Submission to the Independent Pricing and Regulatory Tribunal

Response to the 29 September 2020 Position Paper on the *Special Review on Water Pricing and Licensing – Regulating Water Businesses*

30 October 2020

This page is intentionally blank.

Contents

1. Introduction

WaterNSW is pleased to submit this response to the Independent Pricing and Regulatory Tribunal's ("**IPART**") 29 September *2020 Position Paper on the Special Review on Water Pricing and Licensing – Regulating Water Businesses* ("**Position Paper**").

The Position Paper highlights that about every four years, IPART sets the maximum prices that Sydney Water, Hunter Water, the Central Coast Council and Essential Water can charge their customers. IPART also regulates the bulk water charges that WaterNSW and the Sydney Desalination Plant can charge to their customers, and the Water Administration Ministerial Corporation's ("**WAMC**") charges for water planning, management and regulation services.

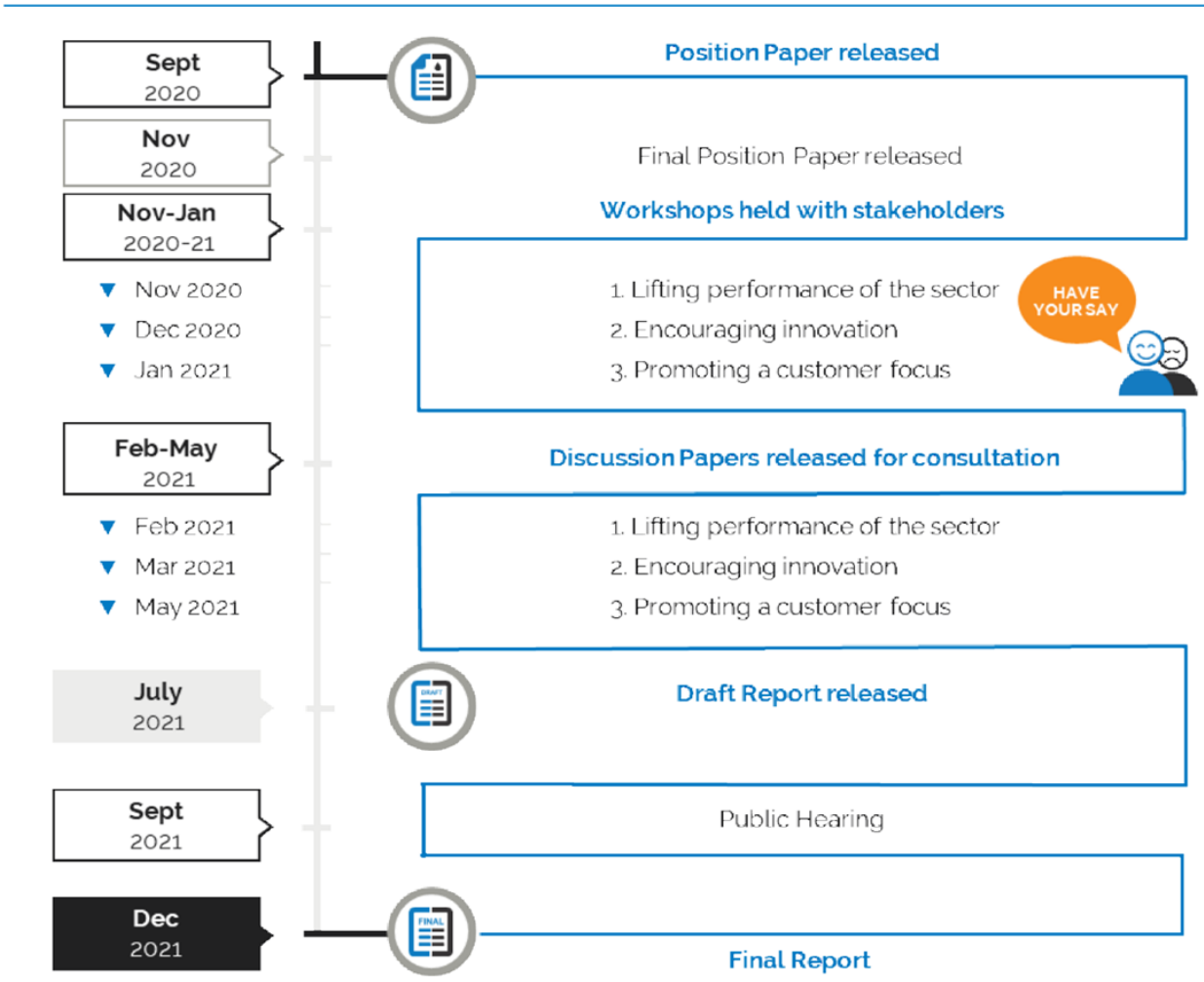
Every four to five years, IPART also recommends the terms and conditions of the operating licences for WaterNSW, Sydney Water, Hunter Water, and SDP to the Minister for Water. IPART regulates the performance of these businesses by monitoring their compliance against their operating licences each year.

Water utilities are monopoly suppliers of essential services to millions of NSW households. IPART's regulatory framework aims to ensure the water businesses' services meet the needs of their customers and the community.

IPART's stated intent of this review is to identify improvements in how IPART regulates the NSW 'monopoly' water businesses, to make the people of NSW better off. IPART is seeking feedback on the scope and timing of this review by 30 October 2020.

The timeline for the review is provided below:

Figure 1 – IPART's indicative timeline for the framework review[1]



This submission is WaterNSW's response to the initial Position Paper that seeks feedback on the scope and timing of the *Special Review on Water Pricing and Licensing – Regulating Water Businesses* ("**review**".

1.1 Background – Who we are

WaterNSW was formed on 1 January 2015 under the *Water NSW Act 2014*, effecting a merger of the Sydney Catchment Authority ("**SCA**") and State Water Corporation ("**SWC**"), creating a centre of excellence for raw water supply and the development and delivery of raw water infrastructure solutions for all of NSW. WaterNSW is Australia's largest water supplier and is the major supplier of raw water in NSW, delivering raw water from 42 large dams, pipelines and the State's rivers.

WaterNSW ensures that the water supplied is reliable and, where that water is to be used by end-use customers for drinking, that it is safe. We develop water infrastructure solutions to improve water security and proactively manage reliability issues and then plan, develop, operate and maintain that infrastructure.

[1] See IPART's 29 September 2020 *Position Paper on the Special Review on Water Pricing and Licensing – Regulating Water Businesses*. Page 40.

WaterNSW also promotes improvements in achievable water quality standards and contributes to the protection of public health and the environment through enhanced catchment protection practices in declared drinking water catchments.

In the Greater Sydney area, our role is to protect 16,000 square kilometres of drinking water catchments, and manage dams, pipelines and other infrastructure that are used to supply customers with quality raw water. WaterNSW supplies raw water to urban water utilities for treatment and then consumption by Sydney, Illawarra, Blue Mountains, Southern Highlands and Shoalhaven communities. Our customers include Sydney Water, Wingecarribee Shire Council, Shoalhaven City Council and Goulburn-Mulwaree Council. WaterNSW also provides raw and unfiltered water supply to over sixty other smaller customers.

In rural NSW, WaterNSW maintains, manages and operates major infrastructure to deliver bulk water to licensed water users on the State's regulated rivers. There are approximately 6,300 customers in 14 regulated river systems. WaterNSW owns and operates 20 dams and more than 280 weirs and regulators to deliver water for town water supplies, industry, irrigation, stock and domestic use, riparian and environmental flows. We plan, investigate and develop water infrastructure solutions to water security and reliability issues and then operate and maintain that infrastructure.

1.2 Legislative framework and pricing determinations

WaterNSW's pricing is subject to the following legislation:

