

Hunter Water Corporation
Customer engagement on prices for monopoly services
Comments on IPART discussion paper

Hunter Water has reviewed IPART's February 2012 discussion paper on customer engagement on prices for monopoly services.¹ Hunter Water has previously provided comments on the earlier engagement case study work carried out by Cambridge Economic Policy Associates (CEPA) and attended the engagement workshops conducted by IPART. We welcome the opportunities to comment on the matters raised in the February discussion paper and to continue to work with IPART on how best to engage customers and the community in the price setting process.

A number of the points made in Hunter Water's September 2011 submission on the CEPA review are relevant to the current discussion paper, particularly those under the headings 'Clarity on engagement activities and responsibilities' and 'Regulation and scope for consultation'.² The following comments build on the points raised in these sections of the earlier submission.

Some aspects of IPART's expectations of utilities on engagement are still unclear from the discussion paper. This is particularly so for engagement in relation to prices meeting mandated standards and other regulatory requirements and the respective responsibilities of utilities and regulators in customer engagement on mandatory requirements. In the following discussion, we refer to the trade-off between prices and the level of mandated standards and other regulatory requirements as the "price/outcomes trade-off".

The IPART discussion paper appears to focus the responsibility for consultation on the trade-off between price and levels of service or service standard on monopoly providers (utilities), even though these service levels and standards are frequently set externally and independently by regulators. There appears to be little focus in the discussion paper on the roles and responsibilities of regulators for community and customer engagement on the price/outcome trade-off, particularly where service standards are determined by regulators. While a later section of the discussion paper does outline IPART's proposed communication initiatives using new media, these initiatives seem largely directed at communications with customers rather than engaging customers in constructive approaches to develop shared outcomes.

All regulatory review and standard setting processes do include community consultation. However, an important observation from the following comments is that the regulatory review and standard setting processes of regulators do not currently make explicit provision for a constructive engagement process around the price/outcome trade-off. If this trade-off is to become important in

¹ IPART, 2012, **Customer engagement on prices for monopoly services**, Research – Discussion Paper, February, Sydney

² Hunter Water submission to IPART on the CEPA review of customer engagement arrangements, 13 September 2011.

the price setting process, then the engagement processes of regulators need to make provision for engagement of this type in their regulatory review and standards setting processes.

Engagement on mandated standards and regulatory requirements

Hunter Water's September 2011 submission on the CEPA report highlighted that the regulatory environment faced by water utilities constrains the influence that customers can have on regulation through the utilities' engagement processes. We further commented that there needs to be processes for assessment of the costs and benefits associated with mandatory standards to be included in the standard setting processes of regulators.

The diversity of regulatory arrangements, the existing consultation arrangements carried out by regulators and the number of regulatory instruments involved together means that it is very difficult to identify a simple and universal approach to engagement by utilities on standards and regulatory requirements.

Regulators generally have their own consultation processes for standard setting and sometimes have processes defined by legislation for establishing regulatory requirements. Apart from formal and transparent consultation with the regulated utilities, these processes for establishing regulatory requirements are rightfully independent of utility influence. The preservation of this independence from influence by regulated bodies could be a constraint on utilities having a primary role in assessing price/outcome trade-offs and further reason for this role to rest with regulators.

In this context, it is difficult to see how a cost-benefit analysis, carried out by a regulated utility, of adopting or complying with the service standards set by regulators fits easily within the standard setting processes of most regulators.

This difficulty can be illustrated by looking at the regulation of Hunter Water's access to water sources. This access is regulated by water access licences issued by the NSW Office of Water. A requirement of these licences is compliance with water sharing plans for the water sources accessed by Hunter Water. The *Water Management Act 2000* sets out extensive processes for the development of water sharing plans and the plans are legal instruments with the status of regulations.

The water sharing plan for the Hunter unregulated and alluvial water sources was developed by the NSW Office of Water and its predecessor agencies over an extensive period from 2006 to 2009. This plan involved consultation with a wide range of users and interest groups. The plan outcomes serve as regulatory instrument, not only for Hunter Water, but for all users of the resource including irrigators and major industry.

In this case, a price/outcome trade-off of the plan's requirements relevant to Hunter Water's customers would be only one consideration in setting overall water sharing plan requirements and may be outweighed by other regulatory considerations.

Cost-benefit analysis of mandated standards

Many mandated service standards and associated expenditures are imposed by other regulators, such as health and environmental standards. Standards may be set to achieve environmental goals or protect broader community interests ...

