and opportunities. For that reason, it is important that the regulatory environment evolves through periodic review.

We share IPART's concern the current process has become resource intensive for water businesses and IPART. We agree with IPART the regulatory framework needs to promote business accountability in understanding and delivering good outcomes for customers and the community. This requires a regulatory framework that provides businesses with autonomy and responsibility for decision-making, responding to clear guidelines and incentive arrangements.

1.2 The water industry needs a resilient economic regulatory framework

The current approach has evolved over many years and, as IPART recognises in its Position Paper, during that time the industry has changed significantly. Meeting future challenges requires not only a resilient water industry but also a resilient regulatory framework, capable of evolving and innovating over time. Ongoing periodic reviews of the regulatory framework are critical for delivering results that are in the long-term interests of customers.




We agree with IPART that it is important for the review to look at the entire regulatory framework, including governance arrangements, methodologies and processes. We agree with the three focus areas identified by IPART: lifting the performance of the sector; encouraging innovation; and promoting a customer focus. Promoting a customer focus is central to our business strategy and a foundation piece for this review, so we lead with this focus area in our response.

We support many of IPART's proposals and suggestions which we believe are consistent with establishing a regulatory framework that better meets the long-term needs of customers.

1.3 A focused review is required

An in-depth review of the framework for economic regulation of the urban water sector in NSW is necessarily broad and complex. In this response we propose a framework for prioritising issues for the next stages of the review.

At a high level, we are of the view that IPART should prioritise those issues that concern all urban water businesses and are likely to deliver the biggest benefits for customers and the community:

 Promoting a customer focus	<ul style="list-style-type: none"> • Business-led customer engagement to identify what customers want and are willing to pay for so that service levels and outcomes reflect customer preferences • More guidance on acceptable methods of engaging with customers where this is used in the regulatory decision-making process
 Lifting the performance of the sector	<ul style="list-style-type: none"> • More autonomy to determinate customer-preferred outcomes and resulting expenditure • Enhanced incentive mechanisms, tied to the business performance in meeting customer expectations prudently and efficiently
 Encouraging innovation	<ul style="list-style-type: none"> • Light-handed approach to expenditure review: greater reliance on customer engagement and enhanced incentive mechanisms • A longer regulatory period with arrangements to manage risk and uncertainty

These issues are closely related and consistent with IPART's desire to promote business accountability in first understanding and then delivering outcomes that meet the long-term interests of customers and the community.

1.4 About this response

This response is structured as follows:

- Section 2 presents the context for the review from Hunter Water's perspective
- Section 3 sets out the overarching objectives of the economic regulatory framework and the implications for the scope of this review
- Section 4 presents our view water businesses should lead customer engagement, which is embedded in service outcomes and decision-making
- Section 5 discusses the importance of incentives and risk management to lifting the performance of the water industry
- Section 6 explores the importance of incentives to promoting innovation
- Section 7 agrees with the proposed deferral of the WACC review
- Section 8 supports IPART's proposed review process.

Hunter Water looks forward to engaging constructively with IPART on this important review to ensure the industry delivers outcomes in the long-term interests of customers.

2 CHALLENGES AND OPPORTUNITIES

2.1 National urban water sector

Water is critical for life – health, well-being, environmental sustainability and economic prosperity. Australia’s urban water sector has been providing essential services to cities and towns for over a decade. Over that period the operating context has changed significantly and the pace of change is accelerating. Those changes bring a range of challenges and opportunities for the water sector, governments, regulators and other stakeholders to work through to maximise the benefits for customers and the community.

In terms of recent and emerging factors affecting the sector, Infrastructure Australia’s 2019 *Australian Infrastructure Audit* found that “the urban water sector faces challenges, including the impacts of climate change, population growth, ageing assets, and changing needs and expectations from users. Failure to adequately address these challenges could lead to rising water bills...”.

Offsetting these challenges are improvements in, and increased adoption of, technology and opportunities for improved integration of land use planning and water planning to contribute to liveability. A summary of the challenges and opportunities that are affecting costs, and therefore the tension between bill affordability for customers and financial sustainability, are summarised in Figure 2.1. In addition, we provide two charts showing the magnitude and drivers of Hunter Water’s capital program over a 15 year period (see Figure 2.2 and Figure 2.3).

Figure 2.1 A snapshot of challenges and opportunities faced by the Australian urban water sector



Source: Adapted from Aither, 2017, *Urban water sector: Future cost and affordability analysis: The role of water reform in alleviating national household affordability issues*, available at: <http://infrastructureaustralia.gov.au/policy-publications/publications/reforming-urban-water.aspx>

2.2 Hunter Water

Area	Challenge/ opportunity
<p>Lower Hunter Water Security Plan</p>	<p>➤ DPIE Water and Hunter Water are working closely with NSW Government partners, key stakeholders and the community to finalise the next iteration of the Lower Hunter Water Security Plan by 2021. The investigative, cost-benefit analysis and community engagement work underpinning the review is looking at all feasible options, on both the demand and supply side – recycled water, water conservation, desalination, dams and inter-regional transfers. Hunter Water has relied on its existing dam and groundwater assets for many decades. A growing population and bigger commercial base will require Hunter Water to invest in conservation initiatives and infrastructure projects to ensure a resilient water supply at some point in the next decade. Figures 2.2 and 2.3 do not include any investment in the bulk water system.</p>
<p>Drought response</p>	<p>➤ Hunter Water's dam storage levels fell to 52% in early 2020. This triggered planning and regulatory approvals work on an emergency desalination plant on the coast at Belmont, 20 kilometres south of Newcastle. Hunter Water incurred substantial operating costs in responding to the drought conditions, including a significant spend on design and environmental approvals for the Belmont plant. Hunter Water's water storages can fall fast, meaning there is always the chance that Hunter Water would proceed to construct emergency infrastructure if storages fell below critical trigger points. It is difficult for Hunter Water to accurately forecast likely costs of these emergency actions.</p>
<p>Hunter River estuary wastewater masterplan</p>	<p>➤ Hunter Water is currently developing a pollution reduction program for wastewater treatment plants that discharge, directly or indirectly, into the Hunter River. The five wastewater treatment plants are Hunter Water's largest inland plants, that do not discharge treated wastewater to ocean: Farley, Kurri Kurri, Morpeth, Raymond Terrace and Shortland. The modelling work is looking a nutrient levels in the Hunter River and the environmental impact of different investments in treatment infrastructure. Hunter Water's capital program (Figures 2.2 and 2.3) does not include any costs associated with implementing this masterplan over the next decade.</p>
<p>Strategic land use planning</p>	<p>➤ Hunter Water is working closely with the six local councils in our area of operations on ways to incorporate integrated water cycle management into the planning regime. We are also looking at a number of initiatives for councils and Hunter Water to invest in stormwater capture, wetland rehabilitation, stormwater channel upgrades and recycled water projects for public parks and gardens.</p>
<p>Policy reviews</p>	<p>➤ The NSW Government has initiated various reviews of the institutional, governance and regulatory arrangements that are relevant to the NSW water sector. The reviews underway at present are:</p> <ul style="list-style-type: none"> • DPIE Water is preparing a State Water Strategy, • NSW Treasury is undertaking a review of the <i>State Owned Corporations</i> model to strengthen the commercial performance of SOCs and to better align SOCs with Government policy. • NSW Productivity Commission is looking at infrastructure contributions and broader productivity reforms.
<p>Open data</p>	<p>➤ The NSW Government is looking at establishing a platform to share water sector data. Open data that is readily accessible and easily searchable should help government agencies and utilities, both public and private, make better planning and investment decisions. The publicly available information could include rainfall, water quality and utility metering data.</p>