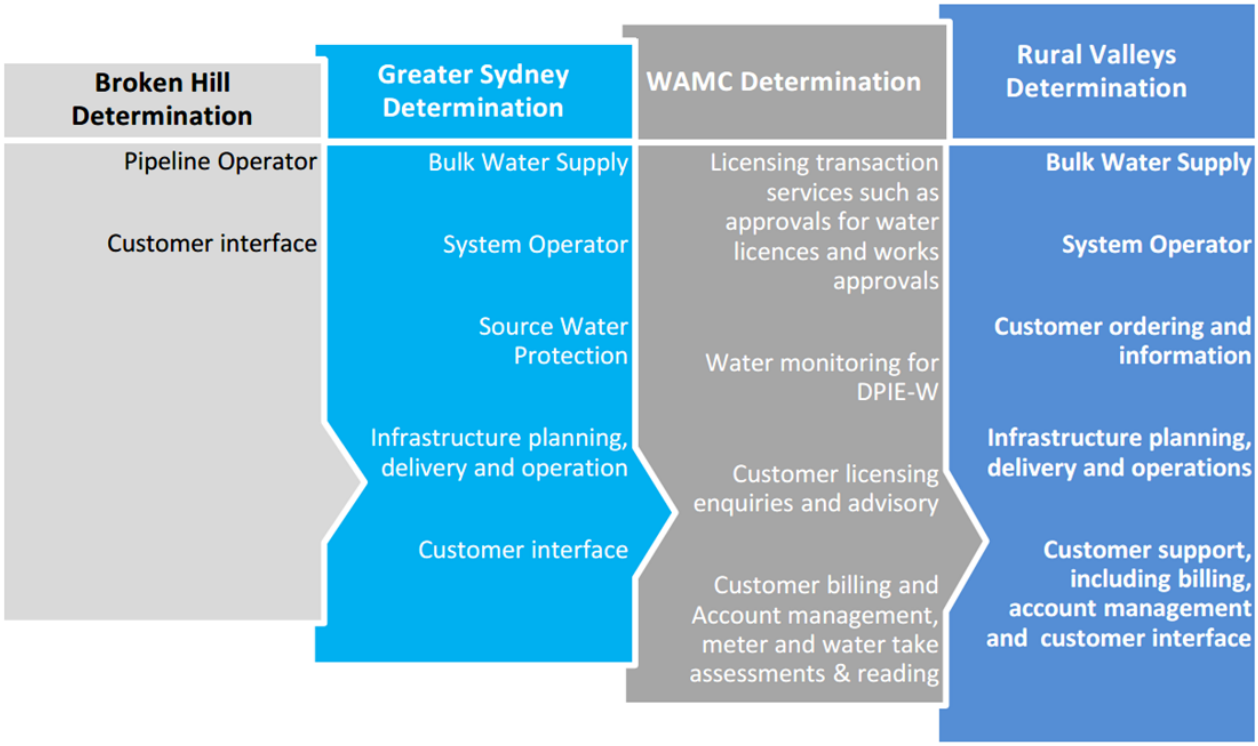
- New South Wales price regulation for monopoly services under the *Independent Pricing and Regulatory Tribunal Act 1992* (NSW); and
- Commonwealth price regulation in the Murray Darling Basin ("**MDB**") under the:
  - *Water Act 2007* (Commonwealth);
  - *Water Charge Rules 2010* (WCR) made under section 92 of the *Water Act 2007*; and
  - Australian Competition and Consumer Commission *Pricing principles for price approvals and determinations under the WCIR* of July 2011 ("**ACCC Pricing Principles**").

The prices for WaterNSW's bulk water and licensing services are guided by four IPART determinations. These determinations are set out below:

- **Greater Sydney** - services we supply to Sydney Water, some councils and raw and unfiltered water customers in the Greater Sydney area are subject to the IPART Determination *Maximum prices for Water NSW's Greater Sydney Services from 1 July 2020,* which applies until 30 June 2024;
- **Rural Valleys** - services we supply to irrigators, regional councils, mines, energy companies and environmental water holders in rural areas are subject to the IPART Determination *WaterNSW, Prices for rural bulk water services from 1 July 2017,* which applies until 30 June 2021;
- **Water Administration Ministerial Corporation** ("**WAMC**") - services we supply under our conferred WAMC functions are subject to the IPART Determination *Water Administration Ministerial Corporation, Maximum prices for Water Management services from 1 July 2016*. We share this revenue with the Department of Planning, Industry, and Environment, Water ("**DPIE-W**") and, from 1 May 2018, also with the Natural Resources Access Regulator "**NRAR**") as all three entities share responsibility for the delivery of WAMC functions. The current determination applies until 30 June 2021; and
- **Murray River to Broken Hill Pipeline** (the "**Broken Hill Pipeline**") - services we supply to Essential Water and a small number of landholders near Broken Hill for the Broken Hill

Pipeline are subject to the maximum prices under the IPART Determination *WaterNSW Prices for water transportation services provided by the Murray River to Broken Hill Pipeline from 1 July 2019,* which applies from 1 July 2019 to 30 June 2022.

Figure 2 – IPART Determinations applicable to WaterNSW



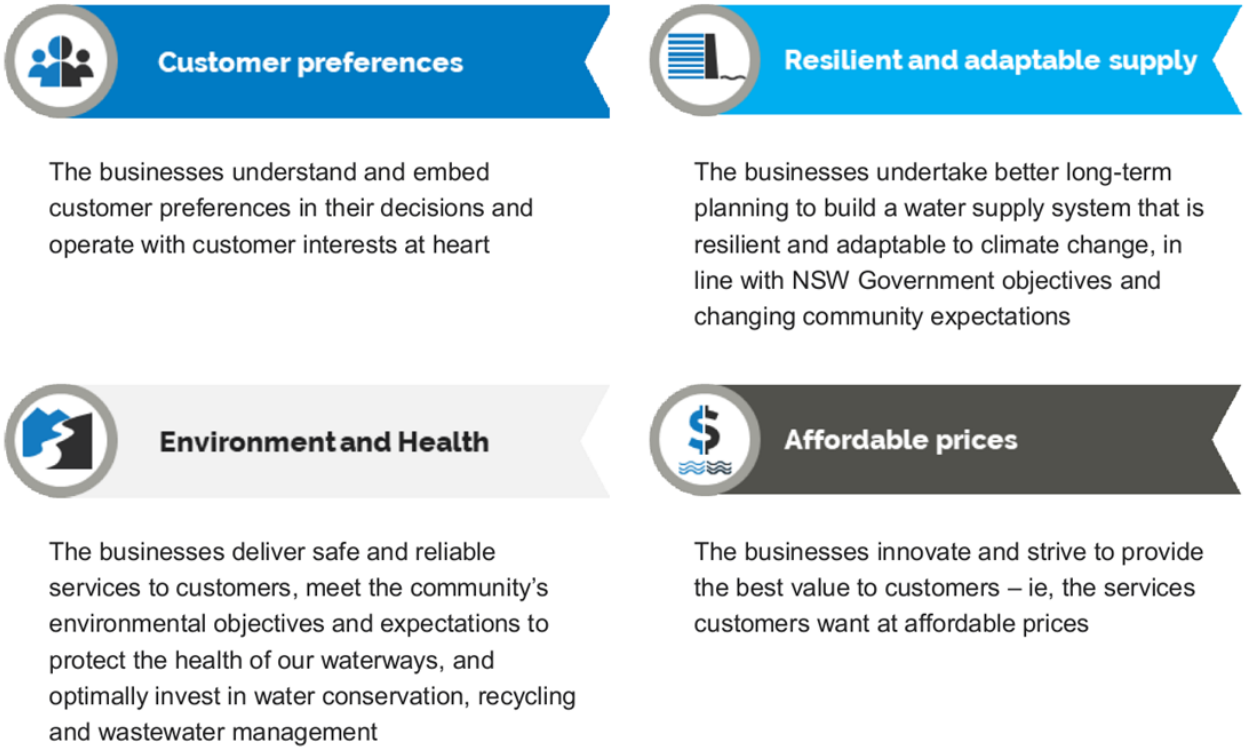
These decisions and determinations set out the maximum prices and methodologies for calculating the maximum prices WaterNSW can charge its customers for the services described in the relevant decisions and determinations. WaterNSW has implemented the outcomes of the decisions and determinations by charging customers the prices as set out in or as calculated by the decisions and determinations.

The NSW Government continues to provide financial assistance of up to $4,000 to all general security licence holders in NSW and to customers of Irrigation Corporations for the water year, in line with the maximum revenue targets set out in the decisions and determinations.

WaterNSW's budget and financial targets are set to ensure the outcomes in the decisions and determinations are met. Key outcomes outlined by IPART in the position paper

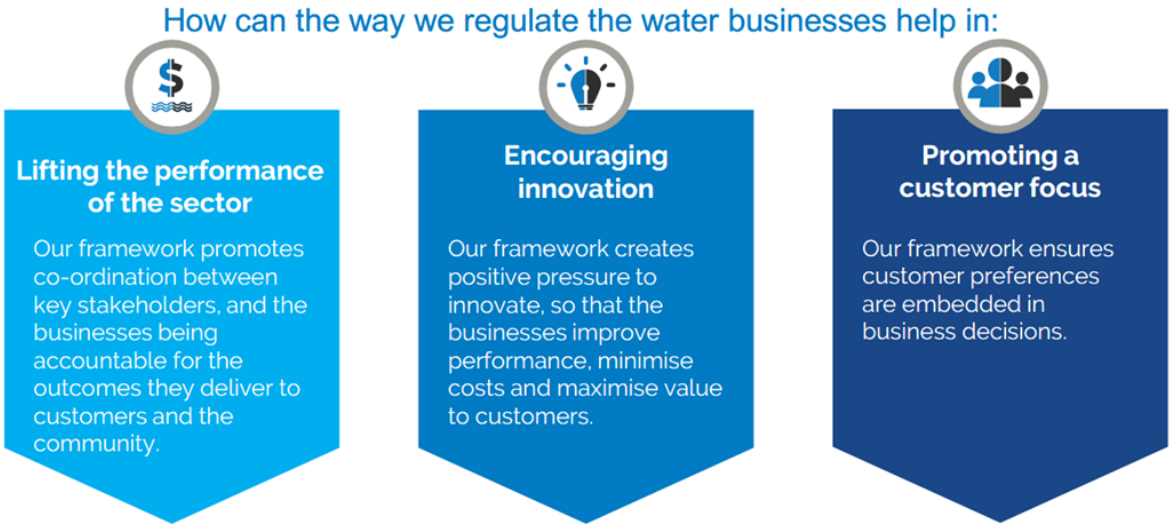
In its review, IPART is seeking the overarching outcomes that benefit the community as outlined in Figure 3 below:

Figure 3 – IPART's overarching outcomes that benefit the community[2]



IPART's proposed focus areas for the review are reproduced in Figure 4 below.