For service standards mandated by the government, our [IPART's] view is that utilities should provide us with the supporting cost-benefit analysis for the service standard, in addition to the cost-benefit analysis for the required capital expenditure. Whilst we [IPART] are not involved in the setting of mandated standards, we will determine the efficient costs of implementing these standards.

IPART Discussion paper, page 6

Cost-benefit analysis (CBA) is, or should be, an integral part of a regulator's processes in establishing mandated standards for water utilities. It is a requirement of regulatory impact assessments and statements. In short, CBA of mandatory standards is part of the justification of adopting such standards, and as such, appropriately belongs with regulators, not regulated utilities.

In view of the fact that it should be part of a regulator's process for establishing regulation and standards, it is difficult to see where a CBA by a regulated utility of mandated standards at a price review fits into the established processes of regulators.

Where the regulatory outcomes apply more widely than to Hunter Water alone, it is questionable whether it is our role to be carrying out a CBA of the regulatory arrangements or assessing our customers' willingness to pay. A CBA of wider application of regulation and standards would clearly require assessment of wider benefits and costs to the community, not just to Hunter Water customers. It is questionable whether such analysis is appropriate for one regulated party when others are subject to the same regulation.

In some cases there may be a range of regulated parties with quite different access to resources for such an analysis – for example, a major urban water utility may be better placed to carry out CBA than individual irrigators subject to the same regulation. If one regulated party carries out such an analysis as it relates to that party alone, such action could be seen to be seeking to be treated differently to other regulated parties. Such action by regulated parties with ready ability to fund such analysis could be seen as inequitable and inappropriate. These situations again suggest that CBA of regulatory standards is best carried out as part of the regulatory impact assessment by the regulator concerned.

Hunter Water agrees that, during any consultation on standard setting, it should provide regulators with information about the costs of complying with any proposed regulatory arrangements and about customers' willingness to pay. Indeed, wherever possible, we do provide such information to regulators. The Burwood Beach reference group work – relating to the upgrade of the Burwood

Beach wastewater treatment plant - is a good example of seeking community input on the willingness to pay for environmental outcomes.³

In situations where the regulation or standard is applied to Hunter Water only, Hunter Water can provide information to the regulator about the acceptability of the standard to customers and their willingness to pay. Hunter Water can also provide details about the costs of meeting proposed standards and the likely physical outcomes. However, it is often difficult to translate physical outcomes into economic benefits. For example, higher wastewater treatment standards resulting, say, in benefits such as reduced nutrient discharges to the environment, may be extremely difficult to value in economic terms. Because such standards are often framed by regulators in a wider regulatory context (ie “protecting broader community interests” as stated in the quotation from the discussion paper at the head of this discussion), regulators may attach a range of other, possibly intangible, benefits beyond physical improvement to outcomes.

The points raised above all suggest that it is questionable whether it is the place of utilities to provide IPART “with the supporting cost benefit analysis for the standard” as suggested in the discussion paper or more appropriately the role of regulators. It is unclear to us whether Hunter Water carrying out such a CBA of a regulator’s standards is in line with other regulators’ expectations, whether it can be accommodated in their regulatory processes and practices and the degree to which it might influence the imposition of various standards or the costs we need to recover from Hunter Water customers. It is also unclear at what stage of any standard setting process, a utility is best positioned to carry out such a CBA. At the consultation stage in standard setting, such an analysis may only be based on a range of options for standards whereas, once the standard is set, the analysis can have little tangible influence in standards or costs.

Overall, it is our view that CBA is tool to be used in justifying regulated standards as part of the standard setting process and therefore should be primarily the responsibility of regulators, not regulated utilities. CBA should not be seen simply as a tool for justifying utility prices. Hunter Water believes IPART needs to engage with other regulators with a view to establishing regulatory processes that can accommodate IPART’s desires to have CBA and/or other substantiation of the merits of standards available for consideration in the price setting process. We believe it is not appropriate for the responsibility for justification of externally mandated standards to be imposed on utilities alone through an IPART requirement on utilities to “provide a supporting cost-benefit analysis for the service standard”.

Hunter Water believes IPART needs to provide more clarity about its expectation for CBA analysis of mandatory standards and how such analyses would integrate with the standard setting and regulatory processes of all regulators.

³ Cambridge Economic Policy Associates Ltd (CEPA), 2011, **Regulated monopoly service providers and customer views, preferences and willingness to pay. A report for IPART**, June and Hunter Water submission to IPART on CEPA review of customer engagement arrangements, 13 September 2011.

