



Regulating water businesses – special review

Response to IPART's Position Paper

30 October 2020

Sydney
WATER

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1 Executive summary

Key messages

- Our sector faces major strategic challenges, which a reformed regulatory framework can help to address. The investment outlook, the need to promote efficiency and innovation and the prospect of real increases in customer bills in the medium-term all mean that customers should demand a greater contribution from the regulatory framework to the solutions that they require.
- Establishing a stakeholder reference group for this review will facilitate a strategic dialogue and encourage active participation. Reform that does not engage stakeholders will not be successful.
- Reform should focus on aligning the regulatory framework with best practice. In line with best practice, IPART should have an explicit objective to make decisions in the long-term interests of customers. IPART can provide guidance on how it interprets its duties to meet this objective.
- IPART should embrace best practice regulatory governance and improve accountability in its decision-making. It should consider ways for regulated businesses (and potentially third parties) to be able to appeal or review its regulatory decisions. Establishing consumer panels to review draft determinations is a possible way forward.
- The regulatory framework should give utilities clearer incentives to encourage them to deliver better long-term performance, in the long-term interests of customers.
- At present, this alignment is weak and incentive regulation is low-powered. While IPART will remain focused on the equity return compared to comparators, IPART also needs to think of equity return as a lever to generate incentives and create long-term customer benefit. This type of performance framework is a strong feature of reforms delivered elsewhere.
- IPART should therefore establish a framework for balancing risk and reward between shareholders and customers. It can then consider the scope to strengthen incentives and place more performance risk on utilities, relative to the potential impact on equity return. Placing risk on utilities that they can influence and control is, from a customer perspective, likely to be a better use of the companies' risk capacity than putting risks on them that they cannot control, such as managing inflation risk or revenue volatility associated with price caps.
- Another issue to consider is promoting coordination among regulators to avoid potentially conflicting or misaligned requirements. This can hamper utilities' ability to deliver cost-effective outcomes, while protecting the environment and public health.
- Understanding what our customers value is essential to delivering outcomes that are in their long-term interests. We welcome discussions with IPART and other stakeholders on how we can evolve our customer engagement processes to better inform our business planning.
- It is recognised by regulators elsewhere that the building block model does not help to create a culture of innovation. Special measures are required. IPART should explore lessons learned from regulatory innovation in this area and consider how to stimulate innovation for customers.



Reform is essential to improve sector performance

The NSW water sector faces huge investment and operational challenges if it is to deliver a better service to a much bigger city over the next 20 years, while maintaining the support of its customers who fund the system. While this review covers all regulated water business, the State Owned Corporations (SOCs) are a major component of it. The Independent Pricing and Regulatory Tribunal (IPART) and the SOCs, working together, have the opportunity to ensure that the regulatory framework makes a much bigger contribution to meeting this challenge than it does at present.

Utility regulation in Australia and the UK has undergone various reforms over the last 20 years with significant change in water regulatory frameworks in Victoria, South Australia, Scotland, England and Wales as well as developments in Australian energy network regulation. Meanwhile, water regulation in NSW has been largely unchanged for 20 years. Reforms elsewhere make the scope for improvement in NSW very clear. We have the benefit of being able to draw on experimentation and innovation elsewhere, and to apply the best of it to NSW.

As IPART sets out in its Position Paper, drought and climate change require new thinking on how best to ensure secure supplies and manage demand, while promoting integrated water management.¹ However, the imperative for reform is greater than IPART suggest for two reasons:

- The investment outlook, in a growing city with ageing assets in need of replacement, means real customer bills will most likely increase in the medium term.² Historically low interest rates are presently masking the impact of increased capital expenditure and enabling customers to avoid paying more now. Meanwhile, the financial resilience of the sector has declined, with balance sheets more highly geared than in the past.³
- Customers must become more central to the industry's processes for determining the service they receive. As part of this, IPART and the companies it regulates must become better at strategic engagement to address the city's challenges. Without embedding new ways of working, the NSW water sector will not have the support of its communities and customers for the price increases that may become necessary.

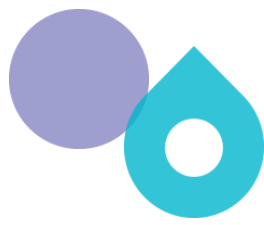

The regulatory framework must therefore support the industry in seeking to become more efficient, more innovative and higher performing. To help SOCs' performance to improve, shareholder and customer interests must be strongly aligned. This is the basis on which the SOC model was created. The SOCs' commercial incentives should encourage them to deliver better long-term performance for customers, and in turn to deliver a higher long-term return to their shareholder, the NSW Government.⁴ These returns enable more public funding for communities, customers and taxpayers.

¹ IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, p 5.

² For instance, the regulatory asset base of Sydney Water is approximately 40% of the estimated replacement cost of the company's assets.

³ Sydney Water's gearing ratio has steadily risen from 49.73% in 2017 to 57.99% in 2020.

⁴ Under section 21 of the Sydney Water Act, Sydney Water has three equal principal objectives: to be a successful business, to protect the environment and to protect public health.



There are opportunities to improve the alignment of shareholder and customer interests. The present incentives in the framework are limited and low-powered. Government has many demands on its finances and the water utilities need to be attractive to our shareholder. Whenever equity returns are less than their opportunity cost, there is a transfer from the NSW taxpayer to SOC customers. With service standards under pressure, the capacity and risk appetite of the SOCs to take on more performance risk and to respond to incentives is likely to be dulled. More transparent management and monitoring of the balance of risk and reward between shareholder and customer can address this issue and unlock the potential to put in place stronger incentives. These incentives might in turn deliver dynamic efficiencies, leading to productivity and service improvements that benefit customers.

We need a change of culture to promote better stakeholder and customer engagement

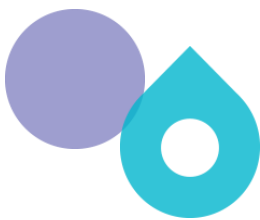

We welcome IPART's openness to identifying new and more collaborative consultation processes. An ambitious reform program requires support from stakeholders to be successful. This means we need effective governance and feedback mechanisms. This should involve cultural change as well as transparent public processes. Good regulatory frameworks are of limited value unless they engage senior management and boards, influence corporate behaviour and actively engage customers and stakeholders.

Consistent with this spirit, IPART should establish a special review stakeholder reference group. At this forum IPART can share and hear different perspectives and seek to achieve consensus on the scale and type of change that is proposed. This would extend to the planning of the work program, so that all parties can plan their participation. This group could meet for the first time in November, after parties have had a chance to consider responses to IPART's Position Paper. Consultation with such a group will allow IPART to be better placed to design a work program in cooperation with industry participants and customer and community representatives.

To be successful, the proposed workshops will require industry, stakeholder and customer groups' participation. They will require significant preparation from all participants and a strong sense of engagement and commitment to achieving some shared goals.

IPART should have a clear objective to promote the long-term interests of customers

Unlike other economic regulators, IPART is not clearly and explicitly bound by a duty or objective to focus on the long-term interest of customers. This is out of line with best practice and with regulators such as the Essential Services Commission (ESC) and the Australian Energy Market Commission (AEMC). It would be useful to consider if a review of the IPART Act would be helpful, or whether some guidance from IPART about how it interprets its duties under Section 15 of the IPART Act might be useful for stakeholders and SOCs. Previous guidance from IPART provides little certainty for investors or customers about how IPART will trade-off its conflicting duties under



Section 15.⁵ Sydney Water seeks to act at all times in the long-term interests of customers and it is important for our business planning that our regulator considers our plans in the same light.

