



## **Submission to IPART Discussion Paper Encouraging innovation in the water sector**

**25 October 2021**

## About the Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is leading social justice law and policy centre. Established in 1982, we are an independent, non-profit organisation that works with people and communities who are marginalised and facing disadvantage.

PIAC builds a fairer, stronger society by helping to change laws, policies and practices that cause injustice and inequality. Our work combines:

- legal advice and representation, specialising in test cases and strategic casework;
- research, analysis and policy development; and
- advocacy for systems change and public interest outcomes.

## Energy and Water Consumers' Advocacy Program

The Energy and Water Consumers' Advocacy Program (EWCAP) represents the interests of low-income and other residential consumers of electricity, gas and water in New South Wales. The program develops policy and advocates in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives input from a community-based reference group whose members include:

- NSW Council of Social Service;
- Combined Pensioners and Superannuants Association of NSW;
- Ethnic Communities Council NSW;
- Salvation Army;
- Physical Disability Council NSW;
- Anglicare;
- Good Shepherd Microfinance;
- Financial Rights Legal Centre;
- Affiliated Residential Park Residents Association NSW;
- Tenants Union;
- The Sydney Alliance; and
- Mission Australia.

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The Public Interest Advocacy Centre office is located on the land of the Gadigal of the Eora Nation.

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## **Introduction**

The Public Interest Advocacy Centre (PIAC) welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART) Discussion Paper (the Paper), Encouraging innovation in the water sector.

PIAC supports the scope of proposals contained in the Paper and the intent to undertake structural reform of water regulation. The focus of the proposed framework on the interests of consumers and the community, and the need to incentivise more innovative long-term planning by businesses, is welcome. There is scope for the framework to more explicitly direct businesses to incorporate proposals into long-term planning, and opportunities for better structural links with other regulating agencies, and policies impacting businesses.

PIAC is not convinced proposed ex post incentives have been justified and thinks more consideration is needed. Incentives for innovation should be integral to the framework, rather than discrete mechanisms added on. There is merit to the view that implementing the framework is a significant reform requiring time and investment of resources to deliver the intended outcomes. The addition of a range of incentive mechanisms at this time may add complication and undermine the likelihood of success.

## **The role of regulation**

The purpose of regulation in essential services is not to mimic the characteristics of the competitive market, whatever they may be, but to deliver outcomes that are in the long-term interest of consumers and the community.

The Paper reiterates the assumption that competitive markets are inherently innovative and regulated businesses are fundamentally disadvantaged by comparison. In the context of contemporary water regulation this is an overly simplistic and potentially inaccurate assumption.

Competitive businesses delivering essential services, such as electricity retailers, have not demonstrated a strong innovative tendency or consistently delivered services that reflect consumer interests and preferences. IPART's own retail monitoring reports show a majority of energy consumers pay much more than they need (or, in PIAC's view, should). The complex contestable retail market leaves many unable to afford the energy they need, and unhappy and distrustful of the service they receive. Whether or not a business operates in a competitive market is not a reliable determinant of innovation that serves consumers' interest.

Appropriately regulated monopoly providers of essential services have greater scope to shape their business according to consumer and community long-term interests. Correctly incentivised and directed, such businesses would not focus on short term revenue, market share, profitability, increased sales, and other drivers which can undermine the incentive to deliver services that meet consumer needs and interests. Instead, they could innovate toward delivering better consumer outcomes, rather than simply attracting more customers, outperforming competitors or delivering better short-term returns to owners. The question for IPART to consider in this review is what constitutes a regulatory framework that appropriately guides and incentivises regulated

businesses to focus on the long-term interests of their consumers and deliver better outcomes that meet consumer needs and preferences.

In the remainder of this submission, we respond directly to content in each section of the Paper, and the questions posed regarding IPART's Proposals.

