DRAFT WATER REGULATORY FRAMEWORK

AUGUST 2022

Response to IPART's Draft Report
Regulating Water Businesses Special Review

Acknowledgement of Country

Hunter Water operates across the traditional country of the Awabakal, Birpai, Darkinjung, Wonaruah and Worimi peoples. We recognise and respect their cultural heritage, beliefs and continuing relationship with the land, and acknowledge and pay respect to Elders past, present and future.

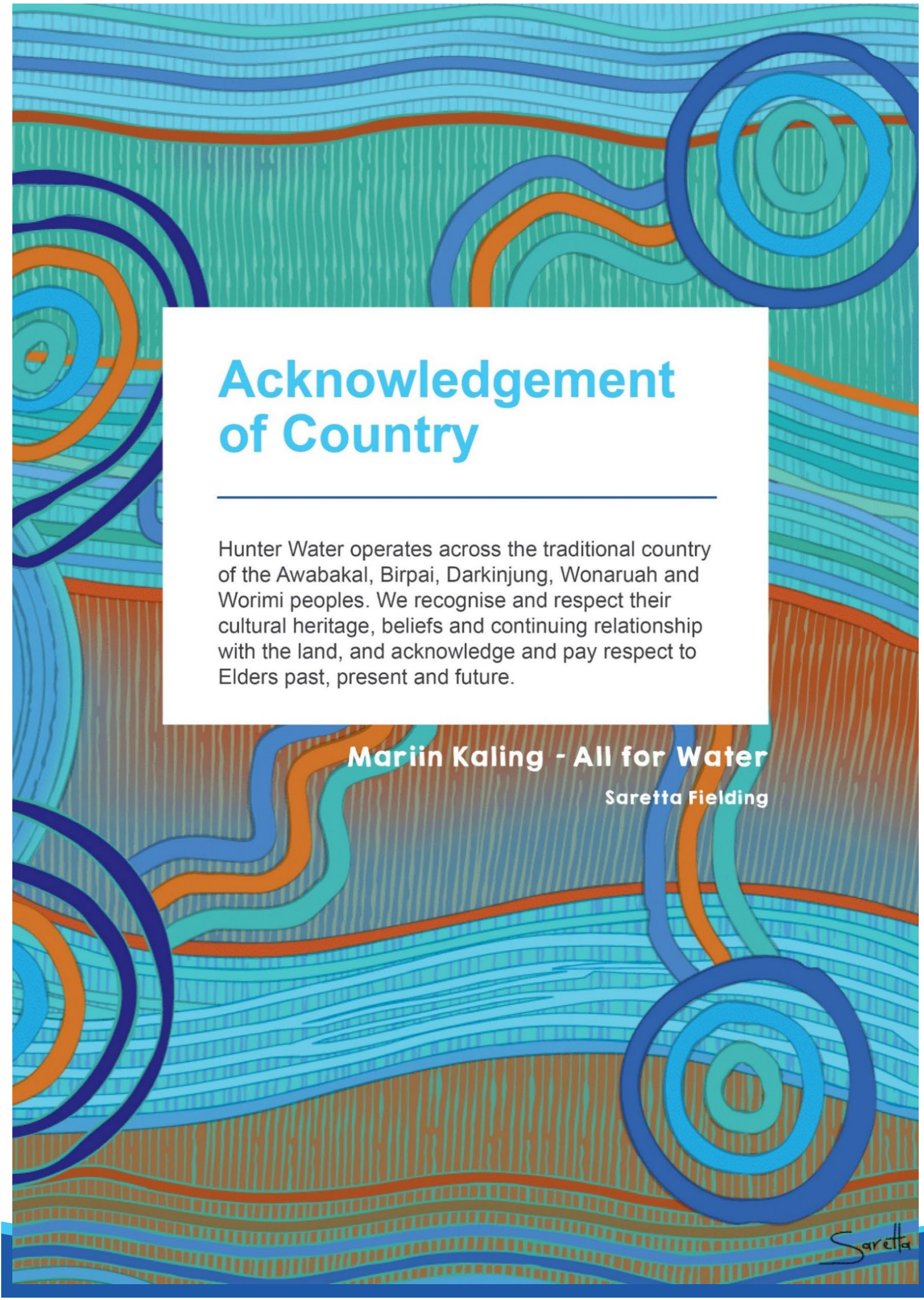


TABLE OF CONTENTS

OVERVIEW

IPART's new regulatory framework takes a big step in the right direction. Hunter Water supports the key elements of the framework and the improvements to regulatory guidance and process. Over the last two years, IPART has invited an open exchange of ideas, provided multiple opportunities for constructive feedback, and drawn on regulatory best practice in the water and utility sectors.

IPART's role, like all economic regulators, is to protect the interests of customers in a sector dominated by a single service provider. IPART ultimately makes judgment calls on efficient costs, service levels and financial returns. The current regulatory model relies far too heavily on third-party expenditure consultants to inform those decisions.

The centrepiece of IPART's new framework is the 3Cs model: customers, costs and credibility. As detailed in earlier responses, we strongly support the shift in emphasis to customer centricity, engagement and outcomes. IPART's framework will see the water businesses fully responsible and accountable for designing and carrying out meaningful customer engagement activities. We share a common end goal of improving customer value.

Our 2024 regulatory proposal will need to show how we have reflected customer insights and feedback in our investment plans and service commitments to the end of the decade. We will need to show how we've given customers the ability to participate and influence the design of outcomes that matter the most. We welcome and accept this challenge.

Hunter Water welcomes IPART's commitment to earned autonomy. *"We commit to streamline reviews where a business can demonstrate better customer value for money and provide well-justified and transparent plans".* [1]

The new regulatory framework includes changes to the way IPART approaches expenditure reviews: base-step-trend for operating costs, changes to information returns to support benchmarking, reviewing historic expenditure by exception, and use of predictive capex models. We are keen to work with IPART on how this information, in conjunction with the 3Cs model, can help make the case for a streamlined expenditure review.