Figure 2.2 Capital expenditure on water and wastewater services, \$m \$2020-21

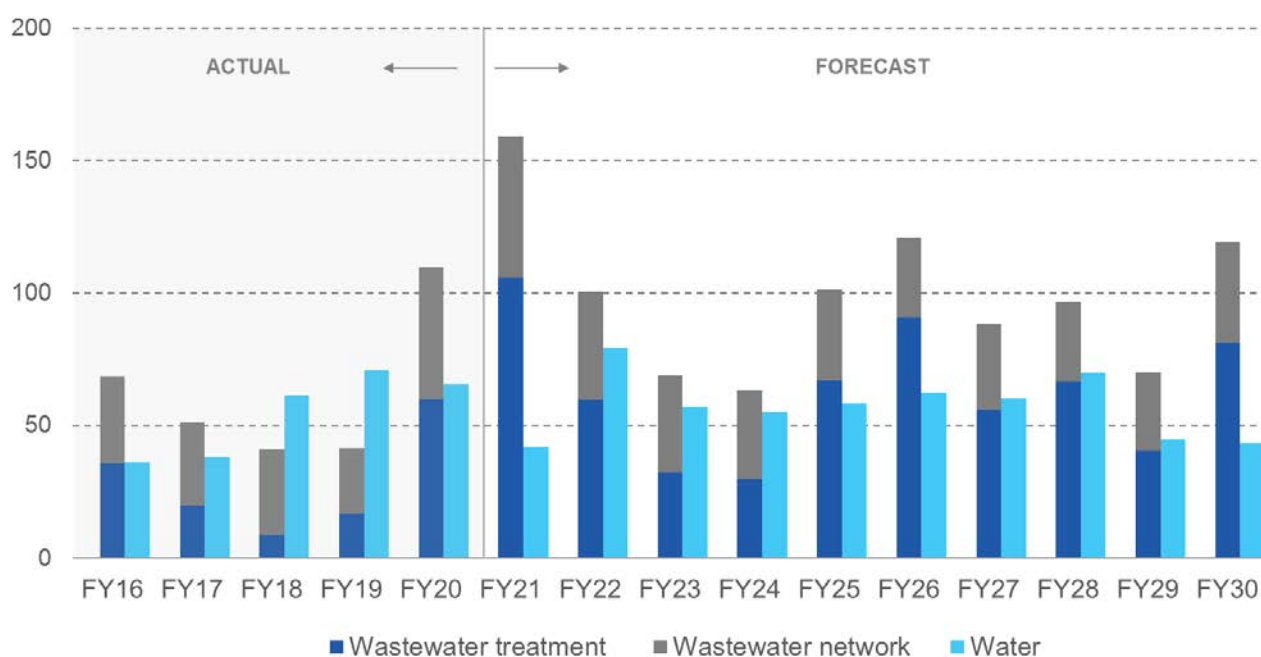
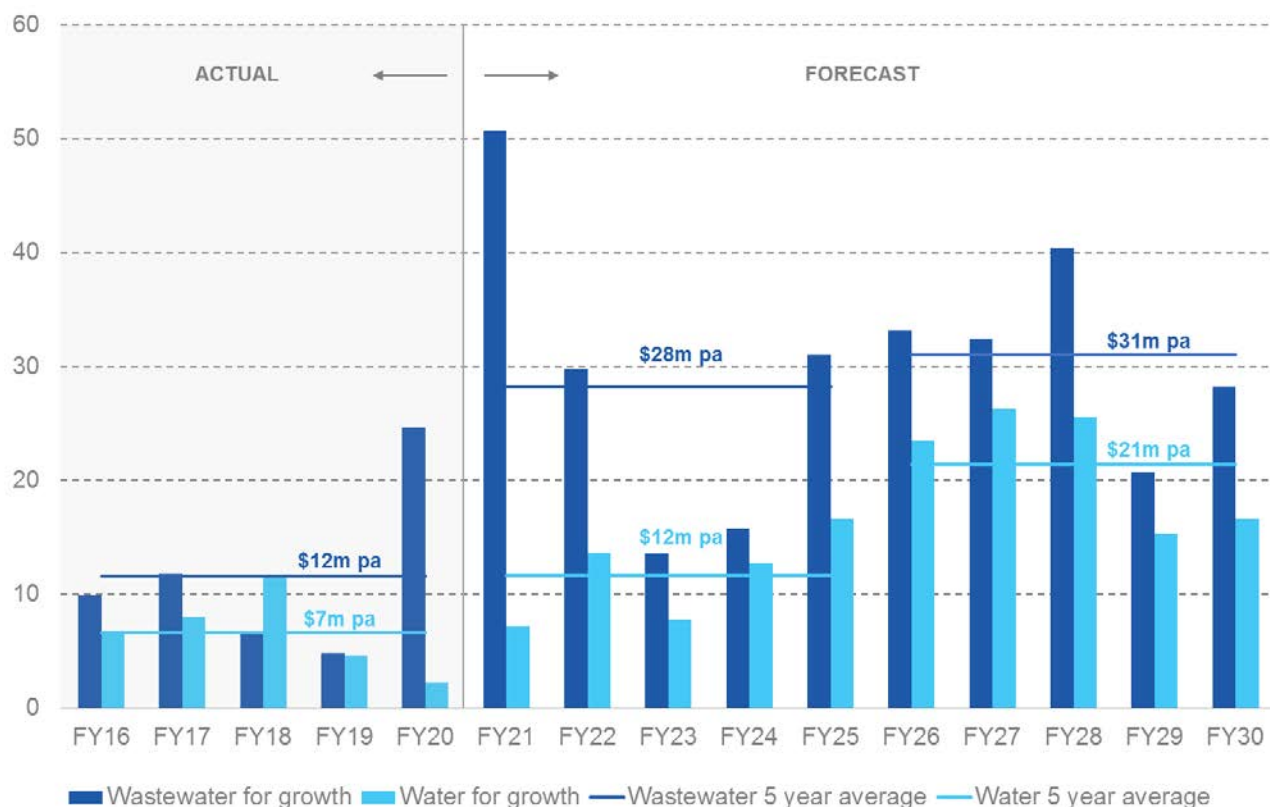


Figure 2.3 Capital expenditure to service growth, \$m \$2020-21



3 FRAMING THE REVIEW

As IPART observes in its Position Paper, its regulatory framework aims to ensure the water businesses, as monopoly suppliers of essential services to millions of NSW households and businesses, meet the service needs of their customers and the community.¹ We agree with this, and set out a framework for how this overarching objective can frame this review and regulatory decision-making.

3.1 Regular methodology reviews between price reviews are valuable

We strongly agree with IPART that periodically examining the regulatory methodology between price reviews will be valuable.² This involves extending IPART's current approach of periodically reviewing issues such as WACC and financeability between price reviews.

Ongoing review will ensure the regulatory framework continually evolves to enable regulated businesses to meet increasing customer and community expectations in the face of future challenges and opportunities. This requires continuous assessment of how the regulatory framework can best provide businesses with autonomy, guidance and incentives to promote business accountability and responsibility.

Reviewing the regulatory framework, including prices and service levels, licensing and competition, is a broad scope. Adopting a staged approach, including identifying issues that can be addressed in later reviews, promotes effective use of both IPART and stakeholder resources during this review. We therefore suggest a systematic approach to prioritising issues to be addressed in the current review. Other issues can be addressed in future reviews, undertaken as part of a regular step-back review following each round of price reviews.

Hunter Water proposes a five-year regulatory period with regular reviews of methodology between price reviews. This is consistent with a 3:2 review cycle applied by other economic regulators, notably Ofwat and the Victorian Essential Services Commission. Following the completion of a price review, IPART would have the time to canvass ideas on possible improvements, finalise ways of implementing changes and publish a statement of approach for the next round of price reviews (by the end of year three). This would allow two years for Hunter Water to develop its pricing proposal and for IPART to conduct the price review.