Assessment of prudence and efficiency

In general, we do not set service standards for utilities. Our role is to determine if the expenditure to meet service standards, mandatory expenditure, is prudent and efficient.

IPART Discussion paper, page 8

This statement appears to be at odds with the earlier expectation that agencies provide CBA. The discussion paper refers only to requirements for economic appraisal using CBA. However, economic literature and Australian and overseas economic appraisal guidelines generally propose economic assessment of mandatory standards and community benefits using cost-effective analysis (CEA). In part, this is because the benefits of mandatory standards can be difficult to monetise but it is also because achieving the standard itself is seen as delivering the community benefit. For example, if a standard is set to regulate wastewater discharges to maintain a level of river health, then maintaining that level of river health is considered to be the benefit of any utility expenditure to achieve the standard. It is the role of regulators to assess the community's desire to maintain that level of river health in setting the standards that it imposes on the utility. Once this determination of the standard is made by regulators, the fundamental decision for utilities is assessing options to achieve that standard most efficiently.

Prudence and efficiency of meeting mandated standards are usually assessed by ensuring that the utility has developed a robust range of options for meeting the standard and the most efficient of these options has been selected for implementation.

As mentioned above, the widely accepted economic assessment tool for determining the most efficient expenditure on mandatory standards is CEA, not CBA. This is because achieving the mandatory standard is an expression of the benefit and, in theory, is common to all options under consideration for delivering that standard. As a result, all options achieve the same benefit and so the major variable is costs. Thus the appropriate measure of efficiency is the cost effectiveness with which the defined mandatory standard (benefit) is achieved.

According to NSW Treasury's guidelines for economic appraisal, CEA is used to compare "the costs of different initial project options with same or similar outputs. CEA is applicable to a wide range of public sector agencies with strong community or social welfare objectives".⁴ Similarly, the Australian Government's Best Practice Regulation Handbook notes that CEA is appropriate if the measure of effectiveness (eg achieving a standard) captures most of the benefits.⁵

It is important to recognise that, for water utilities, mandatory standards are frequently the means by which community and environmental objectives are expressed. For example in the earlier illustration, the community objective to maintain river health is expressed through wastewater discharge standards imposed on utilities.

⁴ NSW Treasury, 2007, **NSW Government Guidelines for Economic Appraisal**, Office of Financial Management, Policy and Guidelines Paper, TPP 07-5

⁵ Australian Government, 2007, **Best Practice Regulation Handbook**, August, Canberra.

In these cases, it is not a matter for the utility to assess community benefits because these are embodied in standard set by the regulator to meet the community's objectives. Where this is the case, CEA is the most common type of economic appraisal used by water utilities in seeking to identify the most efficient (cost-effective) way of achieving the community or environmental objective. In addition, the outcomes of regulated standards are often difficult to quantify and value and therefore difficult to include as monetised benefits in conventional CBA.

These are important distinctions in the context of the earlier quotation from page 6 of the discussion paper, which states that IPART expects utilities to carry out CBA of capital expenditure needed to achieve mandatory standards. Hunter Water's view is that, for capital expenditure to meet mandatory standards, CEA is the economic appraisal tool most suited to the utilities responsibility to deliver regulated standards and the community's objectives that are embodied in these standards at the time they are set by the regulator. CBA, if practical, is more appropriate as a component of the regulator's regulatory impact assessment.

IPART's preliminary view and issues

Hunter Water does not have any major issues with IPART's preliminary view.

A number of the questions raised in the issues on page 10 were addressed in the Hunter Water case studies in the CEPA report and in our September 2011 submission on the CEPA report.

As the CEPA review found, Hunter Water does engage in a wide range of consultation activities. While many are not specifically framed to inform a price review, they are framed to inform decisions about future activities and spending. Consequently, they are often integral to the expenditure decision making process and therefore influence the costs that Hunter Water proposes to IPART in price submissions.

Price/service trade-offs

The urban water sector is a highly regulated sector in terms of service standards and community /environmental objectives, more so than other utility services such as electricity supply, telecommunications and gas. Service standards set by external regulators cover:

- Customer service in terms of water supply continuity, water pressure, sewer overflows and drinking water quality. These standards are set by IPART and regulated through the operating licence.
- Access to natural surface and groundwater and water resource management requirements are set by the NSW Office of Water through water access licences and associated approvals and water sharing plans.
- Conditions relating to the operation of the sewerage pipe network and sewer discharges to the environment are subject to regulation by environmental protection licences.