IPART makes a number of improvements to the positions in the three 2021 discussion papers:

- We agree with IPART's decision on a five-year determination period. This provides water the businesses the time to do long-term planning, get on with delivering investment programs, the right break between major engagement work for each proposal.
- We support a nine-month price review, starting 1 October of the proposal year. We intend to produce a shorter, customer-focused proposal capturing the key elements of expenditure, services, outcomes and prices, with supporting documents available to the Secretariat. This may provide IPART an opportunity to re-think the content and questions in the issues paper.
- IPART has provided additional guidance on the scope and pathway for cost pass-through mechanisms.

Our response questions two aspects of the grading matrices: where IPART's assessment is above the business's self-assessment, and the financial penalty for lower ambition in subsequent rounds. We suggest that IPART's concern around water sales revenue caps could be ameliorated by the use of a side-constraint on any annual increase in water service charge.

We reaffirm our support for the Regulators Advisory Panel, the shadow price of leakage, and the annual reporting of outcome metrics in a way that is accessible to customers.

Hunter Water's response to Discussion Paper 3 questioned the merits of layering the expenditure incentive schemes on top of the 3Cs model. The 3Cs is designed to encourage and reward regulatory best offers, backed by evidence showing ambition on expenditure levels and risk management.

While we do not oppose the introduction of the efficiency benefit sharing scheme (EBSS) and capital efficiency sharing scheme (CESS), we support capping the schemes in the first regulatory period. This would help mitigate concerns and risks related to unanticipated effects. We support businesses having the opportunity to propose both the level of the cap, and whether the caps apply equally across schemes.

[1] IPART, May 2022, *Draft water regulatory framework: Delivering customer value,* page 22.

In this response, we identify several scenarios where the incentive schemes may not work as intended or where the payments may not reflect an efficient movement in costs. We consider IPART should apply regulatory discretion to review and adjust scheme payments. Our concerns about the mechanics of the scheme would be alleviated if we had the opportunity to explain movements against allowances set many years in advance. We welcome IPART's statements on the linking of the EBSS and CESS to the cost pass-through arrangements.

We support the introduction of an ODI scheme. Linking incentives to outcomes will help drive greater customer value. However, the scheme has many unresolved questions, uncertainties about design and unknowns around the power of incentives. We look forward to working with IPART to address these issues as draft outcomes are developed. Our questions are probably best resolved using actual case examples.

Hunter Water supports IPART's proposals to simplify aspects of the inputs and adjustments within the building block model. We agree that materiality should always be a key determinant of regulatory effort. There is a natural tendency, by the regulator and the regulated businesses, to focus on exactness and accuracy. This can create complexity when inputs represent a small fraction of the overall revenue requirement. We specifically comment on two changes:

1. IPART proposes to use two asset categories per service (depreciating and non-depreciating assets) and allow the weighting of asset lives by relative depreciation or by the value of assets. Hunter Water is very familiar with these questions after disaggregating our RABs during the 2019-20 price review. We strongly support IPART's approach. Given the importance of regulatory depreciation to revenues and funds from operations, we have no problem with doing the work necessary to maintain an asset register and update and re-weight asset lives at each review.
2. We agree with IPART's proposal to apply a default 50:50 sharing rule for commercial revenues derived from the use of regulated assets, as is currently the case. However, IPART should not impose this as a blanket rule. There may be circumstances where we would incur significant additional costs and risks to generate net returns from a project. We strongly suggest that IPART allow exceptions above a materiality threshold, as proposed for asset disposals.

IPART's new regulatory framework incorporates multiple new schemes, incentives, guidance and processes – a major shift from past IPART regulatory philosophy and practice. We are comfortable with the key concepts and the focus on listening to customers. Nonetheless, the number and scope of changes is daunting. We are eager finalise the current review and get on with the job of planning, preparing and publishing our proposal over the next two years.

We welcome IPART's preparedness to consult with individual businesses and conduct industry workshops on the grading guidance and the new elements of the framework. Finalising a 'handbook' that sets out IPART's expectations for each of the 12 principles should be a high priority. This will provide water businesses with the details needed to confidently prepare all key inputs to the proposal and associated price review processes – preparations that are already well underway for 2024. A well-written and comprehensive handbook will help give all businesses, large to small, the direction and guidance necessary to interpret and implement the new framework.

We acknowledge that Hunter Water and the other businesses have a key role to play in finalising the handbook. We provide feedback IPART in the next few weeks on the draft guidance for the 12 principles: things we agree with, areas where we are unsure, and suggested drafting changes.

The 3Cs model and the grading of proposals introduce new forms of IPART decision making and the exercise of judgment. The Board attestation and the risk of a rating downgrade are important elements of the new approach. But the reality is we have no IPART precedent to interpret and learn from. There is apprehension within the business given the level of subjectivity in the rating decision. We have the option of submitting a standard proposal if we are not confident we understand how or whether we satisfy IPART's expectations for a higher grade.

There is no easy way of moderating or removing doubt for businesses under the 3Cs model, particularly given the disparity in size and functions of the NSW water businesses. We recognise that IPART does want to take a prescriptive approach to detailing how the businesses would meet different expectations. One of the features of the model is that it gives businesses the flexibility to identify focus principles and design engagement programs suitable for different customer bases.

The new framework sets out a proposed cycle of engagement and price setting. This includes a stage of early engagement between the business and IPART one to two years before the proposal is due. Hunter Water suggests that this is a crucial step in the new model, especially during the first round of proposals. This is consistent with IPART's commitment to an open-door policy: *"we will seek to proactively engage with board directors, executive leadership teams, to ensure businesses understand the objectives behind this framework and have confidence in its applications"*. [2]

We welcome IPART's statements on supporting each business. We note that IPART regulates far fewer water businesses than the Essential Services Commission. This is a positive in terms of the time and effort required to meet with each business, more than once, over the next two years. Open and effective communication between the Tribunal and our Board will be important in clarifying expectations and testing engagement plans and focus principles, especially during the first round of the new model. IPART's early feedback needs to clear and direct if there are concerns about any gaps or weaknesses. We welcome and acknowledge the Tribunal's and Secretariat's time and willingness to collaborate over recent months.