There is a perception in the water sector that IPART is overly focused on ensuring the least cost over the short-term. We acknowledge that in the recent price reviews of the SOCs, IPART approved large increases in capital expenditure where it judged that adequate business cases had been presented. Nevertheless, there is a perception of a focus on cost, rather than value, and a lack of focus on innovation. While IPART has signalled that it wants regulated water businesses to focus on customer value, the price review process tends to emphasise a focus on costs, prices and performance over a short time horizon. The price reductions delivered for customers of public water utilities in the recent reviews do not obviously sit well with the intergenerational equity challenges that the sector faces. IPART needs to engage directly with stakeholders on these high-level concerns. In the regulatory model eco-system, it is important that all players are accountable for explaining how they make their strategic decisions.

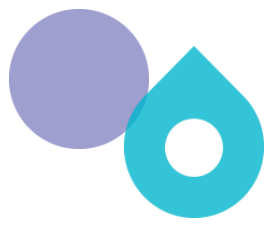

This principle should extend to reviews and appeals. A regulator that wants to preserve its legitimacy and which is committed to improving the quality of its regulation should be comfortable with the companies it regulates (and, potentially, interested third parties) being able to appeal its decisions. The abolition of limited merits review in the energy sector does not change this element of the best practice regulation toolkit. The concerns that led to that decision can be readily addressed by the design of the right of appeal. In this vein, IPART should explore how it can improve accountability in its decision-making, including the scope for the review of the substance (or merits) of its decisions. This could involve other options short of full merits review, such as arbitration or seeking independent opinions from specially constituted panels, as practised by the Australian Energy Regulator (AER). Alternatively, IPART could agree to voluntarily delegate powers to independent or consumer panels, to support review and challenge of final regulatory decisions.

We need an explicit focus on the balance of risk and reward between shareholders and customers

IPART should establish a transparent framework for balancing risk and reward between shareholders and customers. This should be the focus of the price review conversation between the boards of the water utilities and the IPART Tribunal, both in the process leading up to the conclusion of a price review and as a basis for monitoring, at an aggregate level, the financial and operating performance of the utility ex-post, relative to the expectations that IPART set for the regulatory cycle.

This provides a basis for more strategic engagement between company boards, their shareholders, customers and IPART, focused on the performance delivered for customers, relative to the financial returns earned by the company. Regulation of this type is standard in the water and

⁵ In 2010, a former IPART member, Sybille Krieger, asserted that weighing up and balancing different and conflicting policy objectives and the competing interests of stakeholders is what economic regulators do. This approach is not consistent with best practice. S Krieger, 'Should the Law Have a Greater Role in Economic Regulation of Infrastructure Services?', paper presented at IPART Conference - *Encouraging Efficiency and Competition in the Provision of Infrastructure Services*, Sydney, 7 May 2010.



energy regulation of privatised monopolies in Great Britain, and also in the regulation of the state-owned Scottish Water. The most notable feature of the PREMO reforms in Victoria is similarly the linkage made between the quality of the utility business plan and the target return on equity awarded to the company (through an adjustment to the regulated cost of capital).

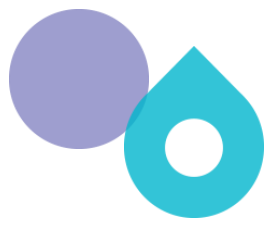

This approach provides for an ex-ante and ex-post assessment of company performance, financial return, incentives and risk in a way that is missing at present in IPART's framework. Expenditure and service standards are determined in isolation from the expected return on equity of the utility. This is not the world in which company management operates. Investors are interested in the financial return they can generate (that is, the return on equity), in their environment, given the risks they face and the incentives they have been given. In contrast, focusing on the return on assets, important though it is, distracts attention from the return on equity that is the focus of equity investors. This equity investor lens should be equally interesting for regulators, customers and stakeholders interested in aligning the interests of equity investors in infrastructure providers and their customers. This balance of expected risk and reward essentially defines the performance contract that arises out of the price review process.

An effective regulatory reform program requires the role of the regulated cost of capital, and how that translates, together with the risk and incentives placed on the company, into expected returns on equity to be at the heart of the program. Once appropriate principles are established, we can then have more detailed discussion about the weighted average cost of capital (WACC) methodology. For this reason, we support delaying the WACC review until after the principles have been agreed between the parties.

A risk and reward framework encourages companies to take on more risk where it benefits both customers and shareholders

We recognise we need to be more customer-focused and to set stretching performance targets. However, the incentives on regulated water businesses to take on more risk are weak unless the underlying performance contract with their regulator is robust and recognises the business risks they face. Moreover, while IPART is committed to diversifiable risk having a symmetrical profile, there is very limited evidence that this symmetry is achieved in practice; in both the calibration and assignment of the business risk as well as the outturn outcomes. IPART's approach can overlook the fact that particular business risks can be inherently asymmetrical and the "mean" outcome can be very difficult to predict ex ante. Sydney Water accepts that it can be in the long-term interests of consumers that we assume a level of business risk, but only where equity investors have reasonable confidence that at least mean expected returns will be received.

Well-designed regulatory regimes seek to maximise the controllable risk and minimise the uncontrollable risk to which the company is exposed, subject to the need to keep the total risk of underperformance within an envelope that mitigates exposure to miscalibration of performance targets and keeps financing costs low. For this reason, we support IPART considering a move to a revenue cap instead of a price cap. The uncertainty over our revenue increases our financing costs and the year-on-year revenue uncertainty it creates makes financial planning and risk management more difficult than it needs to be. Moreover, it takes up a part of our scarce capacity



to absorb risk with no offsetting customer benefits.⁶ We have limited ability to manage the demand risk for our product, particularly as water restrictions imposed by government, over which we have no control, can increase the revenue uncertainty that we face. While the demand volatility adjustment mechanism provides some limited Net Present Value (NPV) protection at the end of the cycle, it does not compensate for cost of the uncertainty we face in the short term.

IPART should take care to ensure that the risks borne by regulated water businesses are risks they are well-placed to control, unless there is confidence that the regulatory framework adequately compensates water businesses for the uncontrollable risks they face. This is the corollary of limiting the range of regulated revenue the regulated company can earn relative to its costs. Within this framework, IPART can then consider the scope to strengthen incentives and place more performance risk on the water utilities, relative to the potential impact (both positive and negative) on the likely equity return the company can target to deliver.

A focus on the likely range of return on equity (that is, within a collar, with a fixed upside and downside around the central expectation) can provide assurance to customers and shareholders, as well as IPART. A particular challenge faced by regulators in other jurisdictions has been managing the risk of mis-estimated targets and mis-calibrated incentive mechanisms. IPART is likely to face similar issues. A collared approach to the return on equity mitigates the risks of regulatory error distorting financial outcomes. In this way it can provide comfort to regulators, as well as regulated companies, and encourage necessary experimentation and innovation in the regulatory framework.

Better coordination is needed among regulators

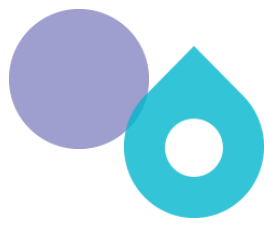

We support better coordination among regulators as an area of focus in this review. In our case, our two key other regulators are NSW Health and the Environment Protection Authority (EPA).

Currently there can be a disconnect between regulators that leaves regulated businesses vulnerable to conflicting and misaligned requirements. This can hamper our ability to deliver cost-effective outcomes, while protecting the environment and public health. Regulated businesses can also face uncertainty in how IPART may assess activities that are contributing to government policy objectives.

Customer engagement must continue to improve and evolve

Understanding what our customers value is essential to delivering outcomes that are in their long-term interests. Involving customers more in the regulatory process has been a recurring feature of regulatory reform over the past two decades. Consumer engagement can take many forms, and

⁶ To illustrate this point, Sydney Water currently forecasts water demand for 2020-21 that will be 5% below our IPART demand forecast. If this materialises, customers will consume 25 GL less water than forecast and the company will generate \$60m less in earnings relative to our net profit before tax target of \$600m. This is not a shortfall we are in a position to manage or influence. If we want to stay on track to meet our net profit before tax target, one might expect uncertainty of this type to affect the company's appetite to take on more risk, given that might itself generate more profit uncertainty.



numerous mechanisms to incentivise and test to what extent the price proposal of a regulated business price proposal meets customer expectations and preferences have been tried.