Figure 4 – IPART's proposed focus areas for the review[3]



[2] See IPART's 29 September 2020 *Position Paper on the Special Review on Water Pricing and Licensing – Regulating Water Businesses*. Page 6.
[3] Ibid. Page 7.

1.3 Key themes proposed by WaterNSW for the review

WaterNSW believes that IPART's regulatory framework as set out in the IPART Act 1992 ("**IPART Act**") and as implemented by IPART through its reviews and determinations, has generally performed well in balancing the needs of stakeholders. It is clear, however, that the regulatory framework as set out in the IPART Act has not been holistically reviewed since its introduction almost 30 years ago and ensuring that the regulatory framework remains fit for purpose is critical in continuing to deliver value for money for customers.

We are encouraged by the opportunity of this review and suggest that it should not be viewed as a 'once off' exercise; rather, a review of elements of the framework should be undertaken every four to five years to ensure it operates efficiently and effectively in delivering regulated services at a fair price for customers.

While the framework has generally performed well, it is clear that the regulatory landscape has changed significantly since 1992. For example:

- Incentive regulation has become more entrenched internationally and within Australia over the past decade, with more reliance on **'higher power' incentives** (the "carrot") and less reliance on heavy-handed regulatory interventions (the "stick") to drive desired behaviours. Implicit in the development of incentive regimes is that there is an inextricable link and clarity between increased performance and increased returns in driving efficiencies.
- While businesses have traditionally operated to deliver a host of technical service standards set out in various regulatory instruments, which were assumed to be what customers wanted, the **active participation of customers** in regulatory processes to identify what they actually want, and at what cost, is a key feature of all modern regulatory frameworks. While 'how' to best identify and embed customer preferences into the regulatory framework is still a work in progress, there is no debate on 'if' additional customer focus is required.
- A better understanding of **vulnerable customers** and issues of **affordability** have influenced the behaviour of utilities in setting tariffs and tariff structures.
- There is less reliance on 'set and forget' regulatory processes that were not designed to adequately respond to risk and uncertainty *within* a regulatory period. Most regulatory frameworks include some cost risk mitigation measures, such as contingent projects, reopeners and cost pass through mechanisms to ensure a fair sharing of risk between the business and its customers, while **building resilience** into the regulatory framework to address unforeseen events.
- Greater awareness in the community of **environmental issues** and the expectation that utilities will reduce their carbon footprint and plan their networks to minimise the impacts of **climate change**.
- **Increased customer expectations** that businesses will innovate, including through the use of technology, to increase performance and customer experience.

In considering the above factors, WaterNSW's response to the Position Paper puts forward the following themes:

- **Overarching objective** - The regulatory framework should incorporate an overarching primary objective to operate in the long term interests of customers. *(Focus area: lifting the performance of the sector)*
- **Accountability and risk -** WaterNSW is committed to taking accountability for outcomes, but needs additional regulatory tools to manage uncertainty and ensure a fair sharing of risk. *(Focus area: lifting the performance of the sector)*

- **Incentives -** The regulatory framework should provide businesses with incentives to increase performance for the outcomes that matter most to customers. Increased performance should lead to increased returns in order to drive further efficiencies. There should also be clarity on what good performance looks like and what are the key measures of performance. *(Focus area: promoting innovation)*
- **Customer focus -** A modern regulatory framework should lead to the identification and embedding of what customers value. Businesses should drive the engagement process, while IPART should outline what constitutes effective engagement and be obliged to accept the outcomes from any such process. *(Focus area: promoting a customer focus)*
- **Efficient investment -** The framework needs to ensure commercial returns to shareholders (e.g. ROE) are sufficient to ensure that the businesses remain financially viable and are able to attract capital to the sector. *(Focus areas: lifting the performance of the sector and promoting a customer focus)*
- **Cost of regulation -** The framework should aim to minimise the costs of regulation while targeting the long term interests of customers. The cost of complying with regulatory obligations should be assessed to ensure value for money for customers. *(Focus areas: all three focus areas)*

These themes are discussed in our response.

1.4 Consistency with other regulatory frameworks

The economic framework must be set consistent with, and supportive to, other regulatory frameworks that water utilities are subject to. This includes aligning the role of price or other forms of regulation to provide investment signals to the market. At the moment there are mixed signals.

For example, several measures in the regulatory framework (e.g. Sydney Water's Economic Level of Water Conservation (ELWC) or Economic Level Leakage (ELL)) are market-based mechanisms to respond to tightening supply. However, to be effective, these measures require a price signal. It is clear that the current economic framework does not provide an efficient price signal as despite the Millennium Drought and the recent 2017- 2020 drought, household water bills have reduced in real terms over the past decade.

Conversely, other components of the regulatory framework rely on non-market measures, namely water restrictions and drought management plans to manage demand and supply. That is, infrastructure investment decisions are made with reference to storage levels (with price being a 'lag' rather than a 'lead' indicator).

As such, while IPART has sought to address the price signal deficiencies by introducing a scarcity (i.e. dynamic) price, this may actually reduce water conservation efforts during drought if it creates confusion amongst consumers about the role of non-market measures.

Further, where prices are not cost reflective, scarcity pricing will not be effective as water restrictions given the required tariff increase to drive demand reduction equivalent to Level 2 or 3 restrictions.

Separately, while well-intended, scarcity pricing may have unintended consequences as it embeds the framework of responding to drought, rather than building resilience. This is in conflict with the policy direction of government.

The above highlights the need for the economic framework to be set consistent with the wider regulatory framework within which WaterNSW operates to be effective. With reference to Greater Sydney, IPART's economic framework and, in particular consideration of an incentive framework,

must be considered having regard to the policy settings for the urban water sector that will be set in the Greater Sydney Water Strategy.

These themes and issues are also relevant for the non-urban water sector, whilst also acknowledging there is a significant difference in the regulatory framework. This cannot be ignored, however, if the performance of the sector as a whole is to be improved.

2. Overarching objective

WaterNSW considers that an overarching objective that focuses on the long-term interests of customers is a key component of the regulatory framework that provides guidance to a regulator in exercising its discretion when balancing often competing objectives.

The IPART Act (Section 15) lists twelve matters that the Tribunal is to have regard to in making determinations and recommendations under the Act. These are:

a. The cost of providing the services concerned;
b. The protection of consumers from abuses of monopoly power in terms of prices, pricing policies and standard of services;
c. The appropriate rate of return on public sector assets, including appropriate payment of dividends to the Government for the benefit of the people of New South Wales;
d. The effect on general price inflation over the medium term;
e. The need for greater efficiency in the supply of services so as to reduce costs for the benefit of consumers and taxpayers;
f. The need to maintain ecologically sustainable development (within the meaning of section 6 of the Protection of the Environment Administration Act 1991) by appropriate pricing policies that take account of all the feasible options available to protect the environment;
g. The impact on pricing policies of borrowing, capital and dividend requirements of the government agency concerned and, in particular, the impact of any need to renew or increase relevant assets;
h. The impact on pricing policies of any arrangements that the government agency concerned has entered into for the exercise of its functions by some other person or body;
i. The need to promote competition in the supply of the services concerned;
j. Considerations of demand management (including levels of demand) and least cost planning;
k. The social impact of the determinations and recommendations,
l. Standards of quality, reliability and safety of the services concerned (whether those standards are specified by legislation, agreement or otherwise).

In the absence of an overarching objective, there would appear to be unfettered discretion that could be applied by IPART in making a determination in order to have regard to each of the above matters. In order to provide certainty to businesses (to attract efficient investment to the water sector) and customers (to better understand the long term pricing arrangements), WaterNSW recommends that an overarching objective is introduced. This would provide guidance to IPART on how to interpret and have regard to the individual matters in Section 15 of the IPART Act for the economic regulation of the water sector.

Fundamentally, WaterNSW considers that the overarching objective should be focussed on the *long term interests of customers* and should be efficiency-based. Drawing on the overarching

National Electricity Objective ("**NEO**"), the following objective of economic regulation in the NSW water sector could be articulated as follows:

> *To promote efficient investment in, and the efficient operation and use of, water and wastewater services for the long term interests of customers with respect to price, quality, safety and reliability and security of supply of water.*[4]

As noted by the AEMC in its Guide on Applying the Energy Market Objectives, a number of sectors and jurisdictions have similar objectives on promoting the long term interests of consumers that guide regulators or rule making bodies:

> *For example, the objective of Part XIC (Telecommunications Access Regime) of the Competition and Consumer Act 2010 is to 'promote the long-term interests of end-users of carriage services or of services provided by means of carriage services'. Other examples include the principle objectives that both Ofgem (Great Britain electricity) and the Northern Ireland Utility Regulator (Northern Ireland electricity) operate under that, again, refer to "the interests of consumers". In water, the Essential Services Commission of South Australia's primary objective is "the protection of the long-term interests of South Australia consumers with respect to the price, quality and reliability of essential services."* [5]

The NEO refers to 'consumers' rather than 'customers' as consumers in the context of the energy market objectives are consumers in general, or all consumers, rather than a particular type or group. The AEMC notes the following with regard to this matter:

> *The energy objectives have been constructed in this way because it is not considered appropriate for an institution with delegated powers like the Commission to make decisions that involve trading off the interests of one consumer group against another. This is a matter for Governments since it is their function to make these trade-offs, as well as having more tools available to them to help manage the outcomes associated with this.*[6]

2.1 Why is 'long term' interests of customers important

The use of the phrase 'long term' is important in setting an overarching objective. The long term does not refer to a particular timeframe; rather, it refers to when the capital or fixed components used in the provision of water services can be changed. Depending on the nature of the investment, the time period can be relatively short (e.g. a few years for IT equipment) or relatively long (e.g. many decades for dams, weirs and pipelines). The concept of 'long term' recognises that there is an implicit trade-off between customers today and consumers in the future.

