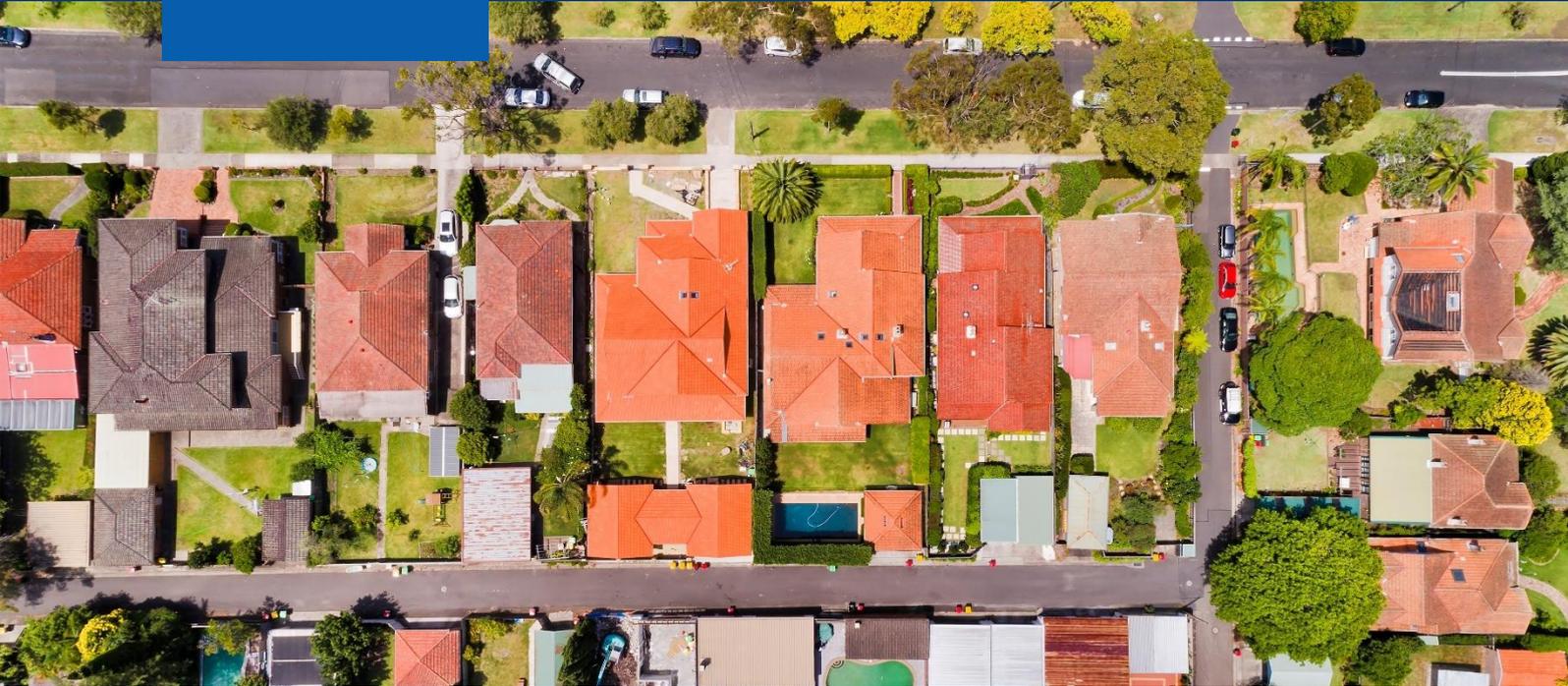




WATER SERVICES
ASSOCIATION OF AUSTRALIA



WSAA Submission

IPART Discussion Paper: Encouraging Innovation in the Water Sector

25 October 2021



Submission to IPART Discussion Paper: Encouraging Innovation in the Water Sector

Thank you for the opportunity to provide a submission in response to IPART's discussion paper *Encouraging Innovation in the Water Sector*.

WSAA congratulates IPART for conducting a comprehensive review of its framework, and for its willingness to embrace change in the framework.

The discussion paper presents a new and fundamentally different regulatory approach.

In its submissions to this review, and its presentations to workshops, WSAA argued that the challenges facing the industry mean that utilities and regulators will need to do things differently. These challenges include maintaining an ageing asset base, providing for significant population growth and, critically, managing and mitigating the impacts of climate change. We set out evidence that the industry nationally has already increased capital expenditure significantly since 2014. In the medium term this will require real price rises. In turn this will place increased focus on the price setting process. We consider this creates a burning platform for change.

This is a key reason why IPART's emphasis on customer outcomes is important and we support major elements of the new framework.

Objective of economic regulation

We are particularly pleased that IPART has unambiguously stated its objective of economic regulation. During the workshops held as part of the review, IPART facilitated discussion around the objective of economic regulation. We welcome IPART's clarity that that it regulates *in the long-term interests of consumers*. While this may seem obvious to many economic regulation practitioners, we consider it remains critical to keep it front and centre of the process.