3.2 The overarching objective of economic regulation is to promote efficient investment in, and efficient operation and use of, water and wastewater services for the long-term interests of customers

We support the four key outcomes identified by IPART for this review: making changes to the framework to encourage the water businesses to reflect their customers' preferences; promoting resilient and adaptable water supply; protecting the environment and health; and ensuring prices remain affordable.³ We support these outcomes because they are consistent with the overarching objective of economic regulation.

IPART regulates monopoly suppliers of essential services to make the people of NSW better off.⁴ Welfare is maximised by an efficient allocation of resources delivered by a full set of competitive markets.⁵ Economic regulation aims to maximise welfare by mimicking the outcomes of a competitive market.⁶

¹ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p4.

² IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p37.

³ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p6.

⁴ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p4.

⁵ This proposition is known as the First Fundamental Theorem of Welfare Economics.

⁶ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p9.

It follows that the objective of regulation in the NSW water sector is to promote efficient investment in, and efficient operation and use of, water and wastewater services for the long-term interests of customers with respect to the price, quality, safety, reliability and security. There are three key elements of this fundamental objective:

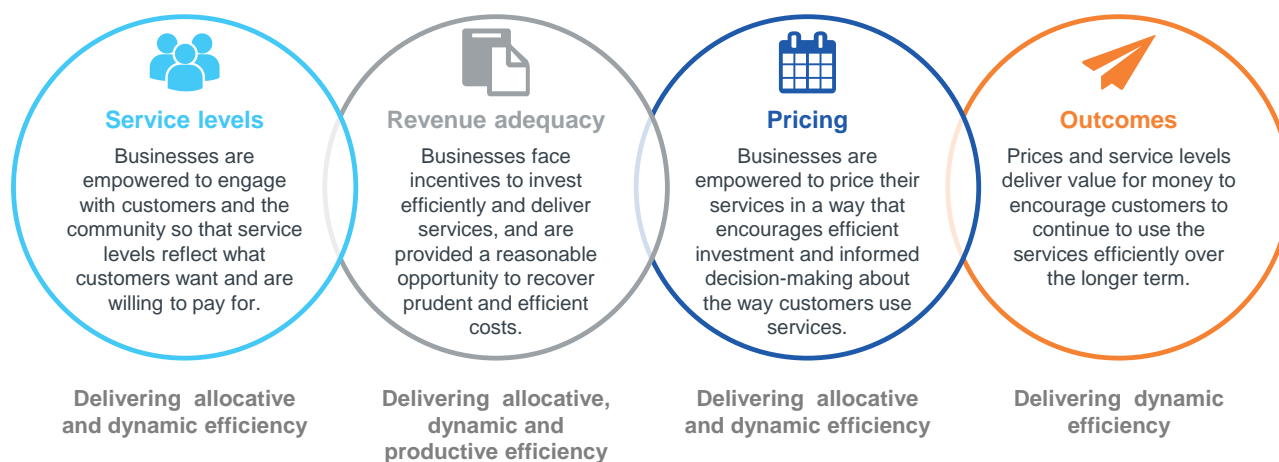
- The objective should promote all three elements of **efficiency**: dynamic, allocative and technical efficiency. All three elements of efficiency are central to ensuring prices remain affordable.
- The **long-term interests of customers** are important – since this objective emphasises the importance of promoting a resilient and adaptable water supply and protecting the environment and public health through efficient investment and use of services over the long term.
- Meeting the long-term interests of customers requires businesses to understand and embed **customer preferences around outcomes** including price, quality, safety, reliability and security in their decision-making.

Embedding the outcomes IPART has identified for this review in an overarching objective for the regulatory framework can guide IPART's work including this review, future reviews of methodology, price reviews and licence reviews.

IPART's Position Paper suggests that all matters related to the regulatory framework are subject to review and change. Hunter Water strongly supports enshrining a single regulatory objective based on promoting the long-term interests of customers in the IPART Act, as applied in other utility sectors. This would provide greater certainty and clarity around IPART's role and the basis for making regulatory decisions.

3.3 A clear objective drives effective regulatory decision-making

Regulatory decisions need to ensure utilities provide a safe, reliable service consistent with customers' expectations and to price these services in a way that encourages efficiency.



We support IPART's aim of strengthening the accountability of water businesses for their prices and performance.⁷ We agree with IPART there is scope to promote the achievement of the regulatory objective by reducing the regulatory burden and providing stronger incentives for water businesses to meet their customers' needs efficiently and effectively.

⁷ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p16.

To this end, amendments to the regulatory framework should be tested against the proposed objectives anchored around the long-term interests of customers and, in doing so, ensure they are fit-for-purpose and consistent with standard principles of good regulatory design.

Box 1: Principles of best practice regulatory design

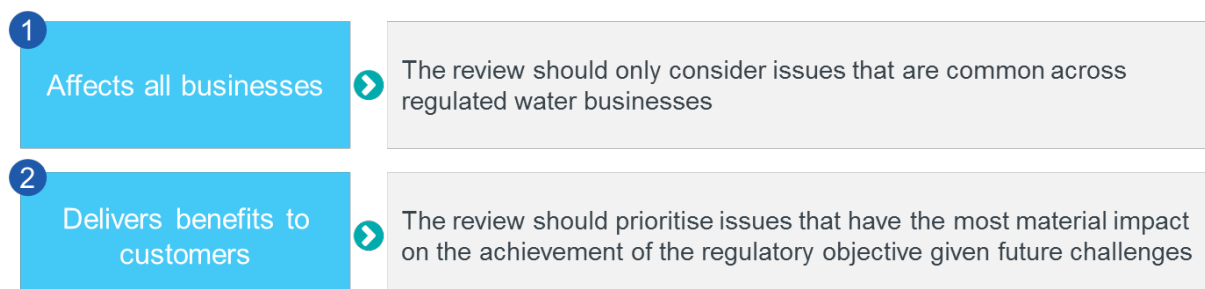
- **Clarity of objectives:** Regulators should have clearly specified and prioritised objectives
- **Cost-effectiveness:** Regulators' decisions should be proportionate and cost-effective. The benefits from regulation should outweigh the costs
- **Focus on outcomes not inputs:** Where possible regulators should use a goals-based approach, driving performance with incentives and giving businesses flexibility to decide how best to achieve clear targets
- **Adaptability:** Regulators should adapt their responses to changing circumstances and continue to be relevant and effective over time
- **Simplicity:** The framework should not be unnecessarily complex or impose excessive regulatory burden
- **Transparency:** Regulators exercise their discretion transparently and with procedural fairness
- **Predictability and certainty:** Regulators should provide a stable environment to anticipate context for future decisions and to make long-term investment decisions with confidence.

Source: Frontier Economics, 2014, Improving economic regulation of urban water: A report prepared for WSAA

3.4 A clear overarching objective can be used to prioritise issues for this review

This review is likely to be more productive and lead to tangible improvements if it focuses on a targeted list of key topics, with remaining issues considered in subsequent reviews.

An overarching objective for the economic regulation of monopoly water businesses in NSW can help prioritise issues for this review. In particular, those issues which affect all regulated water businesses in NSW and have the most material impact on the objective given future challenges should be prioritised for review:



This is consistent with the observations set out in IPART's Position Paper.⁸

The following sections outline the key issues that we consider are consistent with this prioritisation framework within each of the focus areas identified by IPART:

- **Promoting a customer focus** through effective customer engagement and ensuring service standards reflect customer preferences – since best meeting the long-term interest of customers first requires understanding those needs and preferences
- **Lifting the performance of the sector** by providing the right incentives and risk management mechanisms – since this will ensure the businesses' interests are fully aligned with those of its customers
- **Encouraging innovation** through greater accountability and incentive mechanisms – since these will help to ensure the businesses remain focussed on ways to better meet the needs of customers.

We discuss key elements of these priorities in the following sections.

⁸ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p37.