As noted by the AEMC:

> *Changes that may be in consumers' short term interests may not be in their long-term interests* if those changes undermine incentives to make efficient investments and operational decisions *over time.* ***For instance, making changes specifically to provide customers with short-term price decreases at the expense of enabling investors to recover a return on efficient investment will not be in the long-term interests of consumers if it results in generation retirement and power cuts that are more costly than the short term price savings****.*[7] *(emphasis added)*

Applying an overarching efficiency objective based on the long term interests of customers would provide transparency of decision making and incentivise businesses to:

[4] See National Electricity Law section 7 as reproduced on https://www.aemc.gov.au/regulation/regulation

[5] See AEMC Applying the Energy Market Objectives, 8 July 2019. Page 4.

[6] Ibid. Page 4.

[7] Ibid. Page 5.

- Provide safe, reliable and secure water services consistent with customers' expectations;
- Invest in long-lived water services and deliver them efficiently; and
- Set prices in a way that signals efficient use.

3. Lifting performance of the sector

IPART indicates in its Position Paper that the regulated business should be responsible, and held accountable, for delivering outcomes to their customers and the community, consistent with their licence conditions, regulatory requirements and the preferences of their customers.

WaterNSW agrees and strongly supports this review objective. However, for a water utility to be fully accountable for the outcomes envisioned in a regulatory determination requires sufficient regulatory tools to address the risks that may arise during a determination period.

IPART correctly notes that risks should be shared between the business and its customers, but finding the correct balance is a challenge and that the risk should be assigned to the party best able to manage it, and benefit to the business from reduced risk should be shared with its customers.

The IPART Position Paper outlines that over time, IPART has introduced mechanisms to manage the cost and revenue risks that the water utilities face, and price structures that assign volume risk between the business and customers (the proportions of revenue collected through fixed and usage charges). This includes, for example, end of period true-ups and cost pass throughs in some circumstances. These mechanisms also increase the overall complexity of the regulatory framework.

WaterNSW is of the view that the current regulatory framework includes a number of mechanisms to address volume risk, but has introduced relatively few mechanisms to address cost uncertainty, both within and between regulatory periods, placing a disproportionately high level of risk on WaterNSW.

3.1 Managing volume risk

IPART has turned its attention to managing volume risk in regulatory determinations, through the use of tariff structures, demand volatility adjustment mechanisms, risk transfer products and the introduction of dynamic water usage prices. The use of the 20-year rolling average of water sales for setting variable charges by IPART (in our Rural Valleys and WAMC determinations) should be revisited due to the effect it has in driving up prices after periods of drought, when volumes decrease and it is unlikely to provide an effective approach to setting efficient prices.

WaterNSW considers that at least some of these mechanisms and issues noted above could also be addressed through the form of price control, for instance the option of proposing a revenue cap.

We note IPART's views on a revenue cap were identified in Box 2.2 of the Position Paper, which drew the following conclusion:

> *The advantages of a revenue cap include a strong incentive to reduce costs and to use demand side management to reduce costs. However, we would have to think through some potential challenges as well. For instance, that average prices would be adjusted each year,*

> *which creates the risk of price volatility for customers. This could be addressed by introducing side-constraints.*[8]

While WaterNSW is interested in exploring the merits of a revenue cap as part of the review, we caution against the introduction of pricing side constraints that can act as the *de facto* form of regulation if set too tightly. Restrictive side constraints could unreasonably constrain a business's ability to recover its efficient costs unless there is an explicit mechanism to address any revenue shortfalls within and or between regulatory periods. There are other mechanisms, such as revenue smoothing within the regulatory period, may minimise the need for side constraints.

We note that side constraints were previously applied by IPART in its regulation of the NSW electricity distribution network service providers (DNSPs), as noted below.

> *The Tribunal proposes that the side constraints on network prices be applied only to residential tariffs including rural residential tariffs. Increases in the bill of any individual residential customer for the same pattern and volume of electricity consumption may not exceed the bill for the corresponding period of the preceding year by more than the greater of CPI or $20. Increases to the residential class as a whole must not exceed the CPI.* [9]

The DNSPs at the time were concerned that a side constraint of the greater of CPI or $20 for a residential customer and CPI for the residential class as a whole was overly restrictive and would not allow prices to be adjusted to recover the efficient costs of the business if the cost of providing regulated services was increasing. Similarly, restrictive side constraints in future could effectively become the form of control in cases were the efficient costs of providing regulated services are increasing, as the side constraints may not allow a reasonable opportunity for the approved revenues to be recovered through regulated charges.

IPART and the AER previously applied side constraints that applied in changes to individual tariffs within the 'weighted average price cap' rather than applying to average price movements. Side constraints currently apply to 'locational' transmission charges in the National Electricity Market.[10]

3.2 Managing cost uncertainty

WaterNSW has been a strong advocate of the need for the introduction of additional regulatory 'tools' to help manage cost uncertainty of major capital projects, which was set out in detail in our original Pricing Proposal[11] and Issues Paper response as part of IPART's Greater Sydney 2020 Determination for WaterNSW. The key risk facing WaterNSW and its customers at the time of the Greater Sydney was the potential for one or more major drought-related projects to be introduced within the 2020 Determination period.

The financial risk imposed on WaterNSW if one or more of major projects was significant if the costs are not recovered through IPART's determination (and or via Government funding).

---

[8] See IPART's 29 September 2020 *Position Paper on the Special Review on Water Pricing and Licensing – Regulating Water Businesses*. Page 18.

[9] See IPART Pricing for Electricity Networks and Retail Supply Report Volume I, June 1999. Page xviii.

[10] Clause 6A.23.4(b)(2) of the National Electricity Rules states that locational transmission (TUOS) prices in the forthcoming year must not change by more than 2 per cent relative to the price set for the previous year. Non locational prices are to be based on 'postage stamp' prices.

[11] See WaterNSW Pricing Proposal for Greater Sydney Bulk water pricing, 1 July 2019. https://www.ipart.nsw.gov.au/files/sharedassets/website/shared-files/pricing-reviews-water-services-metro-water-review-of-prices-for-waternsw-greater-sydney-from-1-july-2020/legislative-requirements-review-of-prices-for-waternsw-greater-sydney-from-1-july-2020/waternsw-pricing-proposal-for-regulated-prices-for-greater-sydney-2020-to-2024.pdf

Uncertainty around these significant expenditure programs required that WaterNSW consider risk mitigation strategies to address the financial and revenue uncertainty.

It was clear in our assessment of how other jurisdictions addressed cost uncertainty associated with large capital projects required that additional mechanisms needed to be introduced into the IPART regulatory framework to address cost uncertainty, particularly *within* a regulatory period.

WaterNSW considers that IPART should assess the merits of a 'contingent projects' mechanism and other similar mechanisms for inclusion in the regulatory framework to address the cost and timing risk associated with unforeseen major capital projects. Currently **contingent projects** and capital expenditure **reopeners** are included in the National Electricity Rules ("**NER**") for electricity networks for managing the risk of large, uncertain capital projects. We consider that similar mechanisms should be considered for inclusion into the regulation of water utilities in NSW:

- The **contingent project mechanism** allows the regulator to exclude from the forecast expenditure established in the review a project which is uncertain, but which has a clearly defined trigger event, but to include it later if it is required; and
- The **capital expenditure reopener mechanism** in the NER allows for the inclusion of additional capital when the network business spends at least 5% more than the opening RAB.

While the concept of a contingent project framework has merit and would appear to be a candidate for addressing the WaterNSW major projects, it does not currently form part of IPART's regulatory framework and was not supported by IPART in the 2020 Greater Sydney Determination.[12] We request that IPART reconsider its approach to addressing the uncertainty associated with large capital projects both *within and across* regulatory periods as part of this review.

The two main approaches for managing investment uncertainty that WaterNSW considers though form part of the review are summarised below:

3.2.1 Managing investment uncertainty through a contingent projects regime

WaterNSW proposes to include a separate mechanism in the 2020 determination that would allow the costs of a major capital project to be assessed within the determination once the need for the project and the costs have been established with more certainty.

If the regulator does not factor forecast expenditure for uncertain projects into the revenue requirement and the expenditure proves necessary, the infrastructure operator will be undercompensated for its provision of water infrastructure services. This may lead to reduced quality of services for customers and underinvestment in the infrastructure operator's infrastructure. This outcome is not in the long term interests of customers. By not incorporating the costs of a major project within the regulatory period, potential price shocks are exacerbated in the subsequent regulatory period due to the step change in the RAB at that time.

Importantly, in many cases, businesses are not in a position to include the costs of contingent projects in their capital expenditure program at the time of preparing their pricing proposals. This is because the uncertainty around if or when these projects will take place and how much these projects will cost would result in prices that that are significantly higher than efficient costs if the costs were included in the determination and the projects did not go ahead.