## Encouraging innovation in the water sector

### A focus on long term interests

PIAC welcomes IPART's recognition that they regulate in the long-term interests of consumers. This should be more formally enshrined in an explicit regulatory objective that specifies the key aspects of consumers' 'long-term consumer interest'. This would provide a clear and consistent reference for the regulator and businesses in formulating and assessing proposals.

In previous consultations businesses have responded to IPART's intent to focus on long term interests with some confusion as to what this refers and how this focus will be demonstrated in assessing proposals. For instance, does the six-year length of proposal represent 'long-term', and if not, how can long-term be defined and reflected in proposals? PIAC understands IPART intends businesses to develop long term plans and strategies that may span 10 or 20 years or more and integrate their six-year proposals into those plans. While the framework appears to accommodate such an approach, there is scope for greater clarity and certainty. It would be improved by an agreed objective to reflect and promote the long-term interests of consumers. This should be followed by a statement of the principles framing what long-term interests apply to, and may include:

- Health and quality of water
- Sustainability and resilience of water services in the face of climate change
- Efficiency and sustainability of community water use
- Affordability of community access to essential water services
- Equity of access to essential water services both across the community and over time
- Efficiency of investment in infrastructure
- Identification and management of risks to the accessibility of essential water services
- Integration with and support for long-term community planning and policy

IPART must give explicit direction to businesses that long-term interests consider relevant planning, policy and other applicable regulatory frameworks. This should give businesses confidence that long-term plans (and proposals), shaped by state and regional water strategies and environmental and health regulations, will be recognised. IPART may be required to identify the range of relevant policy instruments and agencies to be considered by businesses in revealing and reflecting long-term consumer interests.

Consumer and community interests and needs are distinct from consumer preferences. Consumer preference must be revealed through engagement. Revealing the needs and interests of consumers should also involve engagement, but not exclusively. This distinction is crucial in determining the scope of engagement, and what aspects of service are not subject to trade-off. The needs and interests of consumers, particularly over time, are also determined by requirements and expectations of service established by policy and regulation. For instance, that

all members of the community have a right to equitable access to healthy water regardless of their ability to afford it.

## The ‘3Cs’ Framework

PIAC supports the intent to ground the regulatory framework on the ‘3Cs’. We note the following areas where this grounding could be improved to better direct business proposals:

- **Consumer and community focus**

Customer framing is too narrow and does not fully capture the responsibility water businesses have. Businesses must seek to understand the needs and preferences of the community their operations support, as well the needs and preferences of their consumers.

This focus requires businesses to identify service preferences, but not explicitly recognise the need to identify and deliver services that meet the community’s needs and interests. There are issues of community need which are not subject to preference or trade-off: for instance, health regulations set required parameters for service quality. They reflect the interests and needs of the community for a quality of water that supports community health. The focus of the business must be to correctly identify both the community needs and consumer and community preferences and deliver services accordingly.

These factors would be better reflected by:

‘Consumer and community focus. Regulated businesses must identify community needs. They must deliver services that meet those needs, and reflect the preferences of consumers, affordably and equitably in the short and long term’.

- **Cost efficiency and value**

The focus on cost narrows the scope of issues businesses should consider. This may lead to a lack of consideration for issues of value, equity and efficiency over time. Businesses should be encouraged to consider issues such as generational equity, and to structure their costs in a way that balances value and affordability now with the most efficient solutions over time.

This is a complicated process that must be shaped by deep community engagement and the regulatory framework should clearly require this.

These factors could be better reflected by:

‘Cost efficiency and long-term value. Regulated businesses must deliver the greatest value to their consumers and the community. They must ensure the costs to consumers are sustainable and affordable in the short and long term, and reflect their needs and preferences.’