Our final comment relates to IPART's commitment to continuous improvement. Hunter Water has become accustomed to IPART's focus on expenditure reviews and tariff structures over the last 20 years. Each review has involved longer price submissions in the pursuit of accuracy on individual elements. The new framework marks a major a shift in thinking and process. We see this review as setting a new direction for many price reviews ahead.

We will not get everything right in the next round of proposals; nor will IPART. There is no perfect model – only better ways. We agree that it is important to undertake a step-back review after each round of price reviews, inviting water businesses to reflect on what worked well and areas for improvement. In that way, IPART's next review of the regulatory framework can focus on incremental refinements to the new schemes and processes.

[2] IPART, May 2022, *Draft water regulatory framework: Delivering customer value,* page 22.

1. INTRODUCTION

IPART's *Draft Water Regulatory Framework* and *Technical Paper* mark the sixth and final round of consultation in this review. The draft regulatory framework incorporates many of the proposals set out in IPART's August 2021 Discussion Paper 3, *Encouraging innovation in the water sector*, and earlier papers. This response provides comment on on key elements of the new framework, rather than addressing each of IPART's 21 draft decisions in turn:

- Section 2, 'A big step in the right direction', outlines Hunter Water's overall support for the new framework and the IPART's commitment to regulator 'step back' reviews on regulatory framework.
- Section 3, 'Delivering customer value with a new pricing framework', describes our support for the proposed 3Cs approach, and 12 principles. It commends the progress to date in collaborating with water sector stakeholders to develop the associated grading guidance whilst noting that there is still much work to be done to assist with implementing the framework. It also discusses the rating regime, focussing on how it is applied over multiple regulatory periods.
- Section 4, 'Using in period financial incentives', considers IPART's three proposed incentive schemes that would result in financial adjustments in the subsequent regulatory period. In our opinion, the service levels (outcome delivery) incentive scheme is most important of the three incentive schemes and yet it is the least developed.
- Section 5, 'Managing changing revenue needs', describes over views on changes to the regulatory framework to address uncertainty in the ability to recover efficient costs, particularly where these are subject to external triggers beyond the utility's control.
- Section 6, 'Cost principles and criteria', sets out our support for many of the incremental changes proposed. It seeks to clarify the transition plan for implementation, noting that many of the proposed changes will take time to fully develop and trial – well beyond the 2024 price reviews for Hunter Water, Sydney Water and WaterNSW. It also seeks guidance on the criteria for achieving a fast-tracked or light-handed expenditure review as part of the 2024 price reviews.
- Section 7, 'Simplifying the building block model', describes our support for many of the proposed modelling changes.

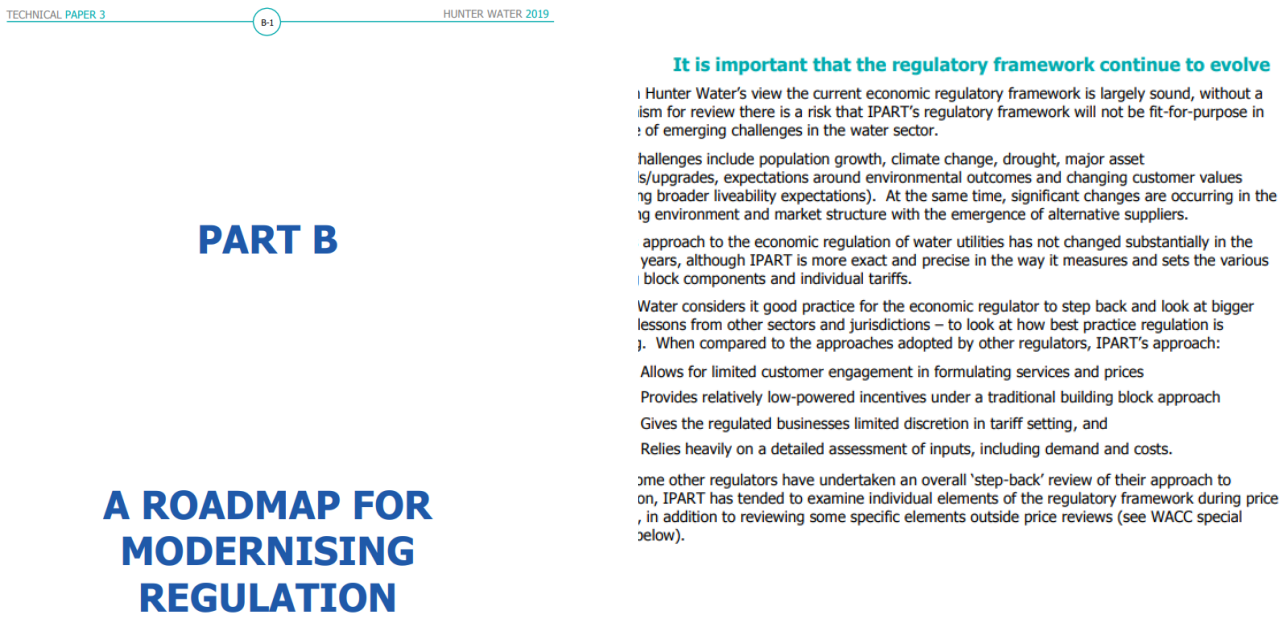
2. A BIG STEP IN THE RIGHT DIRECTION

Hunter Water's 2019 pricing proposal set out a roadmap for regulatory reform. We noted the importance of undertaking step-back reviews of the regulatory framework, and the difficulties of making change under a four-year cycle or within price reviews. We noted key trends in other sectors, and observed how economic regulators published methodologies or statement of approach prior to price reviews.