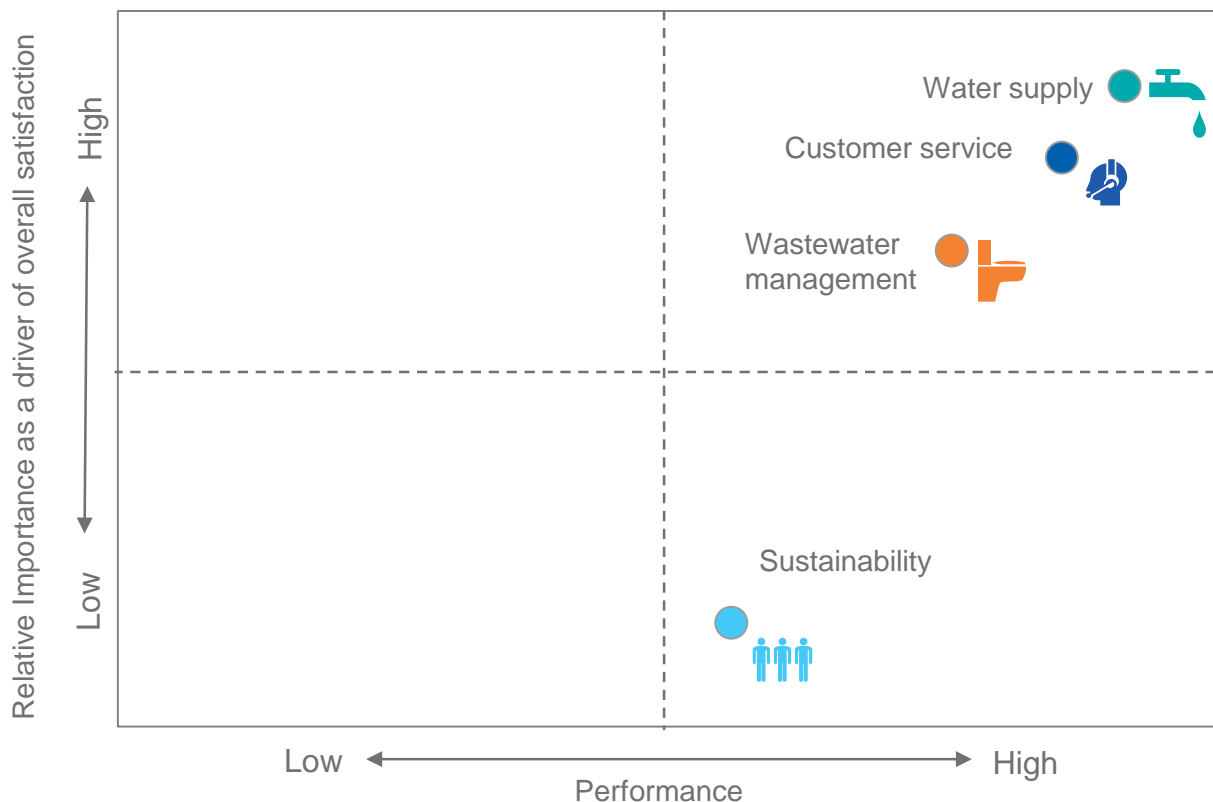
4 PROMOTING A CUSTOMER FOCUS

IPART has identified ‘promoting a customer focus’ as one of the three focus areas for this review. This is because IPART wants the regulatory framework and processes to ensure that the long-term interests of customers are embedded in all major decisions of the regulated businesses.⁹ In order to do so, IPART expects businesses to engage with their customers in a meaningful way, using language and outcomes they understand.¹⁰

We see this issue as a priority as it is not just about the process of improving engagement for its own sake – it is about better outcomes for customers and hence their satisfaction with our services. This is why we consider the focus should be on incentivising both customer outcomes and satisfaction, as well as improving the means of getting to this outcome (by engaging effectively with customers and showing how their views have been considered).

In recent customer engagement we found that customer satisfaction is driven by a combination of service outcomes across the categories of water supply management, wastewater management, customer service, wastewater management and sustainability (see Figure 4.1). When asked to prioritise within a category, most aspects of the services we provide were rated as relatively important by a sizeable portion of the community (see Figure 4.2 to Figure 4.4). The types of aspects we asked about do not neatly fit into categories of “mandatory” or “discretionary”.

Figure 4.1 *Customer perceptions of services that matter most to their satisfaction*



⁹ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p12.

¹⁰ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p12.

Figure 4.2 % Respondents that ranked the following aspects of water supply in their top three for importance

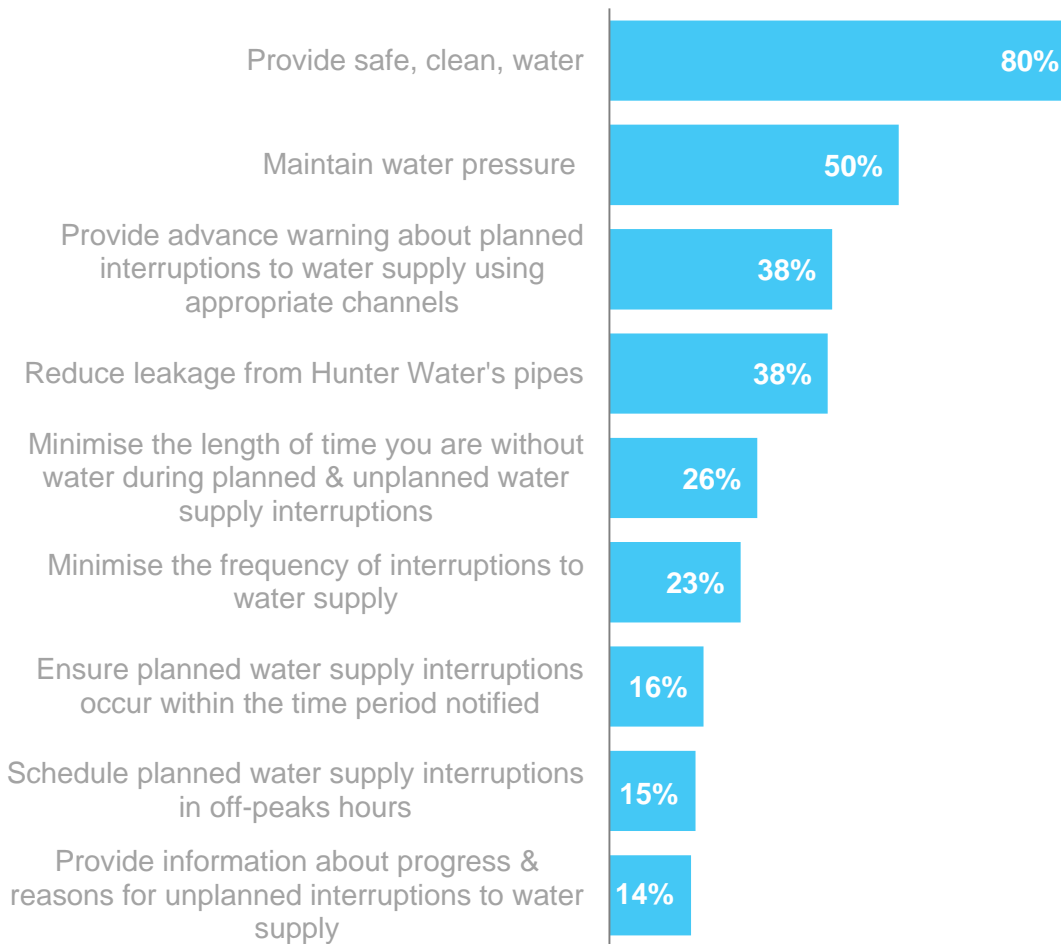


Figure 4.3 % Respondents that ranked the following aspects of wastewater management in their top three for importance