- **Credibility and commitment**

Business proposals must be a meaningful reflection of what is possible and likely. They must include enough transparent evidence to demonstrate that this is the case. They should demonstrate credibility by declaring what they are prepared to put at risk, and what provisions are in place to protect the community from any risk or impacts that may result when they are unable to deliver what is proposed. It is unreasonable to expect perfect foresight from businesses, or for that to be the measure of credibility, yet transparency and preparedness are important aspects of credibility. Credibility of proposals should be demonstrated by:

- Comprehensive planning that is capable of addressing identified issues.
- The quality of evidence and decision-making processes underpinning the proposal.
- The identification of risks or potential inaccuracies in assumptions.
- The identification of measures to address potential risks or the impact of inaccuracies and assumptions
- Tangible demonstration of business commitments to deliver outcomes, in the form of targets, performance indicators and other measures that are attached to financial risk on the part of the business.

IPART should ensure the final framework includes clear guidance to businesses, such as that above, on what the aspects of credibility include. This could be provided as narrative in addition to the updated guiding principles related to credibility.

These factors could be better reflected by:

'Credibility. Regulated businesses must demonstrate their proposals are credible, are able to be delivered, and address potential risks to delivery. This must include tangible commitment to delivery and means to assess success and address shortfalls.'

**Question: What are your overarching comments about our proposed approach?**

PIAC has incorporated overarching comments into the preceding sections of this submission.

**Question: Should separate funding for innovation be part of our regulatory framework? If so, how would such a scheme be designed to promote demonstrably better outcomes for customers?**

PIAC does not consider separate regulated funding for innovation to be appropriate at this time. Innovation should be an integral aspect of business decision making and operation. It should be inseparable from effective decision making in the long-term interests of consumers. There is merit in further consideration of mechanisms to better drive and direct innovation but PIAC does not consider there to be sufficient justification for the mechanisms proposed.

It may be more appropriate to implement the new regulatory framework while potential mechanisms to incentivise innovation are further considered. The nature of this funding must recognise that consumers and the community bear the risks and the costs regardless of outcomes. Addressing the balance of cost and risk to consumers must be a priority consideration for potential innovation incentive mechanisms.

## Encouraging good proposals

PIAC broadly supports IPART's focus on encouraging good proposals and identifying opportunities to provide better direction to businesses as well as improved regulatory processes.

### Clearer guidance to businesses

PIAC supports providing clearer and more effective guidance to business regarding their proposals. The existing guidance to businesses is not fit for purpose. The overarching principles are vague and do not give adequate direction to businesses about the role of pricing proposals and what they must address.

PIAC highlights the key role a regulatory objective should play in ensuring a common reference point for IPART and water businesses in the development and assessment of proposals. IPART should consider developing an agreed regulatory objective as the foundation of its guidance to businesses.

It is reasonable to structure further guidance to businesses according to the '3Cs' and a range of principles which underpin them. We have provided comment on how the 3Cs framework can be improved.

**Question: How effectively would our 11 principles promote a better regulatory process, and support our customer value, cost efficiency and credibility framework.**

PIAC supports principles outlining what each element of the '3Cs' framework covers and how they relate to business decision making and the development of proposals. In addition to the aspects already outlined, PIAC notes the following improvements to the proposed customer principles:

**Consumer and community principles**

1. Consumer and community centricity

How have you integrated consumer and community preferences, interests and needs into planning and delivery of investment, operations and services over the short and long-term?

2. Consumer and community engagement

Is engagement an integral aspect of your business decision-making processes? And are you engaging meaningfully on the correct issues?

3. Consumer and community outcomes

How well does your pricing proposal link consumer and community preferences, as well as the needs and interests of the community, to the proposed outcomes, service levels projects?

How can you demonstrate these outcomes and what are the indicators of success?

4. Community needs

Have you integrated community interests and needs, reflected in other standards, regulations, policy planning and expectations, into your proposal? And have you considered equity of affordable access in the long and short term?

5. Choice as a choice

Are you retaining choice as an option for services and prices that are discretionary? Have you ensured that the choices of some consumers do not unreasonably impact equity or affordability for others?

The cost and credibility principles require further consideration and improvement. As we have noted earlier in this submission, there should be more explicit direction at a principles level to:

- Integrate long-term issues, planning and strategy into business proposals.
- Consider generational risk and equity implications of business decisions.