More recently, regulators have provided financial and/or reputational incentives for regulated businesses to engage in greater customer engagement, as CEPA noted in its report to IPART.⁷ This has typically involved clear guidelines established before the price review on how the regulator will treat outcomes of engagement processes. Without this clarity, company incentives to engage can be undermined for fear of second-guessing by the regulator later in the process.

We welcome discussions with IPART and other stakeholders on the lessons to be drawn from experiences elsewhere and how best to apply them in the NSW water sector.

Dedicated innovation funding provides greater incentives for innovation

We agree that the regulatory framework should encourage innovation to deliver long-term benefits for customers. By their nature, innovation activities tend to be speculative, with a high risk of failure and benefits only delivered in the medium to long term. Without explicit funding for research and innovation, these activities risk being deferred or deprioritised to accommodate other expenditure than can be more convincingly demonstrated to provide short term benefit. This is a systemic, cultural issue with regulated utilities, which have captive customer bases and no ability to capture the benefits of their innovation for their shareholder beyond the short term.

Other regulators have introduced funding mechanisms to provide greater incentives for innovation, such as dedicated funding allowances, or competitions where various utilities can compete for a portion of a funding pool. They then share the findings of their work with their peer utilities. Such an approach would provide much stronger incentives for innovation than exist at present. IPART should explore the options in this area, based on the extensive international experience that is at hand.

⁷ CEPA 2020, *Economic regulation of water utilities - research*, p 18.



2 Introduction

We welcome the opportunity to provide input into this review. In this introduction, we outline our views on the need for reform and the structure of this submission.

2.1 Reform is essential to improve sector performance

The establishment of IPART in 1992 signalled an increase in the transparency and accountability of the water sector in NSW. The subsequent structural and legislative reforms to the water sector in NSW paved the way for greater competition and better outcomes for the people of NSW.

Now, change is needed to ensure the regulatory framework remains fit for purpose. IPART acknowledges the external challenges to the sector such as climate change and population growth.⁸ For example, Sydney Water faces challenges presented as our city expands to the west in areas with little existing infrastructure. This expansion also provides opportunities, including greater opportunity to apply integrated water management approaches. However, we consider the imperative for reform is greater than IPART suggests. The investment outlook for our growing city makes engaging with customers and stakeholders even more important as we seek support for addressing the city's challenges, which may necessitate future bill increases.

As acknowledged by the different approaches noted in CEPA's report to IPART, regulatory practice has also changed significantly over the past few decades.⁹ There is an opportunity in NSW to consider how the regulatory regime could encourage better company performance. While regulated water businesses currently have an incentive to reduce costs within a determination period, there are no financial incentives to deliver outcomes in line with customer needs, or to deliver higher levels of performance.¹⁰ It has been acknowledged in most other regimes that "the building blocks approach can result in a disproportionate amount of attention on the costs and efficiencies of inputs used to produce services, with less specific emphasis placed on the value of outcomes delivered to customers or potential value improvements to customers through more innovative service offerings."¹¹ An effective regulatory framework needs to reward performance that focuses on the long-term interests of customers.

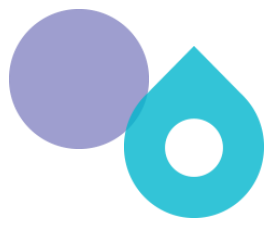

In terms of regulatory process, there is also opportunity for improvement. The outputs of price reviews do not currently facilitate a holistic conversation between the boards of water utilities and the IPART Tribunal. This conversation should focus on what performance customers can expect over the regulatory cycle and what return the shareholder may receive relative to the different levels of performance that may be delivered. Instead, technical components of the package are looked at in isolation. In addition, opportunities to focus on areas where the highest value is available may be missed due to a disproportionate focus on relatively low value issues where there

⁸ IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, p 5.

⁹ CEPA 2020, *Economic regulation of water utilities - research*.

¹⁰ As IPART states on p 35 of its Position Paper: "While our current approach provides a financial incentive to reduce costs and allows for the recovery of discretionary expenditure where there is evidence of customer willingness to pay, it does not provide a financial reward to deliver higher levels of performance to customers."

¹¹ Synergies 2015, *An alternative model for Victorian water businesses*, p. 4



is scope to delegate decision-making to the companies without diluting consumer protection. For example, the price review process for Sydney Water involves the setting of 128 prices, even though 95% of Sydney Water revenue is accounted for by the prices relating to our three core services: water, wastewater and stormwater services. It would be more proportionate to adopt a lighter-handed approach to determining the prices for how this remaining 5% of Sydney Water revenue is recovered.

A greater focus on value, innovation and outcomes will encourage all parties to move away from a short-term focus on least costs. Finally, there is a need to define the role of customer engagement in regulatory review processes, and to assess the use of incentives in the framework.

2.2 The content and structure of this submission

In this submission, we outline our views on why this review needs support for collective change among all stakeholders and how this can be achieved through the structure and processes underpinning the review. We also discuss the principles of best practice regulation and how these are central to a review of the effectiveness of a regulatory regime. We outline how these can be applied to IPART's framework in order to achieve improvements in its key focus areas.

The rest of the report is structured as follows:

- Section 3: Effective management of this review
- Section 4: Best practice regulation
- Section 5: Lifting the performance of the sector
- Section 6: Promoting a customer focus across the water sector
- Section 7: Encouraging innovation
- Section 8: Specific responses to IPART's questions.



3 Effective management of this review

We appreciate the opportunity to comment on the proposed review process and timeline. In our view, greater clarity is needed around the objectives and outcomes used for this review. Further, all stakeholders need to actively support the collective change needed to improve the water sector. In the sections below, we outline why and how this should occur. We also discuss our view that detailed technical issues such as the WACC should be explored in a subsequent review.

3.1 Greater clarity is needed about the objectives of this review

In its Position Paper, IPART states that the changes needed in this review are to make the people of NSW better off, now and in the future.¹² IPART identified four outcomes from this review:¹³

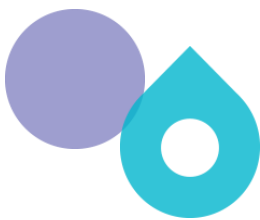

1. The businesses understand and embed customer preferences in their decisions and operate with customer interests at heart.
2. The businesses undertake better long-term planning to build a water supply system that is resilient and adaptable to climate change, in line with NSW Government objectives and changing community expectations.
3. The businesses deliver safe and reliable services to customers, meet the community's environmental objectives and expectations to protect the health of our waterways, and optimally invest in water conservation, recycling and wastewater management.
4. The businesses innovate and strive to provide the best value to customers – ie, the services customers want at affordable prices.

While these outcomes may be laudable, the linkage between the overall objective and the outcomes are not clear. The Position Paper is not clear whether this review represents a chance to make fundamental changes or if the review is instead focused on merely incremental change. There is no information provided about how these outcomes will be measured nor is there reference to how the IPART regime compares now to best regulatory practice. It is also noticeable that none of the proposed outcomes appear to recognise that delivering these benefits may involve some change in the behaviour and style of IPART as the regulator.

We view the regulatory framework as encompassing all institutional actors: the regulator, regulated businesses, private utilities, government departments and customers. Applying a best regulatory practice lens to the regulatory framework involves examining the behaviour of all actors and trying to create a framework which gets closer to best practice and which in so doing, lifts sector performance.

¹² IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, p 6.

¹³ IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, p 6.



In section 4 of this submission, we discuss best regulatory practice. It would be preferable if a best regulatory practice lens were to be applied to the regulatory framework including IPART to consider:

- if the regulatory framework is meeting the standards of best regulatory practice, and
- if not, what changes could be implemented to ensure that these standards are met.