WaterNSW therefore suggest that it is appropriate to include a separate mechanism in the determination that would allow the costs of a contingent project to be assessed within the

[12] Refer to IPART submission to AEMC's Rule change process – *Economic regulation provisions within the National Electricity Rules*. April 2012. Page 7.

determination period only if or when the need for the project and the associated costs have been established with more certainty *during* the regulatory period.

WaterNSW considers that the existing ability to seek an 'early' determination for unforeseen events, while an important regulatory tool to manage risk, is overly restrictive in the matters it is practically able to address as all elements of the determination are opened up. A contingent projects framework is a practical mechanism to allow the regulator to review the efficient costs of an unforeseen project within the regulatory period and to examine the relevant (rather than all) factors.

The application of a contingent projects regime is a common feature of many well-functioning regulatory frameworks. As outlined in detail in the WaterNSW Greater Sydney Pricing Proposal[13] and as summarised by IPART in the Issues Paper (Section 10.2.3), the NER applies a robust framework for contingent project and 'reopener' provisions for Australian electricity distribution and transmission network service providers.

WaterNSW provides the following analysis of how uncertain projects are addressed in other jurisdictions and industries (primarily water) in Australia and overseas and cites examples of effective contingent projects regimes in place for:

- The Australian Energy Regulator's regulation of energy networks through explicit contingent projects provisions in the NER;
- The Australian Competition and Consumer Commission's regulation of water utilities through contingent projects provisions in the new Water Charge Rules;
- The Essential Services Commission of Victoria's regulation of water utilities through the 'uncertain and unforeseen events mechanism';
- The Essential Services Commission of South Australia's regulation of SA Water through the introduction of the new 'intra-period review mechanism'; and
- The Office of Gas and Electricity Markets' regulation of gas and electricity networks in the United Kingdom.

WaterNSW's analysis highlights that a contingent projects regime is a common feature of many well-functioning regulatory frameworks in Australia and overseas. Based on our analysis, we suggest that IPART consider the merits of a contingent projects (or similar) mechanism with *intra period* adjustments as part of this review to manage the uncertainty of large capital projects where insufficient visibility of the associated timing and or costs exists to reasonably include in prices at the time of a determination.

3.2.2 The role of cost pass through mechanisms

We consider that a well-functioning regulatory framework needs to ensure a reasonable sharing of risks so that a business can recover its efficient costs, meet customer obligations and remain financially viable. An important element of the regulatory framework is the inclusion of regulatory mechanisms that allow for significant unforeseen costs that are triggered by uncertain events to be addressed during the regulatory period. If the underlying costs of service provision are increased by an event (such as new legislation or a new service), firms operating in a competitive market would be expected to include the associated costs into their price service offerings.

WaterNSW considers that any cost pass through mechanism should be symmetric and that any cost reductions arising from cost pass through events should be passed onto customers as soon as possible and not retained until the subsequent regulatory period.

[13] See WaterNSW Pricing Proposal for Greater Sydney Bulk water pricing, 1 July 2019. Section 4.5, page 44.

Under the current regulatory model, IPART sets WaterNSW's prices on a forward-looking basis for a defined period. Prices are set to be sustainable over the regulatory period. However, there will inevitably be uncertainties during the period where it is impractical (if not impossible) to forecast the efficient costs of these uncertainties at the time prices are set.

It is in customers' interests for infrastructure businesses to have the reasonable opportunity to recover the efficient costs they incur as a result of unexpected events. Cost pass through mechanisms can provide an appropriate balance in the allocation of risks between WaterNSW (to recover costs to attract sufficient investment in its network) and customers (to ensure that prices are no more than necessary to provide an appropriate level of service).

As noted in the Position Paper, IPART's regulatory framework does include cost pass throughs, although their use is generally much more limited than in other jurisdictions. While WaterNSW acknowledges the role of cost pass throughs and IPART's concerns over the fair sharing of risks, we note the following with respect to the current pass through arrangements:

- **IPART's criteria** – IPART's states that a cost pass through mechanism should only be applied in situations where (amongst other things) the "*resulting efficient cost associated with the trigger event can be fully assessed including whether there are other factors that fully or partially offset the direct cost of the event*" and includes a footnote stating "*The costs to be passed through must be specified in the price determination"*.[14]

  Unfortunately, for most events, detailed cost information is not available at the time of the price determination, given that an event may not have been foreseen at that time (e.g. the case of a new legislative obligation introduced during the regulatory period). In these cases it is not possible to assess the costs in advance and therefore it is not possible to include the event and its costs in the determination.
- **Adjusting prices within the regulatory period** – IPART's ability to adjust prices for the efficient costs of a new pass through event that occurs within a regulatory period is arguably constrained.
- **Firms in a competitive market** – Firms operating in a competitive market would not be expected to absorb the efficient costs of complying with a new tax or legislative obligation and would seek to include these costs in their price / service offerings. It would therefore be entirely consistent with firms operating in a competitive market to provide costs pass throughs for certain events (including legislative changes) within the determination period.

By providing water utilities with the tools to manage their costs within the regulatory period and the appropriate use of incentives (discussed in the following section), businesses would be provided with greater ability to effectively manage risks and to accept accountability for the determination outcomes during the regulatory period.

4. Incentives

4.1 What is incentive regulation?

At its core, incentive regulation is a form of regulation where the regulator forecasts and locks in the total operating expenditure and capital expenditure a business will require to meet its pre-defined service and reliability targets at the start of each regulatory period. Businesses are then given financial rewards where they improve their efficiency and spend less than the forecast during the regulatory period.

[14] Position Paper, Box 2.1, page 15.

A priori, and put simply, if the business spends less than the forecast, it will still earn revenue to cover the total forecast amount. Hence it can 'keep the difference' between the forecast and its actual expenditure until the end of the regulatory control period. Conversely, if its spending exceeds the forecast, it must fund the difference itself until the end of the period.

Similarly, if such incentives exist, businesses are rewarded where they improve service quality that is valued by customers and are penalised where service quality falls. Consumers benefit from efficiency improvements, that are not at the expense of service quality, through lower regulated prices.

The following sections provide a brief summary of the incentives in the current IPART regulatory framework and compares this with two examples of regulatory frameworks that provide higher powered incentives. While the examples provided below are not exhaustive, they do represent two of the higher profile frameworks within Australia and overseas that are focused on providing businesses incentives against which their performance is measured.

4.2 Incentives in the IPART regulatory framework

WaterNSW notes that IPART's regulatory framework, largely as a function of history, contains relatively 'low powered' incentives relative to other jurisdictions and sectors. While this shouldn't have a negative connotation, it does reflect that many other jurisdictions have moved to a more 'high powered' incentive frameworks, but that these come with a cost in terms of data requirements and generally higher administration costs.

The primary incentives in the IPART regulatory framework are the financial rewards (penalties) where businesses improve (reduce) their efficiency and spend less (more) than the forecast during the regulatory period.

If the business spends less than the forecast, it will still earn revenue to cover the total forecast amount. Hence it can 'keep the difference' between the forecast and its actual expenditure until the end of the regulatory control period. Conversely, if its spending exceeds the forecast, it must fund the difference itself until the end of the period.

In 2016, IPART introduced an Efficiency Carryover Mechanism ("**ECM**") for operating expenditure, which allows a utility to retain permanent efficiency savings for a fixed period regardless of when in the determination period they are achieved. The ECM aims to remove a business's incentive to delay efficiency savings from the end of one determination period to the beginning of the next.

In the 2020 WaterNSW Greater Sydney bulk water determination, IPART indicated that, even though the ECM was available for WaterNSW, Hunter Water and Sydney Water, none of the utilities made a claim under the mechanism for this price review and the IPART is yet to apply the mechanism in practice.[15]

There are no specific incentive mechanisms relating to service performance, reliability or customer service standards. Nor is there a link between the financial performance against allowances and the business performance outcomes.

4.3 Office of the Gas and Electricity Markets in Great Britain

The Office of the Gas and Electricity Markets in Great Britain ("**Ofgem**") is the regulator for electricity and gas networks in Great Britain. Ofgem has implemented a number of incentive

[15] See IPART *Review of Prices for WaterNSW Greater Sydney from 1 July 2020 – Final Report*. Page 71.

mechanisms as part of its revenue setting approach based on “Revenue using Incentives to deliver Innovation and Outputs – 2” (“**RIIO-2**”).