- Demonstrate how risks to consumers and the community will be identified and managed by the business.
- Set tangible performance targets and indicators capable of assessing progress.

## **Self-assessment and grading**

PIAC supports the framework requiring businesses to self-assess their proposal, before being graded by IPART.

Providing an explicit objective and clear guidance regarding the principles underpinning the framework will be vital to ensuring this process is effective. Businesses should have scope and incentive to respond innovatively to the needs, interests and preferences of consumers and the community. The framework and principles must balance the need for clear direction and guidance with the flexibility businesses require to respond to their unique circumstances and the needs and preferences of their consumers and community.

**Question: How effectively would our proposed grades, and grading rubric, motivate businesses to develop proposals that promote customers long-term interests?**

The proposed grades and grading rubric potentially help motivate proposals that better reflect and promote the long-term interests and preferences of consumers and the community. In addition to the improvements previously noted, PIAC highlights the following issues with self-assessment and grading which need to be addressed:

- Grading of business performance must primarily be relative to the business itself. Benchmarking and performance relative to other NSW businesses or comparable businesses in other jurisdictions are useful additional criteria, but priority must be the performance of business relative to what it should be delivering in the long-term interests of its consumers and community.
- Caution should be taken in attempting to compare all aspects of businesses which are fundamentally different in nature. For instance, businesses with a residential retail aspect have very different drivers and considerations to those delivering largely wholesale services to large users. IPART could consider which aspects of the framework are comparable across all businesses and which may vary according to the nature of the business.
- Assessment scales must be dynamic, reflecting that businesses should evolve and improve their understanding and responses over time. Clear signalling of this expectation adds to the incentive for business to develop long-term plans and strategies to expand and deepen engagement and explore opportunities to innovate in their responses to that engagement.
- Assessment should explicitly consider a proposal's success in integrating the aspects of regulatory framework. For instance, demonstrating how decisions on pricing support community and consumer outcomes and preferences, long-term risk management and efficiency. Businesses should have scope to innovate in their proposals and be encouraged to seek new ways to deliver outcomes in the long-term interests of consumers.

- Integration of a business proposal into the long-term strategies and planning of the business should be a key criterion for assessment. While there are numerous references in the principles to consideration of the ‘long-term’, there is scope for this to be a more prominent determinant of grade.

## Rewards and benefit sharing

**Question: Should leading businesses receive financial incentives each time they achieve leading status? Should Sydney Water and Hunter Water receive financial incentive for achieving advanced status in the first round of reviews?**

How leading status is assessed from year to year will determine whether a business receives financial incentives each time it achieves this status. What constitutes leading status for a particular business should be recalibrated with each proposal process. The primary consideration should be the performance of the business against its own potential to propose and deliver beneficial outcomes for consumers. The expectation should be that performance justifying leading status in a previous process may be standard practice this time.

Assessments against other NSW businesses, as well as similar businesses in other jurisdictions may also be part of assessing whether a leading business is continuing to demonstrate leading performance. For instance, a business may have demonstrated improved outcomes and performance from its previous proposal but have made gains that are materially below what is expected or demonstrated by other businesses in comparable circumstances.

PIAC considers it possible for Sydney and Hunter Water to receive a financial incentive for achieving advanced status in the first round of reviews. However, it would not be appropriate to set a lower standard for leading or advanced status, or make allowances which may devalue the meaning of leading status and undermine the intent of the framework over time.

## Regulation tailored to business scale and sophistication

Regulation must be appropriate to all businesses and able to drive better performance regardless of the size and nature of the business. However, we do not consider that size and sophistication are the most relevant determinants for regulatory flexibility. Given the small number and wide range of businesses in NSW, the role and nature of the business may be a more relevant consideration for tailoring how regulation is applied. For instance, the Sydney Desalination Plant provides a service to a single customer according to a set of terms that are largely determined by Government policy and Sydney Water requirements. It must respond to very different drivers than Hunter Water which may be of a comparable financial scale and sophistication, but with more complex retail and community considerations. Regulation should recognise this difference.