A stakeholder reference group could assist IPART in developing a strategic approach to this review, based on best regulatory practice. It would also ensure the support of key stakeholders for change. We discuss the stakeholder reference group below.

3.2 Successful reform must strategically engage stakeholders

IPART is undertaking this review to improve the regulatory landscape for water, both now and in the future. Such an ambitious agenda will require support from all stakeholders. Regulated businesses, private utilities, government, customers, WICA licensees and developers are all jointly responsible for ensuring that the water sector operates in the long-term interests of customers. If we are seeking to lift our performance and deliver better outcomes, we need to change the culture of how we work together on policy and regulatory issues and not just the regulatory framework itself.

Consistent with this spirit, we consider that IPART should establish a stakeholder reference group for this review. Stakeholder reference groups have precedents in other processes including price reviews. For instance, CEPA noted in its report to IPART the value of including other stakeholders in the price review process.¹⁴ CEPA commented that increasing the involvement and exposure of other stakeholders ensures their views are included and promotes stakeholder buy in and ownership of the decisions reached. It also improves the transparency of the price review process. In our view, increasing the involvement of stakeholders in this review process will result in similar benefits.

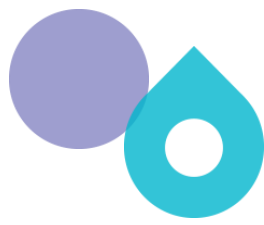

Membership of the stakeholder reference group should be offered to:

- customer groups
- government
- regulated businesses
- private utilities
- business customers, including developers.

In IPART's submission to the NSW Productivity Commission, IPART stated that shareholders of SOCs should be active in driving the performance of the water utilities.¹⁵ IPART also recommended improvements to strategic water planning as well as clarifying roles and

¹⁴ CEPA 2020, *Economic regulation of water utilities - research*, p 5.

¹⁵ IPART 2019, *Submission to the NSW Productivity Commissioner - Kickstarting the Productivity Conversation*, p 2.



responsibilities in this area.¹⁶ We agree. NSW Treasury and the Department of Planning, Industry and Environment should therefore be invited to join this stakeholder reference group.

The stakeholder reference group would:

- provide input into the strategic direction of the review
- provide input into the structure, content and suggested participants for the workshops and the public hearing
- assist IPART in synthesising the discussion from the workshops and public hearing
- provide feedback on the content and scope of the discussion papers
- assist IPART in testing its draft decisions and recommendations including by discussing the practical outcomes of IPART's proposed approach.

The first meeting of the stakeholder reference group could be in November. This would provide sufficient time for the stakeholder reference group to engage meaningfully in the review process.

3.3 Changes to the timetable will enable all stakeholders to respond

Specific changes to the review timetable will ensure all interested participants are able to respond. We suggest the following changes or additions to IPART's proposed process:

- Advance notice of the purpose, timing (date and time), format and content of, and invitees to, the workshops is provided on IPART's website. It would also be useful to know what members of the Secretariat and/or Tribunal will be attending.
- Workshops are not held in late December or January to ensure attendance given that many people will be on leave during the Australian summer. This is particularly important if these workshops are aimed at the general public (which is unclear at present) but remains a consideration for all parties.
- Advance notice of the schedule of publications, and the timeframe in which to respond, is provided. Because many consumer groups are already navigating the complex issues presented by the COVID-19 crisis, providing 6 weeks in which to respond will provide them with more time to consider their response.

3.4 We support deferring the discussion of technical WACC issues

Any review of the regulatory framework should cover the *whole* framework at a conceptual and design level, including the treatment of the cost of capital.

There is merit in a subsequent and standalone WACC review that considers the technical issues associated with the WACC methodology, as this could be a distraction to the broader review of the regulatory framework. Deferring this technical discussion until the completion of the current review is sensible.

¹⁶ IPART 2019, *Submission to the NSW Productivity Commissioner - Kickstarting the Productivity Conversation*, p 2.



4 Best practice regulation

Approaches to best practice regulation can vary across sector and jurisdiction. We have reviewed the approaches of the Organisation for Economic Cooperation and Development (OECD),¹⁷ the UK Better Regulation Executive,¹⁸ the Council of Australian Government's guide to best practice regulation,¹⁹ as well as the Water Services Association of Australia (WSAA)²⁰ and leading academics such as Professor Martin Cave.²¹

4.1 Our analysis indicates where NSW could better align with best practice regulation

In its submission to the Productivity Commission's Inquiry into National Water Reform, WSAA assessed economic regulation across Australian jurisdictions against key criteria that represent areas of regulatory best practice. We have used this analysis as the basis for our own assessment shown in Table 4-1, with some modifications. These are:

- We have assessed NSW as not having the long-term interests of customers as its key objective. This is because IPART does not have a clear legislative focus on the long-term interests of customers. We discuss this in more detail in section 6.1.
- We have assessed NSW as partially meeting the 'assessment of financial viability to protect the long-term interests of customers.' This is because of the incomplete framework for holistically assessing financial resilience,²² as well as the perceived focus on the least-cost over the short-term, as outlined in the Executive Summary.
- We have added 'transparency of process and decisions' as an additional factor, given the importance of this concept in leading academic literature and among other regulators including the OECD.

In addition to these modifications, we consider the concept of 'merits review being part of the framework' could be broadened to accountability more generally, which (like transparency) is an important concept in regulatory theory and practice.

¹⁷ OECD 2014, *The Governance of Regulators*, OECD Best Practice Principles for Regulatory Policy, OECD Publishing.

¹⁸ In 2005, the UK Better Regulation Executive issued five principles of good regulation. These are: proportionality; accountability; consistency; transparency; and targeting. See M Cave, *Better regulation and certain tobacco control measures*, 24 November 2010, p 12.

¹⁹ Council of Australian Governments 2007, *Best practice regulation: A guide for ministerial councils and national standard setting bodies*.

²⁰ Frontier Economics, *Improving economic regulation of urban water: a report prepared for the Water Services Association of Australia*, August 2014; Water Services Association of Australia submission to Productivity Commission Inquiry into National Water Reform; and Frontier Economics and ARUP, *Urban water regulation reform*.

²¹ M Cave, *Regulatory success*, plenary paper presented at ACCC Conference, Brisbane, 27 July 2017.

²² For example, there is no assessment of return on equity in IPART's financeability and performance analysis.

Table 4-1 Sydney Water assessment of economic regulation

	NSW	VIC	QLD*	WA	SA	TAS	NT	ACT
The regulator has deterministic power to set prices or revenue	●	●	●	●	●	●	●	●
Regulator's key objective is the long-term interests of consumers	●	●	●	●	●	●	●	●
Establishing incentives for productivity and innovation	●	●	●	●	●	●	●	●
Assessment of financial viability to protect the long term interests of customers	●	●	●	●	●	●	●	●
Strong and transparent customer engagement within the regulatory framework	●	●	●	●	●	●	●	●
Merits review part of the regulatory framework	●	●	●	●	●	●	●	●
Transparency of process and decisions	●	●	●	●	●	●	●	●

* Bulk water utilities in Qld regulated

Yes ● No ● Partially ● Not regulated ●

Source: WSAA, WSAA submission to Productivity Commission Inquiry into National Water Reform, p 38; Frontier Economics and ARUP, Urban water regulation reform, Appendix B; Sydney Water analysis.

Our analysis indicates areas where NSW could improve its approach to economic regulation in water include:

- focusing on the long-term interests of consumers including in its assessment of financial viability
- establishing incentives for productivity and innovation
- a strong and transparent customer engagement framework
- accountability for its decisions through a merits review process
- transparency of its process and decisions.