Our 2019 proposal identified five focus areas for regulatory reform:

- Economic regulator giving greater weight to the customer and community engagement that informs expenditure proposals
- Linking performance standards and prices
- Driving cost and service improvements
- Setting tariff structures
- More cost-effective environmental regulation.

IPART's two-year review has examined all of these issues, in one way or another, and made key changes in many areas. We appreciate the work of the Tribunal and Secretariat in consulting with the sector and introducing substantial changes to the framework. We agree with and support the IPART's overall direction and most elements of framework. We are eager to get on with implementing the new framework, with a degree of trepidation about the number and scope of new schemes, guidance and processes.


TECHNICAL PAPER 3 B-1 HUNTER WATER 2019

PART B

A ROADMAP FOR MODERNISING REGULATION

It is important that the regulatory framework continue to evolve

ı Hunter Water's view the current economic regulatory framework is largely sound, without a ism for review there is a risk that IPART's regulatory framework will not be fit-for-purpose in ⁝ of emerging challenges in the water sector.

hallenges include population growth, climate change, drought, major asset s/upgrades, expectations around environmental outcomes and changing customer values ng broader liveability expectations). At the same time, significant changes are occurring in the ıg environment and market structure with the emergence of alternative suppliers.

approach to the economic regulation of water utilities has not changed substantially in the years, although IPART is more exact and precise in the way it measures and sets the various block components and individual tariffs.

Water considers it good practice for the economic regulator to step back and look at bigger lessons from other sectors and jurisdictions – to look at how best practice regulation is]. When compared to the approaches adopted by other regulators, IPART's approach:

Allows for limited customer engagement in formulating services and prices

Provides relatively low-powered incentives under a traditional building block approach

Gives the regulated businesses limited discretion in tariff setting, and

Relies heavily on a detailed assessment of inputs, including demand and costs.

ɔme other regulators have undertaken an overall 'step-back' review of their approach to on, IPART has tended to examine individual elements of the regulatory framework during price , in addition to reviewing some specific elements outside price reviews (see WACC special ɔelow).

2.1. Customers, costs and credibility

IPART's 3Cs model (customers, costs and credibility) is the centrepiece of the new regulatory framework. The 3Cs, along with 12 supporting principles, are the mechanism through which a water business will demonstrate that its pricing proposal promotes customer value.

As stated in our response to IPART's *Discussion Paper 3: Encouraging innovation in the water sector*, Hunter Water supports IPART's 3C model and the preliminary guidance on how IPART would assess pricing proposals against the supporting principles.[3] We think the focus on customer centricity and customer outcomes is particularly important in evolving the framework to better address emerging challenges.

We provide essential services to more than 250,000 customers – customers who do not get a say on who supplies them. Our 2020 service levels engagement (see Figure 1) included an online bulletin board activity with around 50 participants. We heard that top of mind perceptions of a reputable water provider of quality services, who has long-standing in the region, and, essential, effective, experts, accessible and easy to deal with. For a few, Hunter Water is focused on profit-making or slow to respond.

On balance, community impressions are favourable, with most not thinking about Hunter Water (unless a need arises), happy with the service and / or have had no issues (a positive endorsement).

Figure 1: Top of mind customer perceptions of Hunter Water as revealed through an online bulletin board activity in 2020

The 3Cs model makes a fundamental shift in the way customers are protected by IPART in an industry structured around monopoly providers. IPART has set an approach that moves away from a desktop review of submissions, budgets and business cases to a model based on the business listening to its customers.

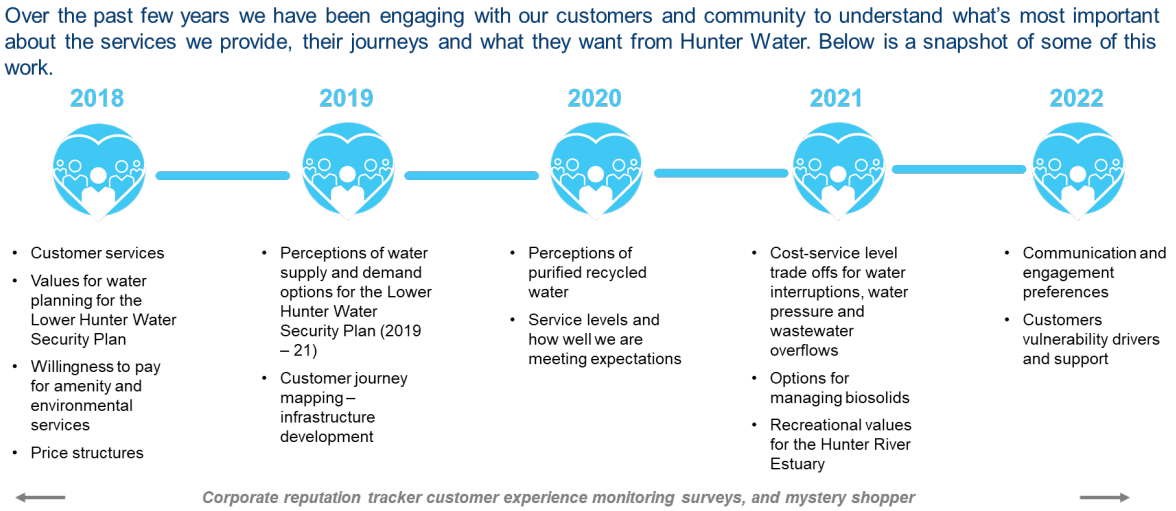
We welcome an approach that entrusts Hunter Water to actively, meaningfully and genuinely know our customers. The crucial element lies in demonstrating that we have not only listened to customers but responded in the way we have developed our investment plans and our outcome commitments. We will work towards a pricing proposal that is not only informed by customers, but a proposal that has customer support – one that delivers better value for customers.

Shifting the focus of price reviews to customers, rather than regulators, aligns with our Towards 2024 strategic focus area *"Customers and communities at the heart of all we do"*, in which we articulate the outcome that *"We will improve customer ease, success, sentiment and satisfaction by delivering services that meet their expectations"*.