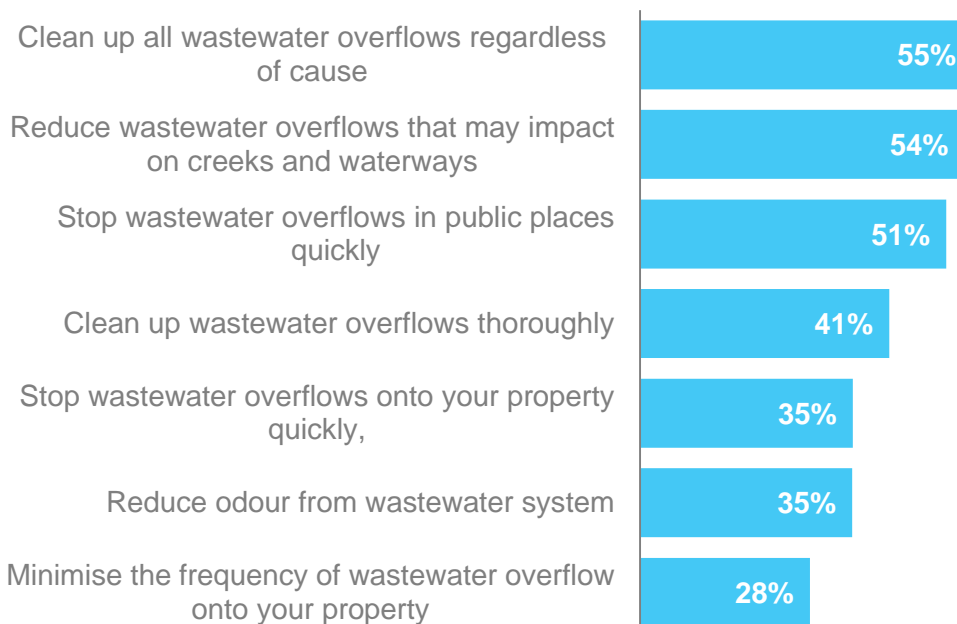


Figure 4.4 % Respondents that ranked the following aspects of customer service in their top three for importance

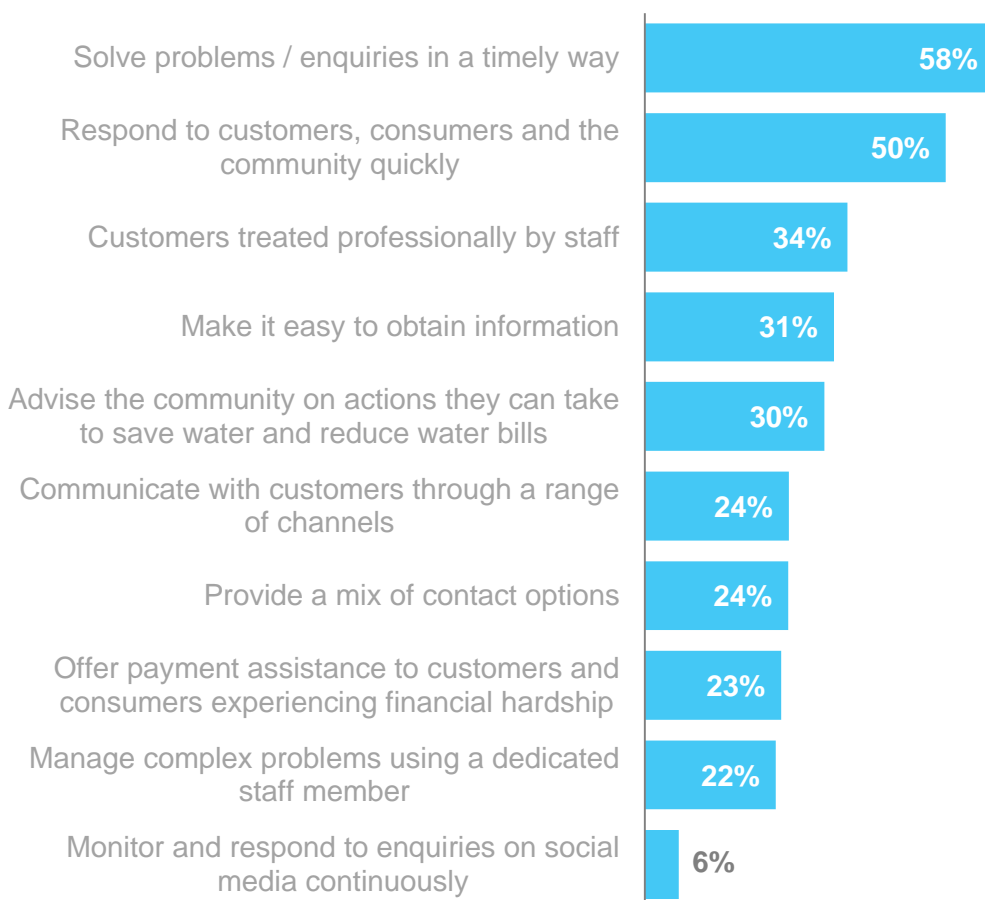
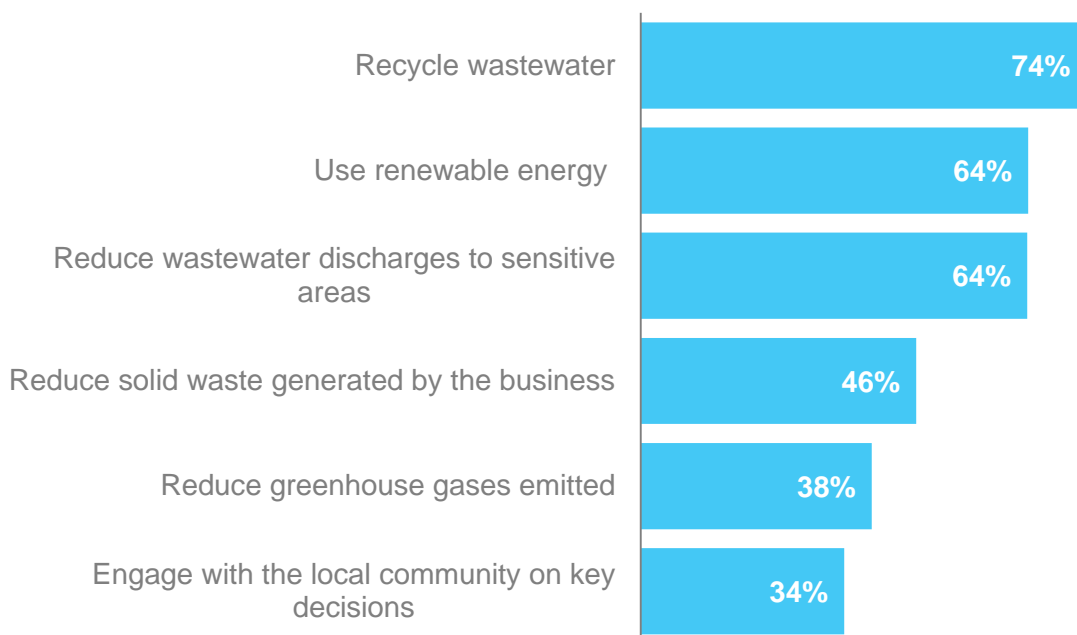


Figure 4.5 % Respondents that ranked the following aspects of sustainability in their top three for importance



4.1 Business led customer engagement should be at the centre of the regulatory process

4.1.1 What is the issue?

We strongly agree with enshrining the principle that the customer voice should be heard and be part of our business decision-making, and therefore be a standard part of the regulatory process. Engaging with our customers is already a strategic priority for us. We recognise that this not only has benefits for our customers, but creates a positive feedback loop to benefit our business.