Table 4-2 shows how we have applied the best practice principles noted in Table 4-1 to IPART's key focus areas. It lists our key recommendations and actions to ensure that this review adopts best practice principles in both its process and its proposed changes to the regulatory framework. In some areas, IPART's key focus areas overlap. For instance, lifting the performance of the sector should also promote a customer focus and increase innovation. As such, some of our recommendations address multiple focus areas. However, we have tried to identify the focus area that best fits the outcomes we are seeking to achieve through our recommendations.

Table 4-2 IPART focus areas, Sydney Water recommendations & best practice principles

Submission section	IPART's focus area	Sydney Water recommendations	Best practice principle
3	All areas	<p>To most effectively manage this review IPART should:</p> <ul style="list-style-type: none"> clarify its objectives establish a stakeholder reference group adjust its timetable to assist all stakeholders to engage delay technical discussion of the WACC methodology. 	<ul style="list-style-type: none"> Transparency and accountability
5	Lifting the performance of the sector	<p>To lift the performance of the sector IPART should:</p> <ul style="list-style-type: none"> consider the use of a performance framework to better align customer and shareholder interests explore the benefits of a revenue cap promote collaboration and coordination among regulators and policy makers. 	<ul style="list-style-type: none"> Establishing incentives for productivity and innovation Transparency and accountability Focus on the long-term interests of customers
6	Promoting a customer focus	<p>To promote a customer focus IPART should:</p> <ul style="list-style-type: none"> have the long-term interests of customers as its central objective promote accountability for regulatory decisions through a review or appeals process clarify the role of customer engagement in regulatory and business processes. 	<ul style="list-style-type: none"> Strong and transparent customer engagement framework Focus on the long-term interests of customers Transparency and accountability
7	Encouraging innovation	<p>To encourage innovation IPART should:</p> <ul style="list-style-type: none"> consider the use of funding or other incentives for regulated businesses encourage innovation among regulators. 	<ul style="list-style-type: none"> Establishing incentives for productivity and innovation



5 Lifting the performance of the sector

We support IPART's focus on lifting the performance of the sector. In this section, we outline our views about how the framework can better reward businesses for delivering outcomes in the long-term interests of customers. We also discuss the benefits of revenue caps, and our support for a regulators working group to promote collaboration and coordination between key stakeholders.

5.1 We need an explicit focus on the balance of risk and reward between shareholders and customers

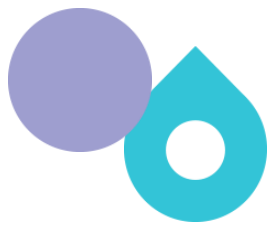

The current regulatory regime does not provide a coherent framework for balancing risk and reward between shareholders and customers. There is also a much weaker link between financial returns and performance for customers than can be seen in all the major comparator markets that have undergone regulatory reform: Victoria, England and Wales and Scotland.

IPART regulates Sydney Water using ex-ante price caps, where, for each four-year period, our revenues are determined through IPART's expectation of efficient costs at the start of the period. The company has a modest incentive to reduce costs during the cycle, an incentive that IPART reinforced on request from Sydney Water through the introduction of the efficiency carryover mechanism in 2016.

However, for a capital-intensive business based on long-lived assets, the incentive to reduce costs is short-term and arguably not well-suited to the real challenges of making regulated businesses more efficient in the medium-term. In particular, short-term savings may be at the expense of long-term performance. This may not be apparent in the short-term because there are weak incentives to deliver outputs to customers, beyond meeting minimum compliance, safety and environmental standards.

Partly to compensate for the weak incentives, there is a reliance on a periodic expenditure audit, performed by external consultants. This is inherently not an attractive regulatory process. It relies on experts trying to accumulate a large amount of knowledge about company processes, business cases and performance so that those experts feel well-placed enough to recommend an alternative expenditure plan to that proposed by the company. This is a very traditional review process that seeks to provide a basis for the regulator to second-guess the company's expenditure plan. The best regulatory regimes today do not feature this same audit-style emphasis. Instead, they seek to encourage the company to reveal its efficient costs through the incentives built into the review process.

In some respects, the current IPART approach has more in common with "cost of service" regulation. If it qualifies as incentive regulation, it is certainly of the low-powered variety. As a result, there is a very weak alignment between shareholder return and company performance. The company's outturn return on equity is not tracked as a relevant metric, and the company's



performance for customers is only indirectly related, if at all, to shareholder return. This relationship does not generally form part of the strategic conversation between water utility boards and IPART at the time of a price determination.

To encourage the utilities to become more outcomes focused, IPART and the companies it regulates need to implement a framework that encourages stronger shareholder and customer alignment. This is the whole basis of the SOC model, which is that if the SOCs are successful businesses, they will at the same time be providing a good service to customers.

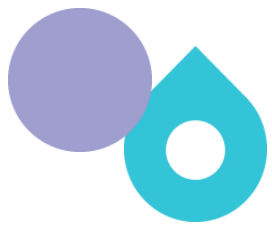

The framework therefore needs to provide a stronger basis for companies to lift their performance, by doing what customers want at a price for which they are prepared to pay. This means encouraging the companies to engage better with their customers to define those outcomes (above and beyond compliance requirements) and offering incentives and rewards to encourage companies to provide higher levels of those outcomes that customers want, where customers value the additional output. Outcome delivery incentives are common internationally and are a well-documented method of incentivising higher performance.

It is implicit in this approach that IPART must take more of an interest not just in the return on equity that it sets for the company in its final determination (based on its cost of capital methodology), but in how that return is related to the *actual* return on equity that the company achieves. Company management is ultimately interested in the latter, not the former. In adjusting the risks and incentives placed on the company, IPART can seek to make improvements in outturn return of equity conditional on improvements in performance for customers. In this way, equity returns can be used as a lever to promote efficiency, innovation and customer focus. This is how incentive regulation works. There are examples of its success in the UK and Australia.

In setting these incentives, the framework needs to have regard to the capacity of the companies to bear more risk. Exposing companies to more risk is a corollary of creating performance incentives. However, the higher the risk borne by the company, the greater the likelihood this will impact on the company's cost of capital. Therefore, the regulator must have regard to the total amount of risk placed on the company and calibrate the potential equity return accordingly.

In particular, to the extent the company faces risk it cannot control, it will have less capacity and probably less interest in taking on additional risk. When profitability is subject to fluctuations outside the company's control, these affect the company's ability to plan its financial future with confidence. In Sydney Water's case, we currently bear the risk of revenue volatility (arising from our price cap) and inflation risk, neither of which we are able to control. These uncontrollable risks are likely to make it more difficult to encourage management to take on more performance risk, which could further affect financial performance, if that financial performance is already inherently uncertain.

For the risk and incentives to be valuable and potentially value enhancing for both shareholder and customer, care should be taken to seek to expose the company to those risks over which it has some control and where customers value that risk being effectively managed. Customer service standards is an obvious example. Assuming customers value ever improved levels of service performance, it may be worth incentivising the company to seek to attain in a linear manner ever higher levels of performance. If the company's costs in achieving this outcome, including its incentive payment, are less than the value of the superior performance to customers, then both



shareholder and customer are better off. No such incentive framework, based on delivery of outcomes, currently exists for NSW regulated water businesses.

A focus on the likely range of return on equity (that is, within a cap and collar, with a fixed upside and downside around the central performance expectation) can provide assurance to customers and shareholders, as well as IPART. In other words, there could be upper and lower limits implemented on any over and under-performance framework, consistent with the range of return on equity contemplated. A particular challenge faced by regulators in other jurisdictions that have introduced risk and reward frameworks linked to performance has been managing the risk of mis-estimated targets and mis-calibrated incentive mechanisms. IPART is likely to face similar issues. A collared approach to the return on equity mitigates the risks of regulatory error distorting financial outcomes. In this way it can provide comfort to regulators, as well as regulated companies, and encourage necessary experimentation and innovation in the regulatory framework.