Hunter Water, Central Coast Water and Sydney Water are all businesses with a similar range of considerations. There are significant differences in scale and sophistication between these businesses. As outlined previously, the primary assessment of a business should be relative to its own circumstances and potential to deliver outcomes in the long-term interests of consumers and the community. Comparisons to similar businesses can then be undertaken to determine the degree to which businesses are satisfying or expanding the frontier of this performance potential.

**Question:** Do you support a tiered regulatory approach based on the grade we assign a water business? If so, how effectively would our proposed approach tailor the regulatory approach to the different businesses we regulate?

It is appropriate to consider what aspects of regulation may vary according to the grading of a business's proposal and the performance it can demonstrate in promoting the long-term interests of consumers and the community. PIAC considers more detail is necessary regarding IPART's proposed approach to implementing tiered regulation, and note a number of issues and questions which would need to be addressed, specifically:

- What aspects of expenditure review may vary according to the grading a business receives? PIAC is concerned with the focus on regulatory 'burden' and consider that 'flexible' expenditure reviews may be a more appropriate framing.

It is not clear how grading and assessment of grading would interact with decisions regarding expenditure review. It is also unclear from the Paper what the role of an expenditure review is in a tiered approach. This would need to be addressed and clearly outlined.

PIAC is not convinced the small potential benefit businesses or their customers gain from avoiding a more fulsome review outweighs the complexity required to create a transparent system with the necessary flexibility. IPART should consider whether this is likely to be a meaningful incentive to businesses.

- PIAC supports more detailed consideration of the scope of incentives for businesses to address the sharing of risks between the business, consumers and the community. Better balancing of risk between consumers and the business is a priority for regulation, and a major failing of the current regulatory framework. Is a choice between price cap, revenue cap or weighted average revenue cap the scope of options businesses have to better balance risk?

Could the balance of risk include scope to provide long-term price stability based on performance targets (such as demand and usage targets) from long-term plans to address sustainability and affordability risks? Business could propose this as part of a long-term plan to reduce exposure to demand volatility risk, setting prices according to sustainable long-term demand targets, or a transition to them. Performance would be measured according to the difference between actual demand and the targets in each year of the proposal. Though extensive analysis would have to accompany such a proposal, it is an example of an approach to risk which may not change the price cap architecture, but change the balance.

- Flexible pricing arrangements for residential consumers should be considered with caution and only allowed in defined circumstances. Water is an essential service for households and a fundamental community right with expectations regarding equity of access. Flexibility of pricing should only be considered where it can be applied as a choice to discretionary water services or products in a way that supports availability and affordability of essential services for all consumers.

## **Using ex post incentives**

PIAC does not consider the proposed ex post incentives are likely to be an effective incentive for businesses. However, ex-post incentive options should be further considered and PIAC supports such a process being undertaken at the conclusion of this review.

Given the scope of proposed regulatory reforms and the substantial shift in thinking and systems that will be required to implement them effectively, it is appropriate to delay implementation of potential ex post incentive measures until they can be considered in more detail.

## **Streamlining the expenditure review process**

### **Proposed changes**

PIAC supports IPART's stated goal to collect the information required to be confident in the efficiency of cost proposals and, subject to greater clarity on implementation in response to our questions and views raised in this submission, broadly supports the proposal to change the approach to expenditure reviews..

Detailed bottom-up expenditure reviews do not always demonstrate material benefits relative to the resources of time and cost invested in undertaking them. As part of the implementation of a new regulatory framework, businesses should be encouraged to provide the scope and quality of evidence necessary to demonstrate robust decision-making processes, comprehensive option assessment process, and effective project management processes and operational structures.

Detailed assessments and reviews of expenditure should be an option employed by IPART when this evidence is not adequate or where there are material issues representing potential risk to the interests of consumers.

IPART should consider whether the development of more internal expert capacity would be more effective and appropriate than continuing to rely heavily on external consultants.