Hunter Water has a strong foundational understanding our customer and community, as described below and shown in Figure 2.

[3] Hunter Water, October 2021, *Encouraging Innovation: Response to IPART's Discussion Paper 3*, page 4.

Figure 2: Recent conversations with customers to understand values, needs and preferences



In the past five years, we have undertaken over 50 discrete activities to gain a deeper understanding our customers and community. These activities have spanned:

- 6 focus groups activities
- Over 12 discrete in-depth interview activities
- 17 separate survey activities
- Several sets of deliberative forums for the Lower Hunter Water Security Plan
- Ongoing participation at community events and exhibitions

These activities have explored customer and community views on an array of topics including:

- Purified recycled water
- Management of biosolids
- Customer vulnerability
- Investment in rehabilitation and liveability improvements
- Service level and price trade-off preferences
- Carbon abatement
- Water conservation and water security.

We've undertaken an array of programs and activities focused on deepening our understanding of our customer's experiences when engaging with us. These programs and activities enable us to identify gaps in customer experience and undertake process improvements to enhance customer experience.

- Residential customer segmentation
- Non-residential customer segmentation
- Customer communication preferences
- Customer experience monitoring program
- Customer journey maps
- Customer experience surveys
- Mystery shopper program.

Hunter Water has already developed, and commenced implementing, customer engagement plan for the next price proposal, drawing on the experience and best practice in the Victorian water sector under the PREMO model at the AER's 'Towards Consumer Centric Network Proposals'

The first phase is all about hearing first hand from customers about experiences, interests, concerns and priorities. We will explore trade-offs between costs and service levels, test customer outcome commitments, establish a report card and ongoing accountability mechanisms in later phases. We are confident that involving customers and the community more closely than ever before in developing our strategic direction, business plans and pricing proposal will result in better customer value and satisfaction.

2.2. Five-year regulatory period

Hunter Water welcomes IPART's position on the longer determination period. This will give the businesses an extra year to get on with the work of delivering capital programs and implementing business plans. The water sector is relatively stable in terms of licence requirements and movements in growth rates for connections and consumption. An extra year provides extra time to observe underlying investment trends in the sector and the region before updating our investment plans.

IPART's new regulatory model relies on genuine and broad-ranging engagement, capturing feedback from a cross-section of customers on most aspects of our service offering. Based on expert external advice, we need at least a two-year period to design and carryout this work properly. This includes a period of time to incorporate customer insights, preferences and outcomes into our price proposal. A five-year period allows the time to do this well, while avoiding engagement fatigue with customer groups and representatives.

We note that IPART would have struggled to complete this broad-ranging review without a one-year extension of the current price periods for Hunter Water, Sydney Water and WaterNSW.

2.3. Periodic review of the regulatory framework

We support IPART's overall direction and the emphasis on customer value. We also recognise that any set of incentives schemes and regulatory guidance will always be a work in progress. We support a 'step-back' review after each round of price reviews as way of constantly refining and improving the framework. IPART's work should be guided by a philosophy of encouraging regulatory best offers, avoiding complexity and false precision wherever possible.

3. GRADING PROPOSALS

IPART's proposed 12 principles are designed to provide water businesses with guidance on the regulator's expectations for pricing proposals at various grades: standard, advanced and leading.

IPART envisages that its guidance will "*enable water businesses to design their own customer-centric pricing proposals and engagement strategy*".[4]

3.1. Guidance handbook

Hunter Water will need to assess how its performance compares against IPART's expectations, as set out in a guidance handbook that IPART is developing in collaboration with the water sector. The handbook will specify expectations at each grade level for each principle. IPART states that businesses can select 'focus principles' from each 'C' that are most important to customers.

We look forward to refining the detail through industry workshops. We will provide detailed feedback on the draft guidance over the coming weeks.

3.2. Grading matrices

As outlined in our response to IPART's discussion paper 3, we are is likely to respond best to incentive schemes that have a reputational effect or procedural benefit, similar to the experience of the government-owned water businesses in Victoria. We accept the premise that the modest uplift in annual revenue requirements for advanced and leading proposals would:

- Provide water businesses with additional headroom to manage risks, or fund innovation
- Not increase end-user bills because the additional revenue is at least offset by cost savings or service level increases.

There is room to further improve the proposed grading tables. We observe that the Essential Services Commission adopted the principle that it cannot rate a pricing proposal higher than a water businesses self-assessment under the Performance Risk Engagement Management Outcomes (PREMO) framework.

IPART's proposed assessment table for a business previously assessed as having a standard proposal does allow for a one-step upgrade. We question whether this approach is consistent with the message that pricing proposals should be the businesses 'best offer'.

We seek clarity from IPART on how the rating matrix and guidance handbook evolve overtime. We welcome IPART's commitment to continuous improvement, including supporting each water business to *"improve on its performance year-on-year and become a leader in the industry"*.[5]

We accept the premise that adopting two pricing proposal rating matrices, one subsequent to achieving at least an 'advanced' rating, provides a safeguard against regression. However, there is also a risk it may discourage water businesses from striving for a higher rating in the first application of the new framework.

This risk can be illustrated with examples. We expect that IPART's guidance handbook would evolve over time as advanced practices become adopted as the norm, as shown in Figure 3. Whilst standard water businesses would be 'catching up', they would need to grow in maturity more quickly to achieve an advanced or leading rating.

A water business that self-assesses, and is confirmed by IPART as 'advanced' in the 2024-25 price review, will earn a 1.25% uplift in the annual revenue requirement (see Figure 4). The same water business must then be graded as at least 'advanced' in subsequent price reviews or else it would under-recover its efficient costs (see red shaded cells in Figure 5). However, when combining the second rating matrix in Figure 5, we are concerned should IPART constantly "sets the bar higher", the water business must make a step improvement simply to recover its efficient costs.

[4] IPART, May 2022, *Draft Water Regulatory Framework*, page 14.
[5] IPART, May 2022, *Draft Water Regulatory Framework,* page 22.