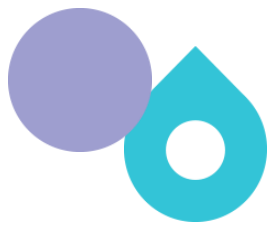

If a risk and reward framework linked to performance is adopted for the price review, consideration of the role of Operating Licence standards will be needed: in particular, are the Operating Licence standards meant to act as minimum, 'safety net' standards to protect consumers or to reflect an optimal level of service? Operating licences are generally based on minimum standards set by the regulator to reflect minimum expectations for society. By comparison, customer preferences based on willingness to pay are typically used by the regulated business to consider trade-offs in meeting or over-performing against levels of service agreed as part of its price proposal or business plan.

Historically, Sydney Water had viewed its Operating Licence performance standards as minimum standards, designed to protect the community from poor performance by their monopoly supplier. In the last Operating Licence review, IPART indicated a preference to set standards at the 'optimal' level of service. Accordingly, Sydney Water engaged with customers to understand their preferences and willingness to pay for changes to levels of service relating to these standards, which informed the setting of standards in the 2019-2023 licence. However, embedding consumer preferences in licence requirements can reduce the opportunity to create positive incentive mechanisms for performance. If some levels of service are already set in the Operating Licence, this could also potentially inhibit the range of service packages that could be offered to customers during the development of a price proposal.

5.2 We support exploring the benefits of a revenue cap

We support exploring the benefits of a revenue cap in this review, given the benefits of reducing financing costs. Regulated companies with costs similar to Sydney Water (largely sunk, fixed costs) generally have revenue caps for this reason.

One of the primary objectives of regulation is to align revenues with efficient costs over time. Under a price cap, when outturn demand varies from the forecasts used in price controls the business will experience a windfall gain or loss. While the Demand Volatility Adjustment Mechanism (DVAM) seeks to mitigate this impact, it is a blunt instrument. Given the 5% materiality band, Sydney Water is only able to recover its expected costs if demand falls materially below forecast, over the price



cycle.²³ Even if DVAM does apply, the company has to wait until the end of the cycle. This causes uncertainty, increases financing costs and is increasingly problematic as regulators set an ever-lower cost of equity.

Moreover, there is no offsetting benefit from attaching this volume risk to the utility. Sydney Water does not control the demand for water. Indeed, to the extent any single party has an influence over it, it is most affected by political decisions on water restrictions which are a matter for government.

Some risks that increase financing costs may be worth placing on the utility. This can be the case if by so doing the company is incentivised to take action to mitigate the risk, such that its private costs of that action are less than the benefits to customers. However, this is not one of those situations.

In addition, there may be wider political economy benefits from the separation of utility revenue recovery from issues connected to how to efficiently price water to customers. The utility is likely to be better placed to consider the customer and efficiency aspects of its pricing strategy, if that strategy has no bearing on the extent to which it fully recovers its revenue requirement over the regulatory cycle.

We agree with IPART that, if adopted, a revenue cap approach should still be subject to pricing principles, principally the National Water Initiative Pricing Principles. We welcome discussions with IPART and other stakeholders about the appropriate pricing principles to be used. It is important that any pricing approach have a coherent and transparent methodology and address impacts on associated prices for other services.

5.3 Better coordination is needed among regulators

We support including better coordination among regulators as an issue to consider in this review. Currently there is a disconnect between regulators that leaves regulated businesses vulnerable to conflicting or misaligned requirements. This can hamper our ability to deliver outcomes that are valued by customers.

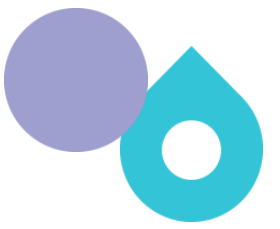

In addition, it is sometimes uncertain how IPART may assess expenditure relating to activities that are responding to or contributing to the delivery of Government policy objectives. For example, it is not clear how IPART will give effect to the NSW Government's policy to achieve net zero emissions by 2050. Specifically, it is uncertain whether IPART will view this as a requirement that utilities must meet or if this approach would be considered as discretionary expenditure.

Greater communication and collaboration between regulators, regulated businesses and, where relevant, Government agencies is needed to ensure that:

- regulatory and policy requirements are understood by all parties and
- the best approach to meet the long-term interests of customers is implemented.²⁴

²³ We note that any DVAM true-up does not include recovery of costs associated with demand that is less than forecast but does not fall below the DVAM materiality threshold.

²⁴ This could be viewed as that approach selected through a cost-benefit analysis or some other methodology.



A regulators working group is one approach to improve coordination of the requirements and impacts that regulators and government stakeholders impose on regulated businesses and their customers. To be effective, such a group should adopt best practice regulatory principles to guide its activities (as discussed in section 4). For example, a regulators working group should:

- have terms of reference, including an objective to promote the long-term interests of customers in its decisions
- be transparent in its processes and methodology and accountable to its key stakeholders. For instance, the minutes and decisions of this group should be made public, as should the methodology applied in establishing new regulatory standards and the evaluation of the impact of such standards on regulatory businesses and their customers
- periodically review its effectiveness in achieving the objectives set out in its Terms of Reference.



6 Promoting a customer focus across the water sector

We welcome IPART's focus on customers. The long-term interests of customers are central to the work that we do at Sydney Water. Similarly, these interests should be at the heart of the regulatory framework. In the sections below, we discuss changes to the regulatory framework that would promote a customer focus across the water sector and reflect best practice in regulation. We also note how other regimes have sought to reward businesses for good customer engagement, and the need for developing clear guidelines and transparent standards for customer engagement.

6.1 IPART should have a clear objective to promote the long-term interests of customers

As noted in section 4 above, a best practice regulatory framework has the long-term interests of customers as its central objective. This is reflected in the objectives of regulators including the Essential Services Commission of South Australia (ESCOSA), the ESC, the Productivity Commission,²⁵ the AEMC, the AER and Ofgem, often, though not always, in legislation. In its report to IPART, CEPA provides commentary around the objectives of many of these regulators.²⁶

In its Position Paper, IPART states that it considers whether a business's pricing proposal establishes outcomes that are in the long-term interests of customers.²⁷ However, IPART does not have an explicit focus on the long-term interests of customers in either its legislation, guidance or policy documents or its website. According to IPART's website, IPART's role is to "make the people of NSW better off through independent decisions and advice". Section 15 of the IPART Act states the factors that IPART must consider when setting prices (although IPART may also consider any other matters that it deems relevant). However, IPART has not issued guidance on how it considers each of these factors, both in isolation and together, nor how they jointly contribute to 'making the people of NSW better off'. In 2010, a former IPART member, Sybille Krieger, asserted that weighing up and balancing different and conflicting policy objectives and the competing interests of stakeholders is what economic regulators do.²⁸ But this approach is not consistent with best practice, as WSAA noted in its 2014 report entitled 'Improving economic regulation of urban water'.²⁹

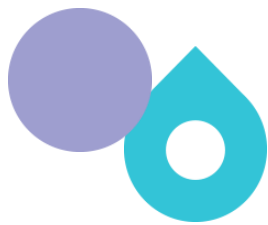

²⁵ In its report on National Water Reform, the Productivity Commission stated that the objective of regulation should be to promote the long-term interests of consumers. Productivity Commission 2017, *National Water Report, Inquiry Report*, Canberra, p 18.

²⁶ See, for example, CEPA 2020, *Economic regulation of water utilities - research*, pp 46, 68, 98, 103, 118 and 129.

²⁷ IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, p 27.

²⁸ S Krieger, 'Should the Law Have a Greater Role in Economic Regulation of Infrastructure Services?', paper presented at IPART Conference - *Encouraging Efficiency and Competition in the Provision of Infrastructure Services*, Sydney, 7 May 2010.

²⁹ Frontier Economics, *Improving economic regulation of urban water: a report prepared for the Water Services Association of Australia*, August 2014, p 42.