A shift to customer outcomes

In its submission to the review WSAA we set out our support for regulatory approaches that support greater customer focus. We argued that customer preferences should be at the centre of the regulatory regime. The onus is on utilities to understand their customers' needs and demonstrate to the regulator in a rigorous way that they are being followed through.

We also argued that there should be greater use of incentives to support innovation and efficiency.

Each of these elements is embodied in IPART's three C's approach. As the discussion paper says:

A focus on customers, costs and credibility – the 3Cs framework – would empower the business to 'put its best foot forward' to deliver pricing proposals that meet the long-term interests of customers.

As we see with the PREMO model in Victoria and in the quote, the fundamental change has been to *empower* utilities. The framework re-defines the role of the utility and regulator in relation to customers. Utilities have greater responsibility and accountability for customer outcomes. The regulator's role is to hold the utility to account to deliver customer outcomes rather than itself be the voice of the customer. This empowerment involves a risk transfer to utilities. It is a risk transfer that is appropriate and that they are willing to embrace, but one that should also be explicitly acknowledged in the regulatory framework. Two observations follow from this.

First, it is this empowerment through the 3 Cs which provides very significant and high powered incentives *by its nature*. Greater transparency creates very strong reputational incentives to engage deeply with customers, and to deliver on the outcomes they demand and are willing to pay for — including greater efficiency over time. In addition, a requirement to report on delivery of those outcomes creates strong incentives to get them right in the first place and to have a clear plan for delivery.

The rankings of standard, advanced and leading add to the incentives of the regime but are not the source. The source is the empowerment of the utility to define customer outcomes and being held to account for their delivery.

The second observation is that while all utilities have embarked on a customer journey, it should not be underestimated how much utilities will have to adapt to meet the three Cs framework or the resources required. Overall, the guidance provided in the 11 principles set out expectations clearly to all parties of what good looks like. However, in the transition to the new framework some flexibility in guidance may be required as all parties adjust to the new world.

It is also important that there is sufficient time to implement the new framework. One example of the complexity facing utilities relates to costs – one of the three C's. All business should become more efficient over time and be able to demonstrate that to customers. However, as set out in our opening comments, for some utilities this is likely to involve demonstrating underlying cost efficiencies against background of rising costs overall — and where ageing assets are concerned, increasing costs to maintain similar service levels to customers. The analysis, framing and engagement with customers on this task is likely to be significant.

Areas for refinement

WSAA supports the core three C's elements of the new framework. However, as with any radical change we think the framework is unlikely to be fully formed at its first appearance.

The framework brings together elements of the Victorian PREMO, framework, Ofwat's UK framework and incentive mechanisms from the Australian Energy Regulator. WSAA has not worked through all the individual incentive elements. However, from a reading of the discussion paper, it is not clear how they all fit together or whether they are all necessary.

There are three types of regulatory incentives: financial, procedural and reputational. Each has a role to play but each must be calibrated to suit the particular regulatory circumstances.

In this case, reflecting the points made above, it may be that IPART has not fully appreciated the strength of the reputational incentives contained within the core 3Cs approach.

If the 3Cs are doing the heavy lifting it is not clear whether the ex-post expenditure incentive mechanisms such as the CESS fit within the ex-ante expectation of companies with specific gradings proposing costs on the efficiency frontier.

Nor does the framework appear to make as great a use of procedural incentives as possible. Fast tracking or lighter efficiency reviews have can provide a financial benefit to utilities, but more significantly they serve as a significant internal motivation for utility staff and a reward for effort.

WSAA suggests that if the broad framework is supported there is an opportunity for utilities and IPART to engage further in the co-design of the incentive framework.

Finally, WSAA notes that customers prefer certainty and predictability in water bills over time, whether bills remain flat in real terms, or more likely, increase in the medium term. Price spikes, or large fluctuations in prices, are more difficult for customers to manage, budget for, and contribute to affordability pressures.

We note that IPART is proposing to move to a longer determination of 6 years in the form of 3+3. However, longer determinations are not the only way to achieve a longer-term price settlement, and by themselves may not be the whole answer. There are a range of mechanisms that could be used to ensure predictable price paths and price smoothing across determinations.

Specific mechanisms could be proposed by utilities or jointly developed with the regulator. Such mechanisms should work for customers and for utilities. The intention is not to 'protect' the revenue of utilities; rather they should be symmetric in how they operate (balanced between consumers and utilities). Relative to the status quo, over some determination periods utilities may recover less than they would otherwise, and in other periods they may recover more. Over time the outcome should be neutral.

WSAA believes that smoothing or adjustment mechanisms can support the long-term interests of customers and could be included in IPART's framework without disrupting its fundamental architecture.



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