PIAC notes many of the proposed changes in approach, such as expenditure setting and information gathering, involve assessments of operations and decision making of businesses. IPART details the level of co-operation between IPART staff and expert consultants that would be involved to undertake this effectively and in a more streamlined fashion. In conjunction with the range of other changes to the framework, and the wider scope of issues the framework is intended to incorporate, PIAC asks: What changes IPART has to make to its role and structure to effectively accommodate such changes?

The range of information to be considered by consultants and the implications of their advice could effectively leave material decisions and determinations in the hands of unaccountable parties. In a framework that encourages flexibility and innovation from businesses, but provides little transparency on how consultant advice in assessing businesses is formulated and weighted, there is danger for consumer outcomes in less accountable and transparent 'outsourced' decision making.

## **Encouraging long-term planning – the 3-3-6 model**

PIAC broadly supports the proposal to move to a 3-3-6 model for determination periods. But we do not agree that this alone is sufficient encouragement for long-term planning. While longer than most determination periods under the current regulatory framework, six years is not a long-term timeframe by any measure. Water businesses must plan for risks and eventualities that extend over decades and manage infrastructure with asset lives of up to 100 years.

A six-year determination period does give greater scope for businesses to focus on engagement and developing and implementing long-term plans to deliver better outcomes in the interests of consumers and the community. Six-year determination periods should be considered as a part of encouraging long-term planning, but not sufficient to enable or ensure it on their own.

The mid-point check-in architecture is a useful addition. It should be used as an opportunity to assess performance indicators determined as part of acceptance of the proposal covering that period. These performance indicators should be proposed by the business as credible evidence of progress implementing its long-term plan. In this way the business is encouraged to set long-term horizons, while plotting three-year progress points where it can be assessed against the outcomes it has set itself to deliver.

IPART should also have clear assessment criteria it will consider at the mid-point check-in, in addition to those the business sets. It should be clear to businesses that failure against identified performance criteria may result in reopening the determination or the application of a penalty or sacrificed incentive where appropriate.

**Question: Given the new 3-3-6 model, should we make changes to the way pricing and licencing align?**

PIAC agrees comprehensive licence reviews at every instance is unnecessary. Implementation of a new regulatory framework is an opportunity to alter the way licencing reviews interact with pricing reviews to support the objectives of regulation and outcomes in the long-term interests of consumers and the community. There is merit in considering how licencing reviews could target issues of concern identified through the ongoing process of pricing review so as to become a more effective tool in improving the operation of businesses.

PIAC recommends IPART set out conditions that govern how the scope of any licencing review should be determined and by whom. Any decisions regarding the content of licence reviews should not be unilateral, and should be subject to transparent principles, with the potential for consumers to nominate an expanded scope.

## **Updated cost pass-through guidelines**

PIAC does not consider the current guidelines for cost pass-throughs are operating in the consumer interest. Businesses are not appropriately managing risk if they regularly pass through new costs to consumers, over and above those they have proposed to recover, so regular cost pass-throughs become a material and variable portion of the customer bill

Monopoly water businesses have limited real risk to their viability. The essential nature of the services they provide for the community mean governments and the community will not allow

them to become unviable. While this presents a moral hazard, it is important context to IPART decisions regarding how risks, including those that may be unforeseen, are handled. Water businesses should be capable of managing risks, as a foundational aspect of good management. This is particularly so for monopoly utility businesses where there is no material risk of losing customers.

PIAC considers it is more appropriate for water businesses to manage risks through better integration of proposals into long-term plans to manage demand (through targets), smooth prices, and develop mechanisms to ‘self-insure’ for unforeseen risks. In any case, such measures should precede any recourse to cost pass-throughs.

In updating the guidelines, IPART should consider narrowing the applicability of cost pass-throughs and providing direction to businesses to seek other means of addressing risks they are best placed to manage on behalf of consumers.

## **Continued engagement**

PIAC welcomes the opportunity to meet with IPART and other stakeholders to discuss these issues in more depth.