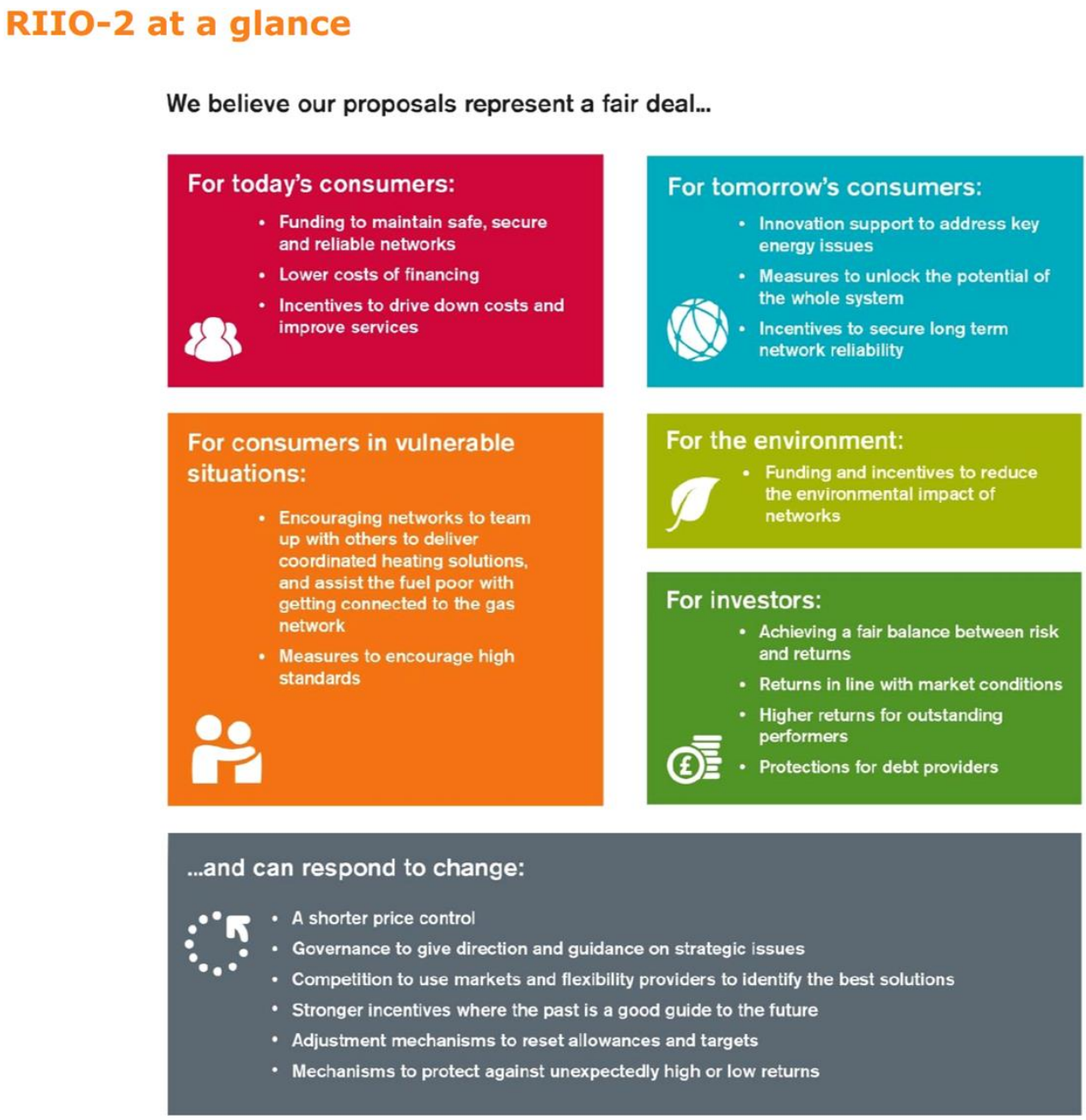
In refining its approach from RIIO-1 to RIIO-2, Ofgem states that:

> *We have learned lessons from how we have set the revenues for network companies in previous price control periods and are looking to achieve a better balance of risk and return in RIIO-2. This will involve a lower cost of financing these businesses alongside measures to flex the controls to respond to a range of future scenarios and to protect investors from risks that they are not well placed to manage. We will apply incentives on companies where appropriate, and facilitate innovation and competition to find new and better ways of achieving this at the most efficient cost.*[16]

Ofgem’s RIIO-2 framework, summarised in the figure below, contains an extensive array of incentives for technical, innovation, environmental performance as well as the financial incentive of higher returns for outstanding performance.

[16] See Ofgem *RIIO-2 Sector Specific Methodology, 18 December 2018*. Page 4.

Figure 5- Ofgem's RIIO-2 framework 'at a glance'



WaterNSW is not proposing that IPART adopt each of the Ofgem's incentives as listed above – noting that the move to such a framework would be a quantum shift in focus and cost (i.e. Ofgem employs 930 people[17] in regulating the sector) and it is not clear that the benefits of its approach outweigh the costs.

In any case, we highlight that some elements of the RIIO-2 framework, including incentives for improved performance and financial incentives for higher performance should be assessed by IPART as part of the review in order to ensure the regulatory framework delivers outcomes that are in the long term interests of customers.

[17] See Ofgem 2019-20 Annual Report. Page 54. Ofgem notes that of the 930 staff, 392 are involved in 'Regulatory' activities, 288 involved in the "E-serve" Assurance Hub and 250 involved in 'Delivery'.

4.4 Australian Energy Regulator

The Australian Energy Regulator ("**AER**") regulates electricity networks and covered gas pipelines in Australia, in all jurisdictions except Western Australia. The AER sets the amount of revenue that network businesses can recover from customers for using these networks.

In 2014, the AER undertook its Better Regulation reforms to enhance incentive-based the approach to regulation in the energy sector. The AER sees incentive-based regulation as a preferable approach to 'cost of service' forms of regulation that simply allow network businesses to recover the costs of providing services. The AER sees cost of service regulation as creating limited incentives for ongoing efficiency improvements and revealing true efficient costs.[18]

The Better Regulation program provided incentives to encourage businesses to make efficient decisions on how to allocate expenditure during the regulatory period. The AER applies four incentive schemes that might apply to an electricity network as part of its decisions:

- Operating expenditure efficiency benefit sharing scheme ("**EBSS**");
- Capital expenditure sharing scheme ("**CESS**");
- Service target performance incentive scheme ("**STPIS**");
- Demand management incentive scheme ("**DMIS**") and demand management; and demand management innovation allowance mechanism ("**DMIAM**").

The AER's expenditure incentive schemes (EBSS and CESS) were designed to encourage a business to pursue efficiency improvements in operating expenditure ("**opex**") and capital expenditure ("**capex**"). These efficiency gains are then shared with consumers. The business stands to receive rewards and penalties for its performance under the schemes. The CESS and EBSS incentives were designed to be balanced and constant to promote efficient spending decisions in terms of the timing, amount and type of expenditure.

The STPIS was designed to incentivise a business to maintain or improve the quality of its services. The AER's expenditure incentives were designed to be balanced with STPIS incentives so a business does not make expenditure savings at the expense of service quality.[19]

The AER also has introduced a framework that supports a business considering non-network alternatives. Non-network alternatives defer or reduce the need for expenditure on building more network capacity. On 13 December 2017, the AER published a new DMIS and DMIAM.

The DMIS contains three elements:[20]

- A cost uplift on expected costs of efficient demand management projects;
- A net benefit constraint, to ensure the incentive payment for any project cannot be higher than that project's expected net benefit; and
- An overall incentive constraint, which limits the total incentive in any year to one per cent of the distributor's allowed revenue for that year.

The DMIAM comprises:

[18] See AER *Overview of the Better Regulation reform package*, April 2014. Page 7.
[19] See AER *Overview of the Better Regulation reform package*, April 2014. Page 9.
[20] See AER, *Demand management incentive scheme, Electricity distribution network service providers*, December 2017.

- A fixed allowance as set out in the relevant post tax revenue model. As an example, the Ausgrid distribution determination for 2019-24 included a fixed allowance of $200,000 ($2016–17) plus 0.075 per cent of the annual revenue requirement for each regulatory year;[21]
- Project eligibility requirements; and
- Compliance reporting requirements.

Together, the incentive mechanisms highlighted above indicate that the AER has transitioned from a relatively low powered incentive framework with limited incentives towards a higher powered framework that includes elements of the Ofgem RIIO-2 approach.

4.5 Summary of incentive frameworks

In summary, IPART's current regulatory framework tends to rely on the core features of incentive regulation (i.e. outperforming the regulatory opex and capex allowances) to deliver efficiencies. With the exception of the ECM, IPART's regulatory framework does not rely on additional incentives to target efficiency and does not have in place specific incentive mechanisms to drive improvements in technical, operational or customer service performance.

WaterNSW notes that a truly high powered incentive framework to target performance requires extensive data and administrative resources to implement, and before any such move is contemplated, it is important to ensure the benefits of any new incentive mechanisms outweigh the associated costs of its implementation and that the impacts on attracting investment to the sector are fully understood. It is also important to link incentives relating to capital and operating expenditures to customer and operational performance outcomes.

While we are not supportive of moving to Ofgem's RIIO-type incentive framework for the NSW water utilities at this time, WaterNSW is interested in exploring the suitability of additional incentive schemes in the current review to target service performance, customer service performance and innovation, and clarifying the link between performance and financial returns within the regulatory framework.

Until the workings, data requirements and implications on other elements of the regulatory framework associated with any new incentive mechanism are fully understood, WaterNSW suggests that no (or minimal) financial benefits or penalties are in place during the first determination in which any such mechanism is introduced.

5. Better defining the role of customers

IPART indicates in the Position Paper that its objective for the framework to replicate as much as possible the outcomes of a competitive market, where firms continually strive to understand what their customers want and structure their businesses to deliver their services accordingly.

Therefore, when determining prices, IPART has encouraged the businesses to understand their customers' preferences and reflect these in their pricing proposals.

IPART states that it currently leaves it to the business to lead and engage with customers and that IPART has limited interaction with customers. This is because IPART considers:

[21] See AER Overview *Final decision – Ausgrid distribution determination 2019–24,* page 41.

> "*the biggest benefits of customer engagement are from the dynamic and cultural effects of putting customers' interests at the centre of the business on an ongoing basis*. *There is less benefit to simply making customer engagement something that occurs once every four years as part of the price review process*". [22]

During a pricing review, IPART considers whether the business's pricing proposal establishes outcomes that are in the long-term interests of customers and are in line with community expectations. However, at this stage, IPART considers it is often too late to rectify or ask the business to improve its customer engagement.