We are reassured by IPART's commitment to 'openness' and 'act fairly' in supporting implementation of the new framework. We understand that businesses would be consulted on future revisions to the guidance handbook. However, we have concerns that the second rating matrix, with penalties for rating drops, may dissuade ambition in the first round given the exposure to financial penalties in 2030.

Figure 3: Conceptual example of the guidance handbook evolving over time

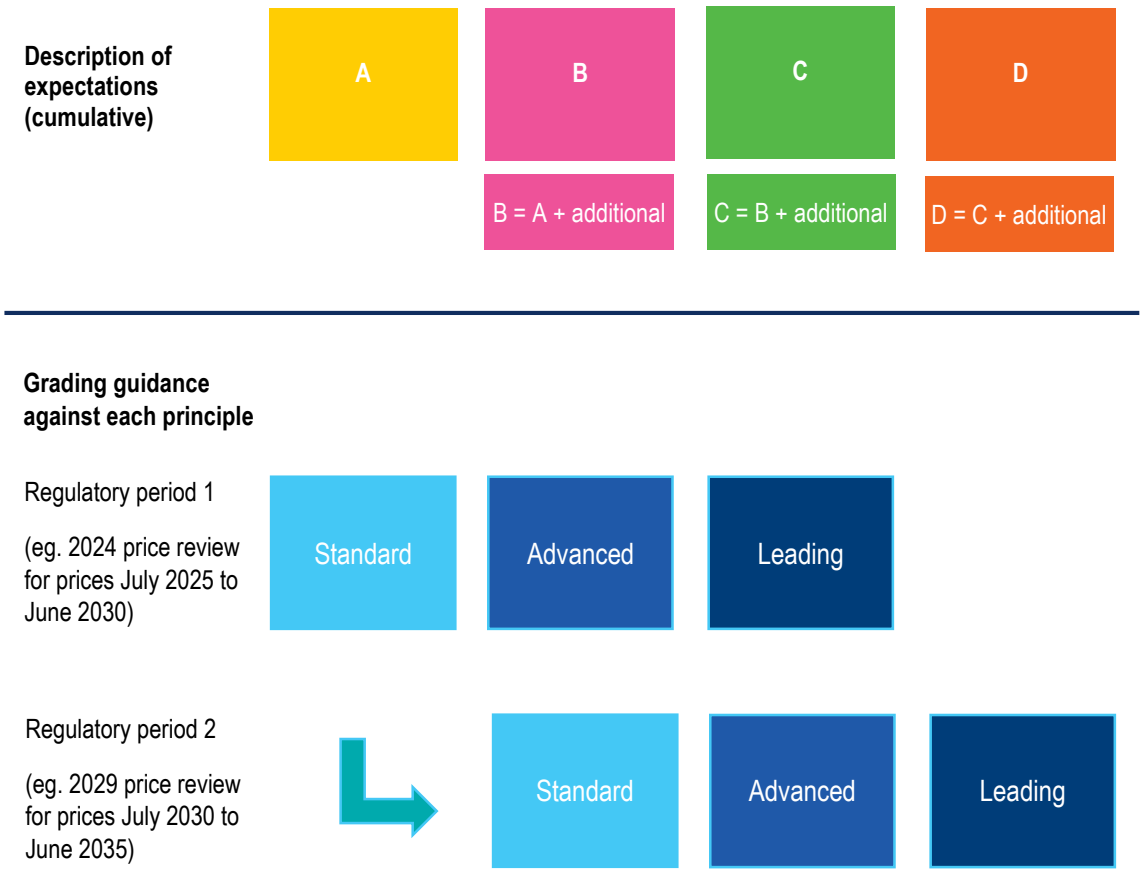


Figure 4: Hypothetical water business rating in 2024-25 price review

	Business's self-assessment		
IPART's assessment	**Leading**	**Advanced**	**Standard**
Leading	2.5%	1.75%	n/a
Advanced	1%	**1.25%**	0.5%
Standard	-1%	-0.5%	0%

Source: Rating table from IPART, May 2022, *Draft water regulatory framework: Delivering customer value*, Table 4.

Figure 5: Hypothetical water business (from Figure 2) rating in 2029-30 price review

	Business's self-assessment		
IPART's assessment	**Leading**	**Advanced**	**Standard**
Leading	1.25%	0.5%	n/a
Advanced	-0.25%	**0%**	-0.5%
Standard	-2.25%	-1.75%	-1.25%

Source: Rating table from IPART, May 2022, *Draft water regulatory framework: Delivering customer value*, Table 4.

3.3. Linking the form of price control to IPART's grading

IPART's draft guidance for the 3Cs model states that advanced and leading proposals will be able to propose different forms of price control, either price caps or a maximum revenue requirement.

> *"We believe there are strong benefits to customers of both forms of price control and will allow moves towards revenue caps where businesses make a convincing case it is in the interests of customers."*[6]

We note Sydney Water's comments on the linking of the grading guidance and form of price control at the public hearing on 16 August 2022. We agree with Sydney Water that IPART should consider the form of price control independently of the decision on a particular grade.