An explicit focus on the long-term interests of customers would improve the transparency and accountability of IPART's decision-making. This could be achieved through legislative change to the IPART Act to create an explicit duty for IPART. Alternatively, IPART could issue a guidance note on how it applies and reconciles trade-offs between the multiple factors listed in Section 15. Such a guidance note could interpret the key objective underlying consideration of these multiple factors as being one of promoting the long-term interests of customers. This would provide confidence to customers, government and regulated businesses about how IPART makes decisions and what the underlying objective is.

6.2 A review mechanism will help promote accountability and align with best practice

Regulators must be held accountable for their decision-making if the long-term interests of customers are to remain at the heart of any regulatory framework. As Frontier Economics noted in its report produced for WSAA:

An effective review or appeals process helps prevent abuse of discretionary authority and preserves the integrity of the regulatory system by making the regulator accountable for their decisions. Accountability is important because it makes regulators responsive to the public, heightens the sense of legitimacy, and reduces regulatory risks as the regulator is in most cases constrained from taking decisions that will undermine the financial viability of the business (Taylor & Ballance, 2000).³⁰

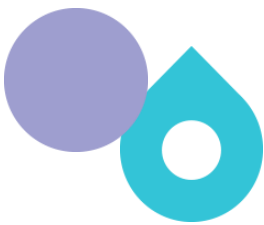

Administrative law recognises that the review of government decisions is a key component of access to justice. Mechanisms to review decisions include by:

- judicial review – to determine whether a decision is lawful
- merits review – to determine whether a decision is reasonable or contained an error of fact
- investigations – for example, by another agency
- internal agency practices – including alternative dispute resolution or codes of conduct that establish a process if a grievance is raised.

IPART decisions are subject to judicial review but not to merits review. In theory, merits review provides the most effective measure to increase the accountability of regulatory decision-makers. In the Australian energy sector, limited merits review of the AER's decisions was abolished given concerns that the process increased costs to all participants as well as contributed to regulatory and price uncertainty. However, some consumer groups argued that the limited merits review provisions in the energy sector were designed to benefit, and be more inclusive, of consumers and their removal was premature.³¹ Other jurisdictions such as Ofwat, Ofgem and the ESC have retained merits review.

³⁰ Frontier Economics, *Improving economic regulation of urban water: a report prepared for the Water Services Association of Australia*, August 2014, pp 34-35.

³¹ J Mansour and B Greenwood, "'Inconvenient Guests'? The Consumer Experience of Administrative Review for Electricity Pricing," *Australian Journal of Competition and Consumer Law*, 26.3, 2018, pp 61-173.



Other options may improve the accountability of regulators without the costs or formality of the court process. For example, the AER established an independent panel to review its Rate of Return Guideline in 2018. This panel's role was to review the draft guideline and report on whether it was supported by sound reasoning based on the available information such that it was capable of promoting achievement of the national gas and electricity objectives.³² Another option to explore is the inclusion of specially-created consumer panels, through which IPART could voluntarily agree to extend powers in price review processes to constrain IPART's ability to make final decisions (in certain circumstances). These mechanisms may provide greater flexibility as well as avoid the costs of an appeal within a formal legal system.

We recognise that the Government, rather than IPART, is responsible for developing and implementing policy around merits review. Nonetheless, IPART can send a powerful signal about its commitment to best practice by supporting the reform of review rights or considering alternative mechanisms. Concerns about potential abuse of a review or appeal mechanism can be mitigated by careful design of the mechanism.³³

6.3 Customer engagement must continue to improve and evolve

As CEPA noted in its report to IPART, most regulators require regulated businesses to undertake customer engagement.³⁴ Involving customers more in the regulatory process has been a recurring feature of regulatory reform over the past two decades. Consumer engagement can take many forms. Numerous mechanisms have been tried to incentivise and test how the price proposal of a regulated business meets customer expectations and preferences.

Empowering and engaging with customers is central to our work as a regulated business. Research by WSAA in 2018 demonstrated future customers of water utilities want to be “at the centre, meaning an industry shift from asset to [a] people-centric mindset is needed”.³⁵ In line with this mindset shift, we have tried to better understand what our customers want and expect from us. We developed our Customer Promises to:

- keep services reliable and affordable (every day)
- be proactive and easy to deal with (every time)
- involve you and plan for our future (every one).

A key part of the third promise is to involve customers in decisions that will impact their community.³⁶

We welcome discussions on ways to further empower consumers within business planning and / or regulatory processes. These discussions should include a focus on issues such as:

³² See AER 2018, *New process - Rate of Return Guideline: Independent Panel*.

³³ There are many ways in which this can be done. For example, appellants could be restricted to the review of an entire decision (rather than simply unfavourable aspects of that decision) or could have costs obligations imposed on them through the appeal process.

³⁴ CEPA 2020, *Economic regulation of water utilities - research*, p 5.

³⁵ WSAA 2018, *The Customer of the Future*. Refer to www.wsaa.asn.au

³⁶ Sydney Water 2016, *Sydney Water Customer Toolkit*, December.

- Who should set the scope of the engagement program?
- Who would conduct and lead the engagement process?
- What are the benefits of complying with the process?
- How can we ensure representativeness of the customer base?
- How can customer preferences be used to inform decisions, or should customer panels be given some decision-making authority?
- What is the role of customer engagement in relation to discretionary and non-discretionary services? Are they different?
- What form should customer engagement take eg, survey-based research and/or more deliberative forms of engagement, such as citizen juries?³⁷ Should this be stipulated by the regulatory framework or left open?

In our view, businesses are best placed to engage with customers as they are customer-facing and have experience in this area. Overly prescriptive requirements could limit engagement with customers on areas that are most important to them. On the other hand, greater clarity around the expected role of customer engagement in regulatory processes will benefit everyone, including the regulator, customer groups and regulated businesses. It will also minimise potential duplication.

A greater emphasis on customer views has typically involved clear guidelines being established before the price review on how the regulator will treat outcomes of engagement processes. Without this clarity, company incentives to engage can be undermined for fear of second-guessing by the regulator later in the process. For example, it is not clear what minimum evidentiary standards IPART requires for customer engagement.³⁸ These standards do exist in other disciplines.³⁹

Uncertainty also exists around IPART's views on what would constitute sufficient customer support (that is, threshold levels of acceptance). It is not clear if this would differ between engagement on discretionary expenditure vs mandatory expenditure (for example, to determine preferences relating to levels of service, billing or preferred methods of communication) compared to issues that are non-expenditure related (for example, restrictions regimes, pricing structures, etc).

³⁷ In December 2016, Infrastructure Victoria tabled Victoria's first ever state-wide, cross-sector infrastructure strategy for the next 30 years in Parliament. Citizens' juries played a major role in forming recommendations contained in this strategy.

³⁸ Sydney Water is committed to benchmarking our customer engagement processes against best practice criteria. For instance, we refer to the principles of inclusivity, responsiveness and materiality under AA1000 AccountAbility Principles Standard (2008) and measure our performance against the IAP2 model and the AASES100 standard for Stakeholder Participation.

³⁹ For example, the Victorian Government publishes guidelines on non-market valuation customer willingness to pay methodologies (refer to www.djpr.vic.gov.au) that are considerably more detailed than IPART's best practice principles contained in IPART 2020, *Final Report - Review of Prices for Sydney Water*, pp 342-344.



7 Encouraging innovation

Innovation is a broad term and can reflect the introduction of new techniques, solution design or technology and business design.

In its Position Paper, IPART's discussion around innovation is mainly at the level of the regulated business.⁴⁰ Innovation, however, can also be considered in terms of regulatory theory and practice, which influences the design and operation of the regulatory agency and the framework within which it operates. IPART recognises this implicitly when discussing the key challenges facing the water sector and IPART's desire to build on the learning and experiences of other regulators to meet these challenges.⁴¹

In this section, we discuss how the regulatory framework can provide incentives for innovation at the level of the regulated business, as well as the opportunities for IPART and other regulators to innovate.