We consider that key issues to be addressed in this review include the following:

- How to balance specific engagement on the regulatory proposal with businesses' ongoing engagement with customers. We agree with IPART that engagement should not only happen during the price review process.
- There is a need to ensure that engagement on the regulatory proposal occurs sufficiently in advance of a pricing proposal to allow for meaningful input. This may change the balance of time devoted to developing the proposal versus the regulator considering and assessing it.
- How is engagement best incentivised? Some examples that could be adapted:
 - One approach is for the regulator to require the business to undertake effective engagement and to show how this is reflected in decisions as part of regulatory processes. This requires guidance around what constitutes effective engagement and a decision on who is the appropriate party to judge whether the engagement has been effective (e.g. regulator or regulator and customer representatives?).
 - If there is a genuine desire to encourage genuine ongoing engagement, it may be better to shift the focus to customer outcomes rather than engagement processes. We would support the approach taken by other regulators to provide financial incentives for improving customer satisfaction outcomes (e.g. through an incentive mechanism as implemented by the AER for electricity distributors).
- How is engagement best managed when the regulatory process involves separate elements at different times, such as the setting of service standards and prices in NSW, when ideally engagement would be integrated, allowing for trade-offs?

A more incentive-based approach is likely to ensure that businesses are making efficient decisions about how to engage, when to engage and the extent of engagement given that engagement can be costly and take time to design and execute.

4.1.2 Towards a solution

We consider that meaningful incorporation of customer engagement into the regulatory process is likely to be characterised by:

- Establishing principles for sound and effective engagement rather than establishing prescriptive process requirements.
- Focusing on providing incentives for engagement rather than mandating requirements.
- Tying engagement to improving customer outcomes and satisfaction rather than being required for its own sake.
- Ensuring sound engagement outcomes and agreements with customers are given weight in regulatory assessments and decision-making.

5 LIFTING THE PERFORMANCE OF THE SECTOR

We strongly support IPART's aim of seeking to ensure that its regulatory framework lifts the performance of the sector by:

- Promoting coordination between IPART, Government, other regulators and the businesses to deliver a resilient and efficient water sector
- Ensuring the businesses being accountable for the outcomes they deliver to customers and the community
- Setting prices to provide the water businesses with sufficient revenue to efficiently provide their services and comply with the requirements of other regulatory agencies
- Encouraging sound long-term decision-making and resilience to adapt to the pressures of climate change, population growth and other factors that can impact on the supply and demand for water services.¹¹

IPART's Position Paper identifies a number of potential initiatives to improve performance of the sector. We strongly agree with several of the initiatives proposed by IPART:

- **Strengthening communication and coordination with other regulators.** We agree with IPART that this would enable IPART to understand the relationship between our regulatory requirements and our pricing proposals. This is particularly important given the significant increase in our expenditure due to these regulatory requirements, as we discussed in Section 2. Closer engagement, for example through a Regulators Working Group, to agree priorities and recognise the implications for expenditure and pricing will improve outcomes for Hunter Water and our customers.
- **Engage the Board.** We agree with IPART that requiring increased engagement and sign-off from the Board will increase accountability for the businesses. Holding the business to account is an important element of a regulatory framework that promotes autonomy and responsibility. More regular engagement between the Board and the Tribunal would also promote IPART's understanding of the drivers and imperatives from the businesses' perspective.

We believe that these measures represent 'no regrets' changes likely to deliver material improvements in outcomes.

There are several other potential reforms identified by IPART in the Position Paper which, although important and worthwhile, we consider could be deferred to IPART's next step-back review of regulatory framework – after the next round of price reviews. For example, in our view the tariff reforms IPART has introduced in recent years, using LRMC estimates to set usage charges and a drought price during water restrictions, have increased the efficiency of those price signals. As with the other focus areas, we would like to work with IPART on prioritising a narrower list of possible changes that could be designed and made ready for implementation in the next pricing proposals. At the same time, it makes sense to think about how these changes may affect subsequent improvements and refinements to the regulatory model.

¹¹ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p13.

In addition, we have identified two key priorities most relevant to promoting customer interests:

- Effective risk management is critical to achieving revenue adequacy and the long-term interests of customers.
- Service levels should reflect customer preferences and priorities.

5.1 Effective risk management is critical to achieving revenue adequacy and long-term interests of customers

We agree that IPART's regulatory framework should seek to replicate the rewards and sanctions that a competitive market provides such that a business operating in a competitive market needs to manage, adapt and respond to risk.

Effective risk management is critical to the financial viability of water businesses, and therefore the long-term interests of customers.

5.1.1 What is the issue?

We are committed to providing our services in a way that manages risk prudently and in our customers' long-term interests. IPART's current regulatory framework effectively involves setting revenue requirements and prices with limited use of cost-pass through mechanisms and re-openers. While this regulatory framework may have managed some key risks in the past, the key question is whether it remains fit for purpose given the increasing risks and uncertainties in the sector.

We agree with IPART there may be an opportunity to provide businesses with more flexibility to manage these risks within pricing periods. Appropriate risk management mechanisms should be guided by the overarching objective of promoting the long-term interests of our customers, and include:

- Ensuring efficient price signals are sent to customers regarding the costs of providing services.
- Supporting efficient cost recovery, financial viability and access to finance on reasonable commercial terms (as would occur in competitive markets).
- Maintaining appropriate financial incentives to manage risks.
- Providing clear 'rules of the game' ex ante about how these risks will be managed and the process for assessing cost and/or revenue change 'applications'.
- Providing a targeted cost pass-through framework which can manage risks resulting from unforeseen and uncontrollable events in a way that represents an efficient allocation of risk.
- Establishing a five-yearly regulatory cycle which could in turn strengthen any service and/or cost incentive mechanisms.

We note IPART's recent decisions have established a precedent for 'contingent projects'.¹² This is a positive development and brings IPART's risk management mechanism more into line with other regulatory frameworks (such as the AER's contingent project framework under the National Electricity Rules).

¹² e.g. the recent Sydney Water price review for a water network augmentation project associated with Expansion of the Sydney Desalination Plant.

However, IPART's contingency mechanism has some important differences in the way it is applied. In particular, it is not suited for many cost uncertainties including those where an event is unforeseen and the resulting cost unknown (for example drought related investments and/or operating cost measures, changes to licence obligations and/or tax and levies).

This means that if there was a material external change to the operating environment that was either an unknown or unforeseen there would be no opportunity to adjust prices to reflect the efficient cost of compliance without re-opening the determination. The absence of is could lead to inefficient prices signals being sent to customers, potential financial viability issues and potential price shocks at the next determination period. Additionally, IPART's regulatory model for Hunter Water does not allow for any ex-post true-up of unbudgeted operating costs (for example, unforeseen drought related measures).

5.1.2 Towards a solution

We believe there is value in exploring targeted options to manage key risks in a way that:

- Enables IPART to re-establish revenues (and prices) that reflect the costs incurred by an 'efficient benchmark business' over the determination period following a change in circumstances.
- Ensures efficient price signals are sent to customers regarding the costs of providing services.
- Maintains appropriate financial incentives.
- Provides confidence that these costs are subject to independent scrutiny prior to revenues (and prices) being adjusted—but without these costs being specified ex ante in the price determination.

We support IPART's suggestion that a revenue cap may be an appropriate mechanism to facilitate the management of water business risk and promote water conservation, without the need to introduce separate incentive mechanisms.¹³

We can also see merit in a 'total expenditure model', although we would question whether that is a matter for the current review or the next step-back review.

5.2 Service standards should reflect customers' preferences

5.2.1 What is the issue?

IPART recognises in the Position Paper it has two main roles in regulating NSW's water businesses: determining prices and recommending operating licence terms, including performance standards.¹⁴ These issues are closely related, since the performance standards for water businesses largely determine the costs associated with meeting those standards, and the resulting prices to customers. Delivering value for money for customers therefore requires a close relationship between performance standards and prices, to ensure standards reflect customer priorities and the scope for beneficial trade-offs.

¹³ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p17.

¹⁴ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p9.

The decoupling of standard setting and price determination process under the current approach raises the question of whether appropriate the regulatory framework delivers the right balance of service levels across the broader spectrum of service attributes, taking into account customer preferences and priorities. The separation of standard setting and price determination under the current regime means opportunities for beneficial trade-offs between standards and prices are likely being missed.