IPART notes that regulated businesses are undertaking significant levels of customer engagement and that this requirement has been introduced as part of the regulators' methods to ensure customer preferences are clearly incorporated into their pricing proposals.

While businesses have traditionally operated to deliver a host of technical service standards set out in various regulatory instruments, which were assumed to be based on customers' preferences, the **active participation of customers** in regulatory processes to identify what they actually want, and at what cost, is a key feature of all modern regulatory frameworks.

While 'how' to best identify and embed customer preferences into the regulatory framework is still a work in progress, there is no debate on 'if' additional customer focus is required.

New engagement models and approaches are emerging for regulated utilities and their customers. These generally fall into the following options:

- **Option 1** - The business is responsible for customer engagement and the regulator reviews the efficiency and effectiveness of the final outcomes;
- **Option 2** - The business is responsible for customer engagement, with the regulator setting out its expectations and criteria for the engagement;
- **Option 3** - The business and its customers 'negotiate' the key elements of the determination process and the regulator approves / accepts the outcomes; and
- **Option 4** – The regulator undertakes customer engagement on behalf of the businesses.

Recent developments in customer engagement are discussed below.

5.1 Essential Services Commission of Victoria – PREMO approach

The Energy Services Commission of Victoria ("**ESCV**") adopts a customer engagement model called 'Performance, Risk, Engagement, Management, Outcomes' ("**PREMO**") for water utilities in Victoria. Under the PREMO model, the ESCV places the full responsibility on the utility to engage with customers and to develop their regulatory proposals around the findings of the engagement process.

The role of the regulator is to test the quality of that engagement and how well business plans deliver on customer preferences. This is consistent with Option 1 above.

5.2 Australian Energy Regulator – A New Regulatory Process

A new regulatory process ("**New Reg**") is a joint initiative between the AER, Energy Networks Australia ("**ENA**") and Energy Consumers Australia ("**ECA**") that explores ways to improve sector engagement, and identify opportunities for regulatory innovation in the energy sector. The goal of

[22] Position Paper, page 27.

this initiative is to ensure that customers' preferences drive energy network businesses' proposals and regulatory outcomes.

Under the New Reg process, the most significant departure from traditional practice is that a Customer Forum negotiates aspects of the regulatory proposal in advance of the proposal's lodgment with the AER. The Customer Forum does not represent the perspectives of particular interests, instead it must conduct research and customer engagement to ensure it can effectively represent the perspectives of all the network businesses' customers.[23]

The vision for New Reg is outlined below:

> *The overall vision for the project is that energy consumers' priorities and stated preferences should drive, and be seen to drive, energy network businesses proposals and regulatory outcomes. We believe there are significant opportunities to better incorporate consumer preferences in revenue determination processes, and to improve consumer trust and confidence in network regulation. Further, there is scope to improve the efficiency and effectiveness of the regulatory process.*
>
> *The project is proposing a new dialogue and a better process to align interests so that revenue proposals and AER determinations reflect the interests of consumers. This will also provide consumers with confidence that the network revenue is no more than necessary. Other regulatory processes associated with revenue determinations, such as tariff structures, can also benefit from an innovative approach to consultation.*[24]

AusNet conducted a trial of the process and entered into negotiations with a view to reaching, as far as possible, agreement on specific matters that form a part of AusNet's revenue proposal, having regard to the revenue proposal as a whole.

The Customer Forum is intended to understand, and represent to AusNet, the perspectives and preferences of AusNet's customers.

During the period from March 2019 to January 2020, AusNet Services and the Customer Forum completed their negotiations, culminating in submission of AusNet Services' regulatory proposal and the Customer Forum's Final Engagement Report to the AER on 31 January 2020.[25]

New Reg is consistent with the approach to customer engagement outlined in Option 3 above.

5.3 Role of customers in the NSW water sector

WaterNSW is keen to explore the suitability of these models for the NSW water utilities, but suggests the most appropriate approach is likely to be consistent with Option 2 above. This would place the onus on the businesses to drive the engagement process, in a timely manner, with the regulator providing clarity on how it views effective engagement and how the outcomes from such processes will be incorporated into the determination process. The role of traditional customer surveys, deliberative forums and customer 'juries' should be discussed as part of the review.

[23] See New Reg page on AER website https://www.aer.gov.au/networks-pipelines/new-reg

[24] See AER website for *New Reg: Towards Consumer-Centric Energy Network Regulation. A joint initiative of the Australian Energy Regulator, Energy Consumers Australia, and Energy Networks Australia. Approach Paper, March 2018*. Page 3. https://www.aer.gov.au/system/files/NewReg%20Approach%20Paper%20-%20Towards%20Consumer-Centric%20Energy%20Network%20Regulation%20-%20March%202018.pdf

[25] See Farrierswier report titled *New Reg: AusNet Services Trial Stage 3: Monitoring report on conclusion of the Early Engagement Process, 8 April 2020*. Page 1.

There may, however, also be value in a 'negotiated settlement' approach to regulation in the future for determinations characterised by services offered to a small number of well-informed customers. IPART's framework should not preclude (but not mandate) such an approach.

Option 4 (where IPART would engage directly with customers on businesses' behalf) is not supported as the close relationship between a business and its customers is a core feature of any successful firm and as such engagement should be a core responsibility of the business.

A modern regulatory framework should lead to the identification and embedding of what customers value. Businesses should drive the engagement process, while IPART should outline what constitutes effective engagement and be obliged to accept the outcomes from any such process.

A better understanding of vulnerable customers and issues of affordability have influenced the behaviour of utilities in setting tariffs and tariff structures in recent years. These are important considerations moving forward. How IPART addresses issues of vulnerability and affordability, while acting in the long term interests of customers, should also be clarified during the review.

We look forward to working with customers and IPART during the review to assess various engagement models that could be adopted to ensure that customers' preferences can be identified and embedded into IPART's pricing determinations moving forward. We support the following principles for engagement:

- Representative customer groups are engaged; and
- Timely engagement to enable informed customer input on content prior to decision making (noting much engagement also occurs after initial decisions are made).

6. Attract efficient investment to the sector

Ultimately, the regulatory framework should seek to promote efficient investment in, and the efficient operation and use of, water and wastewater services for the long term interests of customers.

In order for the long term interests of customers to be promoted, investment in infrastructure with a life of many decades needs to be attracted to the sector.

Financial resilience across the regulated water sector is fundamental to meeting industry challenges while maintaining the affordability of services. The recession associated with COVID-19 will place pressure on both utility revenue and customers' ability to pay and underlines the need for the industry to be able to withstand financial shocks.

For a business to commit capital to the sector requires it to be financially viable and to ensure that it has a reasonable opportunity to recover its efficient costs in future. As outlined in the WSAA submission to this review, the financial strength of utilities continues to come under pressure. A number of utilities are being downgraded by ratings agencies and are sitting close to the bottom of the investment grade range. For essential services investing in long lived assets, it is imperative that utilities are able to maintain an investment grade credit rating.

Ensuring that debt and equity holders achieve commercial returns is paramount to maintaining an investment grade credit rating and therefore being able to attract capital and invest in the sector at lowest cost. Funding in the current economy is scarce, with equity holders, including Governments, seeking to ensure they receive a fair return before deciding to allocate capital to a particular sector. WaterNSW considers that the current regulatory framework has not led to commercial returns to equity holders in the water sector as equity returns have been 'squeezed'

and equity holders left 'holding the bag' for uncompensated risks (e.g. inflation forecasting) and the costs of complying with new obligations with no regulatory funding (e.g. for unforeseen investments to ensure water security during drought).

WaterNSW is keen to ensure that the review places adequate focus on the need for acceptable returns to equity holders *within* a regulatory period as a core consideration for the review and not confined to debates over specific parameters in the weighted average cost of capital ("**WACC**") review.

A key theme for this review should therefore be the recognition that the regulatory framework should result in returns for baseline performance that adequately compensate debt and equity holders. A high powered incentive framework necessarily results in financial incentives for businesses to outperform their regulatory targets. If a business outperforms its regulatory targets, it should earn additional returns. If it performs below its regulatory targets, it should earn lower returns.

7. Minimise the cost of regulation

WaterNSW is keen to ensure that the costs of regulation are necessary and sufficient to meet the long term interests of customers. As discussed in Section 4 'Incentives', the move to a more high powered incentive framework necessarily results in increased costs, as illustrated by the Ofgem RIIO example and considerable staffing by the regulator (and the businesses) to implement the regime. Before embarking down this path, it is incumbent on the IPART and industry to fully understand the costs, benefits and impacts on attracting capital to the sector of any proposed changes to the current framework.

To this end, WaterNSW encourages IPART to undertake a 'regulatory investment test', including the likely costs of compliance and expected benefits, before introducing any substantial changes to the existing regulatory framework. This represents good governance and would be welcomed by stakeholders in ensuring the long term interests of customers are met.

In addition, IPART is encouraged to seek to align its reporting 'codes' and annual information return categories to those that are used by the businesses in tracking the performance of their activities. This would result in lower costs of regulatory compliance and better quality information for the regulator.

WaterNSW wishes to highlight some areas for consideration that could streamline regulatory processes and lead to more efficient outcomes for the business and our customers.