7.1 Dedicated innovation funding provides greater incentives for innovation

IPART acknowledges that the appetite for innovation among regulated businesses is influenced by the regulatory framework.⁴² We agree. An incentive-based regulation framework must reward innovation if it is to encourage that to occur. This is particularly the case for regulated businesses where the usual rewards available to businesses in competitive markets such as increased market share or higher profits are unlikely to occur.

Sydney Water has a long-standing research and innovation program. Some of the highlights from our 2019-20 program included:

- More than 170 projects in progress across the business
- National AWA Research Innovation Award for a program on intelligent robotics for sewer condition assessment
- 6.2/10 Innovation Effectiveness Index Score 2019
- Approximately \$3.6 leveraged for every \$1 invested into research and innovation.

While we do undertake research and innovation activities, more could be done if the regulatory framework were to provide explicit incentives or dedicated funding to do so. Sydney Water invests a low percentage of revenues to research and development relative to other utilities in Australia and internationally. This is influenced by the current regulatory framework, and the expenditure review process, with its focus on efficiency and least cost. The expenditure review process may disallow or deem inefficient any innovation that appears costly (and is of uncertain future benefit).

⁴⁰ IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, pp 7 and 21.

⁴¹ IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, p 5.

⁴² IPART 2020, *Regulating Water Businesses Special Review - Position Paper*, p 23.

Not all desirable innovative initiatives will satisfy expenditure efficiency tests because their outcomes are generally uncertain and efficiency benefits are likely to emerge a long time in the future (in some cases, if at all).

Research and innovation activities by their very nature are speculative. Some will fail and those that do succeed may lead to improved environmental or societal outcomes, rather than lower costs, which may be difficult or impossible for the utility to capture in its business cases. Benefits can also be hard to quantify at the time of the investment because research can often take many years before these benefits can be realised.

Without explicit funding for research and innovation, these activities risk being deferred to accommodate urgent or unexpected activities, particularly when the expenditure review results in a lower opex allowance than the business had planned.

Other regulators have introduced funding mechanisms to provide greater incentives for innovation. In its report to IPART, CEPA discusses the explicit funding provided by Ofgem and Ofwat via competitions, where regulators and an independent panel assess whether the project is innovative.⁴³ In the table below, we identify approaches of other regulators to provide incentives for innovation.

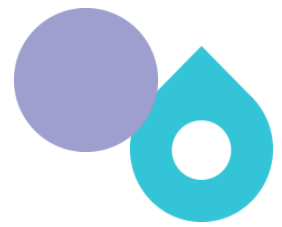
In some cases, innovation mechanisms have resulted in solutions with unexpected benefits many times higher than the cost of the initial investment. For instance, Ofgem funded the CLASS project put forward by Electricity North West to better manage its network by actively managing the frequency of electricity at its substations. In practice, having piloted the service, Electricity North West identified that the service had application to the ancillary services market in electricity and could result in cost reductions for consumers of hundreds of millions of pounds. Innovation carries with it the risk of failure and for every CLASS project, Ofgem will have funded several studies, pilots or investigations which ultimately did not lead to consumer benefits.

The rationale for funding innovation schemes is inherently forward-looking to get utilities to have an ongoing program of exploration and investigation for adopting better practices to meet customer preferences and deliver better services in the long run.

Table 7-1 Innovation funding and incentives for regulated businesses

Incentive category	Best practices	Status in IPART's current framework	Gap to best practice
Funding incentives	<ul style="list-style-type: none"> • AER strategic innovation funding • Ofgem/Ofwat network innovation competitions • Ofgem network innovation allowance • Ofgem Low carbon networks fund • NZCC innovation incentive mechanism 	Limited funding for R&I activities, put forward as part of price proposal	Large relative to other regimes

⁴³ CEPA 2020, *Economic regulation of water utilities - research*, p 49.



Various regulatory reforms could stimulate innovation across the water sector. For example, IPART could introduce an innovation allowance based on a percentage of the regulated business' revenue. Alongside or instead of an innovation allowance, IPART could introduce an innovation competition for incumbents and new entrants to compete to win funding by submitting proposals. IPART could evaluate proposals based on criteria such as the novelty of the proposed investment, the potential of the project to deliver new outputs for customers, and scope for the project to provide learnings applicable to all companies.

7.2 A regulators working group could encourage regulatory innovation

The OECD's 2020 Global Conference on Governance Innovation recognised the need for well-adapted and innovative regulatory policy and governance approaches to support the fourth industrial revolution.⁴⁴ We agree. Innovation is needed not simply at the level of the regulated business. It is also important to compare regulatory practices across jurisdictions if regulators are to remain agile and to respond to changes in the society in which they operate.

In our view, the regulators working group could provide a forum within which leading regulatory practices are discussed, with a view to adoption of best-practice approaches. In its report to IPART, CEPA discusses the 'regulatory sand-box' approach to regulators encouraging innovation.⁴⁵ This is as much an innovation in regulatory practice as it is an initiative to increase the incentives for regulated businesses to innovate.

Sydney Water is collaborating with the EPA in the Hawkesbury-Nepean to understand the role of nutrients in the Hawkesbury-Nepean River. This will lead to improved trading ratios for offset proposals with the EPA, making this a cost-effective option to tackle waterway quality degradation and improve river health. Discussing such initiatives in a regulators working group would encourage continuous improvement and innovation in regulatory practice.

⁴⁴ OECD 2020, *Summary Record*, Global Conference on Governance Innovation.

⁴⁵ CEPA 2020, *Economic regulation of water utilities - research*, p 9.





8 Specific responses to IPART's questions

1. Are the focus areas we have identified the most important? Are there other important issues we should focus on?

We broadly agree with the three focus areas IPART has identified although we recognise that some of the issues overlap. We elaborate on issues that could be explored under each focus area in sections 5, 6 and 7.

2. What mechanisms can we put in place to ensure the water businesses are accountable for the prices, services and outcomes they deliver to their customers and the community?

See sections 5.1 and 6.3.

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

See section 5.3.

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

See section 7.

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

In our view, IPART's recently introduced discretionary expenditure framework does not incentivise businesses to explore service outcomes above mandatory levels. We discuss how a risk and reward framework could better incentivise businesses in section 5.1.

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?

As noted in the Executive Summary, the current expenditure review is a very traditional process that seeks to provide a basis for the regulator to second-guess the company's expenditure plan. This can be challenging for the regulator, due to the inherent information asymmetry between the parties. It also tends to overly emphasise a focus on costs, rather than outcomes. There is scope to change the framework to encourage the company to reveal its efficient costs through the incentives built into the review process.

With respect to benchmarking, we note the difficulties in NSW due to the lack of comparators. This is one of the reasons why a performance-based framework is a more appropriate mechanism to lift performance in our sector. We discuss this in section 5.1.

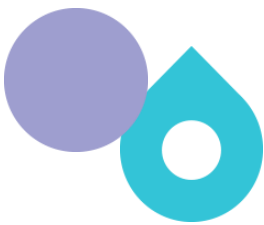

7. What changes to our approach would enhance efficient new entry and competition in the supply of water and wastewater services?

We support competition in the supply of water and wastewater services. Sydney Water relies on competitive tendering processes for the construction and/or ongoing management of its services, for example through BOOT contracts.

In our view, encouraging innovation would provide further opportunities for new entrants. We discuss this in section 7.

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

See section 6.3.



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

See section 6.3.

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

See section 6.3.

11. When should we conduct our next WACC review? What are your views on the scope of the review and when should the outcomes of a new WACC method apply to future pricing reviews?

See section 3.4.

12. Do you have any comments on our proposed review process and timeline?

See section 2.