5.2.2 Towards a solution

We support IPART's identification of increased coordination between pricing and licensing reviews as a potential reform. In its Position Paper IPART acknowledges there may be benefits in running its review processes to set the level of service or standards and prices for those services in parallel, given that the former is a key driver of the latter.¹⁵ However, it also suggests that undertaking these reviews concurrently might increase regulatory costs or burden to the regulated businesses.

Hunter Water agrees that it does not make sense to conduct the operating licence and price review in the same year, given the cost and complexity of doing both, but also the fact that the operating licence considers a broad range of matters apart from performance standards. That does not mean to say that the IPART could not consider all service attributes and service levels in the price review process.

In other jurisdictions standard setting is widely considered to be an integral part of the price review process. Linkages to customer engagement to inform standard setting can ensure service levels meet customer expectations while recognising the scope for trade-offs between standards and pricing. Alternatively, businesses could become more responsible for setting standards through undertakings, rather than imposing mandatory requirements (as occur under the Victorian approach). The Regulator's Working Group provides one mechanism for strengthening the relationship between service standards and pricing.

We agree with IPART that performance assessment should focus on outcomes rather than inputs. This is required to ensure the outcomes and level of services customers want are identified, understood and delivered.¹⁶

¹⁵ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p19.

¹⁶ IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p17.

6 ENCOURAGING INNOVATION

A key challenge for IPART is ensuring prices reflect the prudent and efficient costs of providing these services – as doing so is also in the long-term interests of customers in ensuring services can be provided and investments in key assets maintained. At the same time, identifying and incentivising achievable and ongoing improvements in costs and services is critical to ensuring customers receive value for money.

We welcome IPART's proposal to explore the right mix of incentives that encourage businesses to innovate in the pursuit of efficiency improvements, and to promote better long-term outcomes for customers. The Position Paper also states IPART will examine whether its building block framework remains the most appropriate method to set costs and prices. The Position Paper also indicates that one aspect that the review may consider is financial sustainability—or financeability.

We believe there are two pressing issues relating to encouraging innovation:

- Streamlining and clarifying approaches to determining allowed revenues.
- Designing incentive mechanisms to provide a genuine driver for innovation.

6.1 Approaches to determining level of allowed revenues should be streamlined and clarified

In Hunter Water's view the building block approach remains broadly sound as a methodology to establish the level of efficient costs which the business is permitted to recover. We note that it represents a widely adopted approach both within the water sector and other utility sectors in Australia and overseas. However, we have some concerns about the ways in which it is operationalised, and in particular how efficient operating and capital and operating expenditure is assessed.

6.1.1 What is the issue?

When applying the building block model, IPART assesses the efficiency and prudence of proposed capital and operating expenditure. Prudence and efficiency tests are important parts of the regulatory framework. However, there is limited guidance on how these expenditure tests will be applied in practice. That is, the factors or circumstances that will be taken into account in determining whether certain past or proposed expenditure is efficient are not specified. This creates uncertainty and risk for the business when developing our expenditure plans since we are unable to properly assess whether expenditure will be considered efficient and included in our revenue allowance.

As part of its ex-post review of capital expenditure, IPART can 'disallow' any expenditure over the previous regulatory period that it considers was not efficient or prudent. This has the potential to impose considerable stranding risk on the business. Ex-post reviews impose significant regulatory burden on both IPART and the business. In our view, ex-post reviews should be limited to address clear cases of inefficiency. This is consistent with best practice incentive regulation, and the approach adopted by regulators in other sectors.

In addition, we note that IPART typically engages external consultants to conduct its expenditure reviews and generally accepts the consultant's recommendations. The expenditure consultants face a difficult task: understanding the utility, reviewing internal governance processes and business cases, reviewing the merits of past prioritisation and spending decisions, and forming judgements on areas of weakness or poor practice. The consultant must complete all of this work within a four month window. This is a demanding exercise, and in our view, can create a false perception of rigour and precision.

Finally, while we strongly support the financeability test as an important part of the ‘sense check’ on the revenue requirement derived from the building block methodology, we are concerned that it is not being applied or interpreted in a way consistent with its underlying intent.

6.1.2 Towards a solution

We believe that greater clarity is required on how IPART’s expenditure assessment framework will be applied. In particular, IPART should specify the principles or factors that it will take into account when assessing the efficiency and prudence of capital and operating expenditure. These principles should promote efficient investment in and operation of the business’ assets for the long-term interests of consumers and only consider information that was available to the business at the time the expenditure decision was made.

Hunter Water also considers that to minimise stranding risk and reduce regulatory costs, IPART should restrict ex-post reviews to circumstances where a regulated business has overspent its capital expenditure allowance.

Hunter Water supports the adoption of complementary expenditure assessment measures to test expenditure proposals from the utilities. Hunter Water supports the appropriate use of benchmarking as one of a suite of tools to inform price reviews. In particular, any benchmarking process should be undertaken in a consultative fashion, use best practice techniques, and utilise robust and reliable data.

Hunter Water also supports greater clarity on how the results of the financeability test will be interpreted and used by IPART in future reviews.

6.2 Incentive mechanisms need to be designed to provide a genuine driver for improved performance

6.2.1 What is the issue?

Incentive mechanisms are an important part of the regulatory framework. The objective of these mechanisms is to provide robust incentives for a regulated business to pursue efficiency gains and deliver outcomes that are consistent with the long-term interests of consumers – as would occur in a competitive market.

IPART notes its current approach relies largely on financial incentives to motivate the water businesses to pursue efficiency gains. This is achieved through two key mechanisms:

- The first is a ‘no claw back’ principle, which means IPART will not claw back any underspent expenditure in a given regulatory period. The lag between the time when the firm improves efficiency and when those savings are reflected in prices in the next regulatory period means the power of the incentive reduces as the period progresses.
- The second is the efficiency carryover mechanism, which allows the regulated business to retain efficiency savings for a fixed number of years from when they are realised (typically the length of the regulatory period). This mechanism works alongside the ‘no claw back’ principle to ensure that a business’ incentives to achieve efficiency gains are constant over the regulatory period.

Hunter Water recognises the importance of these incentive mechanisms in ensuring the efficiency, reliability and affordability of water supply in NSW. However, we believe that improvements can be made to strengthen the incentive properties of these mechanisms to generate outcomes that are more in line with the long-term interests of consumers.

6.2.2 Towards a solution

We welcome IPART's proposal to conduct a holistic review of how the different elements of the regulatory framework interact to provide incentives for Hunter Water to reduce its expenditure and innovate.¹⁷ It is also important to consider whether water businesses can respond to those incentives in practice.

To ensure that incentive mechanisms are fit for purpose, it is important that IPART:

- Establishes clear principles that incentive mechanisms should meet that align with the long-term interests of customers. For example, this could include the principles that incentive mechanisms should be symmetrical, proportionate and timely, and as simple and clear as possible.
- Reviews existing incentive mechanisms and assess whether they meet these principles and, if not, propose changes to the mechanisms to better meet the long-term interest of customers.
- Reviews the need for additional incentive mechanisms, drawing in particular on the experiences of other regulators and jurisdictions but noting the particular circumstances of the regulated utilities in question.

Hunter Water also supports consideration being given to an incentive scheme relating to service performance, reflecting the importance of meeting and/or exceeding service standards is a key issue for customer service expectations.

In terms of encouraging innovation within the water business, Hunter Water is keen to explore the practical application of two initiatives outlined in the Position Paper:

- Regulatory or innovation 'sandboxes' that would allow public water utilities a dedicated funding allocation to trial and pilot new technologies or practices in the water sector.
- An innovation fund within the NSW water sector, awarded by an independent panel under a contestable arrangement, to help test and develop new technologies or practices in the sector.