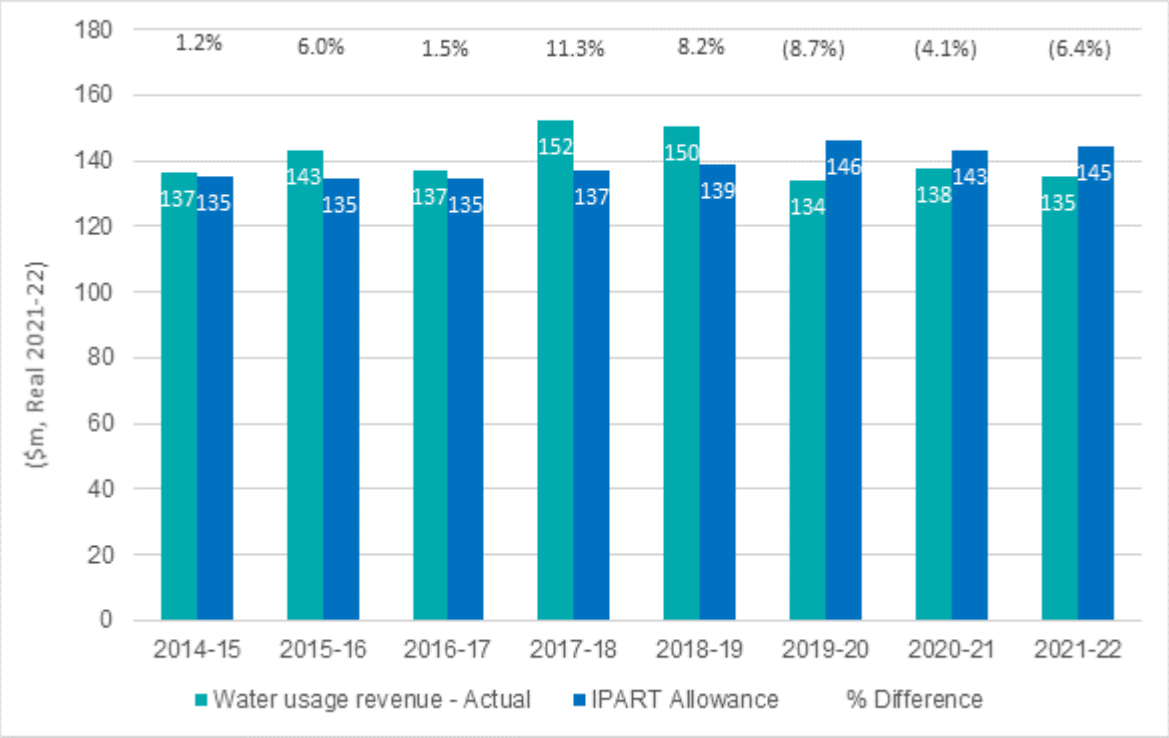
Hunter Water's response to Discussion Paper 1 provided detailed commentary on the merits of maximum prices and annual revenue caps for water sales.[7] We outlined three advantages of a revenue cap:

- Credit rating agencies consider revenue variability when making credit-rating assessments, potentially increasing the borrowing costs of regulated utilities under price caps.
- The difficulty associated with accurately forecasting water sales many years ahead, particularly following periods of extreme dry or wet conditions.
- Setting maximum prices create a disincentive for businesses to pursue additional water efficiency activities with end-use customers. The more successful the water efficiency program, the lower the revenue and the lower the net earnings.

Figure 6 shows Hunter Water's actual water sales compared with IPART's allowance for usage revenue over the last decade. IPART set a maximum water usage price during this time. There are years well below the allowance and years above. After three consecutive years of water sales well below IPART's allowance, we again face the prospect of another wet La Nina year in 2022-23.

[6] IPART, May 2022, *Draft water regulatory framework, Technical Paper, Delivering customer value,* page 29.
[7] Hunter Water, June 2021, *Lifting performance in the water sector: Response to IPART's Discussion Paper 1*, section 2.

Figure 6: Actual compared with IPART decisions on water sales, $million, $2021-22



Source: Hunter Water.

IPART's demand volatility adjustment mechanism (DVAM) is designed to true-up water sales revenue, above and below a 5% threshold. Hunter Water's current revenue requirement includes an adjustment to repay part of the higher usage revenue recovered over the 2016-17 to 2018-19 period. This is effectively a hybrid form of price control; a price cap with partial revenue smoothing in the subsequent regulatory period. Under this mechanism, there is long lag in the true-up of a significant under or over recovery of water sales revenue.

Economic regulators in the water and energy sectors use different forms of price control, with revenue caps the dominant model in Australia.

We agree, under either approach, that the usage price should be set with reference to the long-run of water supply. We currently recover 95% of total water revenues through the usage charge. We are working to updating our LRMC estimate using the sequencing of investments in the Lower Hunter Water Security Plan.

An annual water sales revenue cap, with an adjustment to the service charge in the following year, allows the water business to recover efficient costs. We do not see this as a major change to the regulatory model, rather as a shortening of the lag in the DVAM true-up.

We acknowledge that IPART considers bill stability when determining the structure of charges. We agree that this is an important factor. Other economic regulators use 'side constraints', a fixed percentage or dollar amount, that limits the movement in bills year to year. Should we propose a water sales revenue cap in 2024, we would include a one-sided constraint limiting annual increases in service charges.

4. USING IN-PERIOD FINANCIAL INCENTIVES

Hunter Water's response to Discussion Paper 3 questioned the merits of introducing multiple new incentive schemes. We observed IPART's 3Cs model was designed to encourage and reward regulatory best offers. Water businesses will need to show a level of ambition and efficiency on costs, both operating and capital, to satisfy IPART's guidance for higher-quality proposals.

IPART's Technical Paper outlines expectations for advanced and leading proposals. Under the 'robust cost' principle, an advanced proposal would need to provide evidence which demonstrates value by proposing step changes for operating costs. A leading proposal would be supported by modelling which shows costs are below industry benchmarks. Similarly, under the 'commitment to improve value' principle, an advanced proposal would need to show a cost efficiency strategy with an ambitious annual expenditure efficiency factor, and a leading proposal would need efficiency targets with significant step changes below industry benchmarks.

Hunter Water recognises the expenditure incentives would be applied ex-post, with payments or penalties paid as revenue adjustments in the 2030 price review. Nonetheless, we need to be mindful of the likely or possible future impacts of the schemes when considering expenditure levels. Any board of directors would be anxious about regulatory schemes where decisions today can penalise the business five or six years later.

4.1. Efficiency Benefit Sharing Scheme

Economic regulation using a building block model has existing financial incentives for businesses to spend less than expenditure allowances.