- Other regulatory requirements, such as dam safety requirements, are also established by external regulators.

This extensive suite of regulation means that a large proportion of Hunter Water's expenditure is driven by external, independent regulation. Apart from expenditure needed to meet growth in the customer numbers and water sales, the remaining activities that extend beyond regulated service standards or on un-regulated activity account for a small proportion of total expenditure. Price trade-offs against the outcomes of this discretionary expenditure generally offer little potential for material impact on customers' bills.

The discussion paper focuses very heavily on utility responsibilities for surveying customers and the community and has little discussion about the roles and responsibilities for standard-setting regulators in assessing appropriate trade-offs. Yet, as outlined earlier, service standards are mostly independently set by regulators and, in some cases, are part of a wider regulatory regime. In this context, it is questionable whether it is entirely the role of utilities to assess trade-offs and whether a lesser service standard should be provided at a lower cost. Hunter Water's view is that regulators, who set many service standards, should have primary responsibility for economic evaluation and assessing these trade-offs.

IPART has also suggested in the stakeholder workshops and in the discussion paper that, as an initial step in broader community engagement on price/outcome trade-offs, utilities should consider the local government approach to consultation on trading off rate increases and levels of service. However, local councils have a significantly greater range of unregulated and discretionary services and thus more trade-offs to put to their customers compared to water utilities, whose operations are limited to two or three core services that are tightly regulated.

We appreciate that this is a very difficult area on which to provide a prescriptive way forward. Nevertheless, Hunter Water believes that IPART should be looking at establishing frameworks for regulators of monopoly services to be conducting regulatory impact assessment to inform price setting processes. This could include specific requirements for regulators to provide information on the likely impact of proposed regulation on the individual customers of the regulated utility rather than an overall cost to the utility, which has little meaning to customers.

IPART has initiated a process like this with the current review of Hunter Water's operating licence. IPART's March 2011 issues paper for the licence review stated that IPART, mindful of concerns about the burden of regulation, would undertake CBA of proposed licence amendments, particularly the proposal to require certified systems in place of prescriptive standards.⁶

While the final report on the operating licence is yet to be released, we understand that IPART found it difficult to quantify and value the benefits of moving to a certified systems approach, however the costs to implement and maintain such a system could be more easily quantified.

⁶ IPART, 2011, **Review of the Operating Licence for Hunter Water Corporation**, Water –Issues Paper, March, Sydney

As a result, we understand IPART proposes to include the requirement in the licence to move to the certified systems after considering the materiality of the additional costs of adopting the certified systems approach as a proportion of Hunter Water's current expenditure.

It should be noted that Hunter Water is supportive of the approach to implement systems-based licensing, however, this decision has been made with limited opportunity for customer engagement on the price/outcome trade-off. While the materiality of the costs may appear low, customers and other stakeholders have not had the opportunity to consider the cost and the merits of the regulatory change in the context of the upward pressures of Hunter Water's other operating costs such as electricity, labour, contracts and pass through of other regulatory costs such as water management licence fees.

The important observation here is that, even though an economic analysis of the proposed regulatory changes has been undertaken, the operating licence review processes did not provide opportunities for wider engagement of price/outcome trade-off.

This illustrates the need for the regulatory review processes to make explicit opportunities for constructive engagement with customers and other stakeholders on price/outcome trade-offs. There is a role for both the regulator and the utility to work together to provide greater opportunities for this to occur.

Constructive engagement and capacity building

Engagement tools are changing and constructive or deliberative engagement is more frequently being used by utilities, utility regulators and public policy agencies overseas, particularly in the USA and the UK.

Hunter Water supports moving to constructive engagement whereby the community, customers, regulators, interest groups and the utilities are jointly engaged from an early stage in developing shared solutions or outcomes. The important features of constructive engagement are the involvement of all parties and shared (jointly-owned) solutions.

While Hunter Water is supportive of the constructive approach, it is not clear that the current regulatory and standard setting processes of water industry regulators are conducive to wide adoption of constructive engagement. In addition, as this submission has highlighted, it is certainly not clear that utilities should always be the primary drivers of constructive engagement, particularly where regulated standards are involved. This is particularly so given that good constructive engagement requires early engagement of all parties in the standard setting process. Again, this requirement suggests that there is a key role for regulators as they are the initiators of most standard setting processes.