6.3 Facilitating cost-effective environmental regulation

Under the current arrangements, the NSW Environment Protection Authority (EPA) is responsible for monitoring and regulating Hunter Water's environmental performance. The EPA issues Environment Protection Licences under the Protection of the Environment Operations Act 1997 (NSW) for Hunter Water's sewerage network, pumping stations and treatment systems. NSW Health is responsible for regulating the quality and safety of Hunter Water's drinking water.

Under the current economic regulatory framework, IPART is not responsible for setting the environmental or liveability objectives of the community, nor for determining the best way for such objectives to be met. Rather, its task is to ensure that the businesses' pricing proposals reflect only the prudent and efficient costs of delivering its services while complying with their regulatory obligations. As noted by IPART, regulated water businesses should be permitted to recover the (efficient) costs of complying with environmental and other standards set by independent regulators, as a legitimate cost of doing business.

¹⁷

IPART, Water pricing and licensing: Regulating water businesses - Special review, Position paper, September 2020, p21.

The POEO Act does allow the EPA to consider ‘green offset schemes’ where the pollutants or impacts of an activity cannot be prevented, controlled or mitigated in a “cost-effective way” by direct measures. The concept of green offsets covers works that may reduce environmental impacts in the area affected by the pollutants or impacts.

The EPA has developed a new regulatory framework for the Hawkesbury Nepean catchment, starting in 2024, that sets new load and concentration limits for wastewater treatment plants in these catchments. While placing new obligations on Sydney Water, the framework does allow and permit catchment management and other works to manage nutrient levels. This framework will allow trading of nutrients loads between treatment plants and offsetting treatment nutrient loads with other nutrient load reduction initiatives (e.g. reducing diffuse pollution loads).¹⁸

Hunter Water accepts that the EPA must be assured that any environmental improvements from an offset arrangement or agreement are enduring, measurable, enforceable and auditable.

Hunter Water is currently undertaking a ‘pollution study and reduction program’ for five wastewater treatment plants along the Hunter River. The detailed modelling and investigative work has identified catchment management works that could deliver significant environmental improvements in parts of the Hunter River system.

We are keen to explore with IPART possible ways of facilitating offsetting arrangements in the Hunter Region. These arrangements offer the potential to deliver material improvements in nutrient levels at a lower cost than incremental upgrades at specific treatment plants – a far better environmental outcome for the same or lower cost of some treatment plant upgrades.

We would invite IPART to consider possible funding arrangements that allow pilot programs and testing of catchment management initiatives, to provide the level assurance necessary under the EPA requirements. IPART could also provide clarity of the regulatory treatment of expenditure on catchment management initiatives.

In addition to consideration of nutrient trading and offsetting arrangements, Hunter Water also support the proposals put forward in IPART’s Position Paper on how it might strengthen communication and coordination with other regulators including the EPA.

¹⁸ NSW Environmental Protection Authority, Regulating nutrients from sewage treatment plants in the Lower Hawkesbury Nepean River Catchment, July 2019.

7 REVIEW OF WEIGHTED AVERAGE COST OF CAPITAL AND REGULATORY DEPRECIATION

7.1 A separate review of the WACC should commence in December 2021

Hunter Water supports IPART's proposal to conduct another review of its WACC methodology. Whilst Hunter Water considers that most aspects of IPART's existing WACC methodology are working well, there are areas in which improvements could be made. We consider the treatment of inflation to be a key issue for consideration in the WACC review.

Hunter Water supports IPART's proposal to separate the WACC methodology review from the regulatory framework review. As has occurred in the past, the WACC methodology review is likely to involve detailed and technical considerations of specific aspects of IPART's WACC methodology. By contrast, the issues that are likely to be relevant to the regulatory framework review will not require the same level of granular and technical analysis. Differences in the nature of the issues that are likely to arise in the two reviews, and the level of detail and engagement required by IPART and stakeholders, suggest that it would be appropriate to separate the two reviews.

The position paper proposes that the WACC methodology review would commence in December 2020 and would be undertaken over a 12 month period. This suggests that the WACC methodology review would be conducted in parallel with the regulatory framework review. Hunter Water considers that it would be preferable to stagger the two reviews – for instance by commencing the 12-month WACC methodology review in December 2021 rather than December 2020. This would allow IPART and stakeholders to devote full attention to each review separately, rather than spread resources across two significant concurrent reviews. Hunter Water is concerned that it may be challenging for stakeholders to participate fully in both reviews, were they to be conducted in parallel.

If the WACC methodology review were to be commenced in December 2021, it could be concluded by December 2022. This would allow the new WACC methodology to be applied to Hunter Water's next regulatory period, which is due to commence on 1 July 2024.

7.2 The next WACC methodology review should focus on inflation

Given that IPART recently reviewed its WACC methodology in 2018 it proposes that the upcoming WACC methodology review should focus on select aspects of the methodology. In particular, IPART expects that many of the changes it introduced in the 2018 review remain fit-for-purpose and would not need to be revisited in the proposed review. The matters that IPART considers would not be revisited include the following:

- the trailing average approach to the cost of debt
- a more sophisticated way of estimating the current market risk premium (MRP)
- a more detailed and robust spreadsheet model and automated tools for the bi-annual market update report that minimised the risk of errors.

Hunter Water agrees that these changes represent significant improvements and do not need to be revisited in the forthcoming review.

Hunter Water also supports the approach of undertaking an incremental WACC methodology review that focusses on a small number of material issues where the need for improvements are pressing and would best promote the long-term interests of consumers. To this end Hunter Water proposes that the following issues should be the focus of the next WACC methodology review:

- The treatment of inflation within the regulatory framework, and in particular:
 - The most reliable method(s) to estimate the market's expectation of inflation over the regulatory period *in all market conditions*?
 - How should regulatory allowances be set such that a benchmark efficient business would have sufficient revenue to meet its efficient debt obligations?
- The averaging period used to estimate the long-term risk-free rate
- IPART's response to significant movements in the uncertainty index
- The role of the Fama-French model and Black CAPM in determining the return on equity allowance.

We look forward to elaborating on these issues at an appropriate time.

7.3 IPART review of new and existing asset lives

Hunter Water's 2019-20 price review resulted in new asset categories within the existing regulatory asset bases: water, wastewater, stormwater and corporate. These changes in asset categories and asset lives provide a far better reflection of the remaining useful lives of our asset base, compared with the previous approach.

IPART's review of assets lives and regulatory depreciation allowance considered how best to weight asset lives for each RAB category using information from our fixed asset register. IPART looked at two methods: weighting by the depreciated value of assets in the register and weighting by depreciation using relative depreciation of individual assets. The choice of method has a material impact on the regulatory depreciation allowance.

IPART's final report for Hunter Water flagged a separate review of new and existing asset lives for all regulated utilities. This is an important issue for Hunter Water, with material impacts on our financial metrics – and potentially affecting other NSW utilities. Hunter Water suggests that IPART could conduct a standalone review of asset lives in parallel with the 2022 WACC review.

8 REVIEW PROCESS

IPART's proposed process entails structuring the review roughly into three 6-month periods as set out below:

- Six months to consult on scope and present initial views
- Six months to solve problems and make decisions
- Six months to present, explain and refine draft decisions with stakeholders.

Hunter Water considers that this structure and the time allowed for each is reasonable.

IPART's process differs somewhat from the approach it adopts for price reviews. In our view this is appropriate and consistent with similar framework reviews undertaken by other regulators.

We note and support IPART's proposed approach to consultation and in particular support the use of workshops to canvass key issues and potential reforms to the regulatory framework.

In our view there would be considerable merit in establishing a stakeholder reference group – NSW water businesses, PIAC, NSW Treasury, DPIE Water – to enable detailed engagement with IPART on key issues under the review. The reference group would be helpful, particularly in the early stages of the review, to canvass the key priority issues and the framework for the review, before diving into the detail of specific issues.

Hunter Water suggests one or two initial meetings with the reference group that focus on the objectives and priorities for the review as a precursor to the three workshops on detailed measures in each focus area.

We look forward to working closely with IPART on this important review.