7.1 Relationship with Operating Licence reviews

As outlined in the Position Paper, IPART generally recommends licence standards one to two years before it sets prices. However, IPART notes that the level of service (or standards) that a customer wants a business to deliver is a function of the price the business will charge to deliver the service. This suggests there may be a benefit to running both processes in parallel, or looking at other ways to enhance understanding of the relationship and optimal balance between price and service levels.

However, there would also be costs of concurrent reviews of licence conditions and prices, potentially adding regulatory costs or burden to the regulated businesses. Further, the licence conditions we recommend may not be adopted by government, which creates a risk our prices are then not cost reflective.

IPART has indicated it is keen to explore the benefits and costs of different approaches to enhance integration and outcomes of our licensing and pricing functions.

WaterNSW considers that there is merit in ensuring the timing of the operating licence review is set to enable the outcomes to be understood and the costs included in the business's pricing proposal. This would ensure that the prices charged are reflective of the service standards and that there is no mis-alignment. We note, however, that there are likely to be efficiencies in undertaking the operating licence review and expenditure review in a coordinated manner.

For example, the operating licence audit and the expenditure reviews for the WaterNSW bulk water and WAMC / Rural Valleys determinations were conducted at the same time, but were not part of a fully integrated process. This resulted in a significant level of duplication in the review process by WaterNSW staff and IPART's consultants, leading to higher costs. Better alignment of the review processes in future is likely to result in less duplication and therefore more efficient and effective outcomes.

7.2 IPART's expenditure reviews

IPART states that it relies on a range of information when reviewing a business's proposed expenditure to derive what it considers to be the level of expenditure that an efficient benchmark business would need to deliver services to customers. This includes assessing a sample of the business's specific projects and processes, to compare the business to the benchmark. IPART suggests this creates the perception that IPART has 'allowed' or 'disallowed' individual projects. IPART states the following:

> *A 'bottom-up' expenditure review can become heavy handed and time consuming. It can also focus undue attention on individual projects or programs. This may mean that the businesses may focus on projects which it thinks are the most likely to be "approved" by IPART. It can also mean that the business, IPART and other stakeholders can be focused on debating the merits of adjustments to the allowance for an individual project or program, rather than the aggregate, business-wide allowance (or funding envelope).*
>
> *A bottom-up approach can also suffer from information asymmetry between the business and IPART and generate incentives for inflated cost proposals, in that if the business knows IPART will routinely trim costs its proposal may be proportionately inflated.*[26]

To address these issues, IPART indicates that it could consider:

- Incentives for the businesses to submit ambitious pricing proposals – i.e. proposals that reflect efficient and innovative cost and service proposals.
- Whether IPART's process could focus more on justifying step-changes in proposed expenditure and performance, particularly where the business's historical costs can be demonstrated to be efficient. This could shift IPART's expenditure review to a more 'top-down' approach. However, it may involve greater scrutiny of the business's historical expenditure.
- Whether the balance of industry data IPART uses to review expenditure is appropriate and what additional areas could IPART credibly rely on industry benchmarks to establish efficient costs? IPART states that benchmarking is a challenge in NSW due to market structure, and there may be costs that are not easily comparable across businesses.
- IPART currently deals with some 'generic' issues that apply across the businesses (such as WACC parameters) outside of the pricing review process. IPART could review a broader range of issues, which affect all businesses, between pricing review periods, to

[26] See IPART's 29 September 2020 *Position Paper on the Special Review on Water Pricing and Licensing – Regulating Water Businesses*. Page 22.

allow more focus on important aspects of the business's expenditure during the pricing review.

- While the appetite for innovation is influenced by the regulatory framework, the broader context of government policy and the direction taken by the business's board and its shareholder also have a large impact on the actual performance of the business.

WaterNSW supports much of the thinking outlined by IPART in the Position Paper regarding the efficiency and effectiveness of the expenditure review process. We consider that ultimately the regulatory framework for the capital intensive utility sector comes down to providing a reasonable return on sunk assets and assessing future costs. To the extent that incentives are in place to encourage the business to 'reveal' its efficient costs, this results in less need for detailed expenditure reviews. To this end, we support considering a more high powered incentive framework, but we expect and support the need for some detailed 'bottom up' analysis of costs.

Within the current regulatory framework, we note that there is considerable variation in the approach taken by IPART's technical consultants in reviewing the water utilities' expenditure programs. WaterNSW is well placed to comment on the approaches of technical consultancy reviews, as we are currently in the midst of our third such review over the past twelve months.[27] Some observations on these reviews is provided below:

- Significant variation in information and data collection between technical consultants, leading to considerable variation in compliance costs. For example, we have received over 300 requests for information for one of our concurrent reviews, and approximately 50 such requests during the other review. As a mid-sized utility, resourcing for such variations in approach has been challenging and requires a different resourcing model.
- Different approaches in assessing efficiency, including greater use of 'top down' efficiency reductions by some consultants compared to others.

Some guidance and consistency by IPART in how its consultants should undertake the review, including the approach to the level and type of information requests and the application of 'top down efficiencies' is encouraged. This will help to ensure that the regulatory compliance costs and outcomes across the water sector are not unduly affected by the selection of the technical consultant and rather are applied consistently across businesses in meeting the long term interests of NSW customers.

[27] WaterNSW participated in the technical reviews for our Greater Sydney bulk water assets during 2019-20 and we are currently involved in technical expenditure reviews as part of our Rural Valley WAMC determinations.

8. Responses to IPART's 12 Questions

Question 1

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

WaterNSW considers that the focus areas are appropriate, noting that the matters we've identified and addressed in this response can be considered accordingly.

Question 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?

Our response to this matter is included in our response to Section 3.

Question 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?

WaterNSW encourages IPART to continue to engage with relevant stakeholders during this review. We support the development of a Stakeholder Reference Group comprised of representatives from the utilities, Government and customers to be formed as part of the review to ensure stakeholders' views can be considered appropriately.

Question 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'?

Our response to this matter is provided in Section 4.

Question 5

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

Our response to this matter is provided in Section 4.

Question 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?

Our response to this matter is included in Section 7.2.

Question 7

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

Attracting efficient new entry and competition in the supply of water services will be maximised if the regulatory framework ensures infrastructure charges are cost reflective and deliver commercial returns to investors. This will ensure that potential new entrants have visibility of the risks inherent in the framework and are not making inefficient entry decisions based on prices that are above or below efficient levels. More clarity, transparency and predictability of decision making in the regulatory framework is likely to encourage new efficient investment in the sector.

While outside the scope of this review, the introduction of a well-functioning wholesale water market across the State has the potential to attract new investment to the sector and to encourage new water sources. This may then lead to the case for additional retail competition to further access the benefit of competition for water users.

WaterNSW encourages further examination of the potential benefits of a water market in Greater Sydney to increase the efficiency, innovation and choice in the sector.

Question 8

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

Our response to this matter is included in Section 7.2.

Question 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?

Our response to this matter is included in Section 4 and Section 5.

Question 10

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

Our response to this matter is included in Section 5.

WaterNSW is keen to explore the suitability of various engagement models for the NSW water utilities, but suggests the most appropriate approach is one that places the onus on the businesses to drive the engagement process. The regulator should provide clarity on what constitutes effective engagement and how the outcomes from such processes will be incorporated into the determination process.

Question 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?

WaterNSW supports a review of key elements of the WACC prior to the next round of Greater Sydney determinations. We suggest that the review should not examine all elements of the approach to WACC, but should instead focus on new or emerging issues, including the following:

- IPART's approach to forecasting inflation. Of particular concern is IPART's approach to forecasting inflation when converting a 'nominal' WACC to a 'real' WACC, the latter of which is used in revenue setting under the building block approach. If outturn inflation is below IPART's forecast (which has systemically occurred over the past few years and is forecast to continue), revenues will be insufficient to recover the returns envisioned by IPART in the determination.

  WaterNSW notes that the Australian Energy Regulator (AER) is currently conducting a review of the regulatory treatment of inflation, highlighting the importance of this issue across jurisdictions and sectors;
- Providing more transparency on how IPART responds if its uncertainty index is triggered;
- Increasing the averaging period for the long term risk free rate to be more consistent with the long term market risk premium (MRP); and
- The inclusion of other CAPM models in the assessment of the return on equity (e.g. Black CAPM and the Fama-French model).

We support a 12 month delay to the commencement of the limited WACC review. This would allow stakeholders to focus on the wider economic framework review and to fully consider the findings from the AER inflation review.

We suggest that if the limited WACC review is delayed, the final scope should be revisited prior to commencement of the review to ensure it remains current and addresses any significant emerging issues.

Question 12

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

The timeline for conducting the review (noting our response to Question 11 regarding a 12 month delay to the limited WACC review) seems ambitious, particularly if any significant reforms arise from this review as they would likely not be able to be fully assessed and implemented by December 2021.

We caution that the timeline should not unduly limit the matters that could be contemplated. Rather, IPART may wish to determine a 'road map' with separate consultation processes for the matters that arise from this review (e.g. if a new incentive mechanism is proposed, a separate consultation process with relevant stakeholders would be required to fully assess the benefits and costs, data requirements and impacts on investment).

Experience from the energy sector suggests that the development and implementation of incentive mechanisms (and other elements of the regulatory framework) often takes many years to understand the likely implications and to assess whether the changes are likely to be in the long term interests of customers.