The discussion paper examined potential improvements to IPART's communications with customers on the price review process. The paper focused on communication channels, predominantly new media, but did not address the significant need for IPART to undertake wide-spread community education and capacity building around the price review and setting process. Hunter Water believes that there is a need for this education and capacity building to originate from regulators not just the utilities.

As outlined earlier, Hunter Water believes that there is scope for IPART to work with other regulators to identify opportunities for incorporating constructive engagement on price/outcome trade-offs in regulatory review and impact assessment process of regulators.

Hunter Water believes there is considerable scope for capacity building to enhance customer engagement. In NSW, there is no peak consumer advocate representing the general interests of utility consumers at IPART price and other reviews or on utility customer consultation groups. Particular consumer groups, such as those representing minority customers or those facing hardship are well represented by groups such as the Public Interest Advocacy Centre (PIAC) and, increasingly, by welfare agencies. More general customer representation is often provided by the Energy and Water Ombudsman of NSW (EWON), however this representation is based on EWON's experience and interests as a dispute resolution body.

While PIAC, EWON and welfare agencies provide strong and consistent consumer representation, the resources of these groups are limited. Their advocacy could be complimented by a more broadly-focused consumer advocate. Box 3.1 in IPART's discussion paper gives some examples of 'consumer champions' that provide broader consumer advocacy in other jurisdictions or service areas.

Although not mentioned in Box 3.1, the Consumer Utilities Advocacy Centre (CUAC) in Victoria provides an interesting model of a working peak consumer group, specifically representing utility consumers. It was formed in 2002 to represent energy and water utility consumers in policy and regulatory process. CUAC's submission to the 2011 Productivity Commission's review of the urban water sector⁷ and its submission on the Essential Service Commission's (ESC) 2013 water price review issues paper and presentation at ESC's November 2011 water customer engagement seminar⁸ are all indicative of the strengths that a peak consumer advocacy group can bring to the engagement process.

Hunter Water believes there is scope for a peak utility consumer body similar to CUAC in NSW. An important strength of peak specialist consumer groups like the CUAC is that they act as a catalyst for capacity building with consumers. A peak consumer group has potential to greatly enhance the capacity of water consumers in NSW to engage in regulatory and policy issues and would facilitate the ongoing consultation and engagement activities of the utilities. One illustration of the additional consumer capacity that such a group may bring is through representation on Hunter Water's Community Consultative Forum. Hunter Water has always had difficulty finding general consumer representation for the forum and representation from a peak group would potentially strengthen consumer representation and information dissemination. Such participation also enables this group to become more aware of utility specific matters and take this into account when considering broader issues. CUAC provides

⁷ *CUAC submission to Productivity Commission Urban Water Inquiry – Draft Report*, 27 May 2011, accessed April 2012 at <http://www.pc.gov.au/projects/inquiry/urban-water/submissions#post-draft>

⁸ *CUAC response to 2013 Water price review – Tariff Issues Paper*, 2 September 2011, accessed April 2012 at http://www.cuac.org.au/index.php?Itemid=26&option=com_docman&limitstart=10 and Essential Services Commission, 2011, **Customer Engagement Seminar: Summary Paper**, December.

representation on four utility customer forums in Victoria, including South East Water's customer advisory committee.

Communication using new media

While using new media and the other initiatives outlined in section 3.7 of the discussion paper would improve IPART's communication with many customers and community members, such initiatives are a small part of an ideal engagement process. A range of communication channels will be required to capture the attention of the community, at the very least, to make the community aware of information available on the IPART website and access to information and participation in price setting through new media.

New media communication is essential because an increasing proportion of the community now relies solely or largely on new media for its information. However, it is important to ensure that moving to new media does not disenfranchise elements of the community that do not source information through new media. Often this group within the community include people facing financial or other disadvantage and for whom traditional or other special communications channels need to be maintained or developed.

As outlined in the CEPA review, Hunter Water uses a wide range of communication channels including internet, printed material included with bills, specific purpose community reference groups, media liaison, advertisements, participation in community events, attendance at service club and other interest group meetings, customer panel surveys and Community Consultative Committee meetings.

While developing new media communications can facilitate more constructive customer engagement, it should not be seen as an end point. Hunter Water believes these are desirable first step in journey towards developing more deliberative and constructive engagement processes that enable customers and other stakeholders to engage with IPART, other regulators and utilities at an early stage in developing agreed regulatory outcomes at acceptable prices.

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