The EBSS is designed to further strengthen the incentive for regulated utilities to reveal lower costs in the final years of the regulatory period. Conceptually, there is a weaker incentive to drive down operating costs in the year that sets the base allowance for the next regulatory period.

Hunter Water supported IPART's existing Efficiency Carryover Mechanism in 2016, effectively a one-sided version of the EBSS scheme. We acknowledge the role the EBSS plays in shaping the end-of-period incentive to drive operating costs lower.

In the following section, we highlight two scenarios where the EBSS produces counter-intuitive results.

4.1.1. Scenario 1: Movements between operating and capital costs

We finalised expenditure plans for our 2019 price proposal to IPART in late 2018. At that time, we could not have foreseen the shift of digital and information and communications technology solutions away from on-premise infrastructure to cloud-based services. Nor could we have foreseen the shift in accounting treatment of cloud-based digital projects from capital to operating expenditure.

Hunter Water expects to spend more than $20 million on software-as-a-service (SaaS) projects in the current regulatory period. We received accounting advice on the SaaS expenditure in 2021. We had no credible basis for forecasting this additional operating expenditure leading into the last price review.

The EBSS would identify this in-period deviation as an inefficiency and impose penalties, or a lower reward, in the following regulatory period.

This type of cost movement has a strikingly different impact of the timing of expenditure movements within the regulatory period. Assuming a $10 million addition to operating costs, the penalty is much larger if the forecasting error is in the last year (Table 2, $42 million penalty) than the first year (Table 1, $9.4 million reward).

Table 1: EBSS – First year shift from capex to opex

$m opex	FY26	FY27	FY28	FY29	FY30
Allowance	170	170	170	170	170
Actual	180	170	170	170	170
NPV of EBSS payments					**9.4**

Source: Hunter Water analysis.

Table 2: EBSS – Final year shift from capex to opex

$m opex	FY26	FY27	FY28	FY29	FY30
Allowance	170	170	170	170	170
Actual	170	170	170	170	180
NPV of EBSS payments					**-42.0**

Source: Hunter Water analysis.

The increase in operating expenditure would correspond with an equivalent reduction, a $10 million underspend, in capital expenditure in that year. However, there is not a symmetrical treatment of gains or penalties under the CESS scheme. The incentive effect differs for two reasons:

1. Difference in the intensity of payments: the EBSS penalties and rewards are more powerful per dollar of expenditure – see Table *3*.
2. Timing difference inherent in the design: incentives in the EBSS are more heavily weighted toward the end of the regulatory period, relative to the CESS.

Table 3: CESS – Final year shift from capex to opex

$m capex	FY26	FY27	FY28	FY29	FY30
Allowance	170	170	170	170	170
Actual	170	170	170	170	160
NPV of CESS payments					**1.7**

Source: Hunter Water analysis.

4.1.2. Scenario 2: Changes in uncontrollable costs

Hunter Water acknowledges that water businesses are responsible for preparing reasonable and robust forecasts of operating expenditure over the regulatory period. Within the period, the business is expected to:

- Manage expenditures within an expenditure envelope, as they face both cost increases and decreases that may offset throughout a regulatory period, reflecting a P50 budgeting approach.
- Improve productivity and drive costs savings.

A water business may experience an uncontrollable cost increase that is not offset by some other cost reduction or saving. Cost changes that are outside the businesses' control do not reflect a change in efficiency or business performance.

With the introduction of expenditure incentive schemes, the water business would pay for this change in cost through lower net earnings during the regulatory period. The business is then further penalised under the EBSS.

Hunter Water incurred almost $15 million in unbudgeted operating costs associated with the drought and the implementation of water restrictions during 2019-20. This was the final year of the previous determination. This included costs associated with water conservation measures, awareness and advertising campaigns, concept design for a desalination plant and costs to operate one of our more expensive sources (Tomago Sandbeds borefield). Our shareholder absorbed the full financial impact of the drought event and higher costs through lower net earnings in that year (compounded by lower water sales).

IPART's 2020 Determination introduced a drought usage price from 1 July 2020. We welcomed the addition of this cost pass-through mechanism. Nonetheless, we offer this as an example of a material uncontrollable cost event, one we could not forecast or accurately cost prior to the event.

Managing the wholesale cost of electricity provides another good example. We've achieved impressive efficiencies in energy use over recent years through changes in operational practices, investment in water network pumping software, and behind the meter solar systems. We progressively purchase electricity contracts to mitigate price risks of fixed term contracting. These substantial efficiencies have been overshadowed by uncontrollable price changes in the competitive energy market, possibly resulting in a doubling or tripling of our wholesale energy costs over the remainder of the regulatory period.

4.1.3. IPART consideration of significant cost events

We accept that we need to manage all operating expenditure, and that there will be cost overruns and cost savings over the course of a regulatory period.

At least as part of the first round of the EBSS, we ask that IPART allow the water businesses the opportunity to document and explain any significant unexpected and uncontrollable operating cost events, like the drought and electricity examples where there was no cost pass-through mechanism in place. These events, should they occur, would need to satisfy a high materiality threshold.

In essence, we are asking that IPART not apply the EBSS in a mechanical manner using a pre-set formula. IPART would consider the business's proposal and evidence of uncontrollable operating costs before calculating and determining EBSS payments. Additionally, IPART would consider the movement in uncontrollable costs when setting the base level for the next regulatory period, possibly removing operating expenditure that was unlikely to occur again or was better captured by a cost pass-through arrangement.

4.2. Capital Expenditure Sharing Scheme

Hunter Water has concerns with the introduction of the CESS scheme, as we outlined in our response to Discussion Paper 3:

1. As with the EBSS, a higher-quality grade, backed by ambitious cost forecasts and a commitment to accept risk, would expose the business to financial penalties at the 2030 price review. This concern is heightened by the business's lack of experience with expenditure incentive schemes.
2. Unlike the AER's transmission and distribution businesses, we do more than invest in the renewal and expansion of networks. We cover the full supply chain including bulk water, water treatment and wastewater treatment. These sub-categories account for about half of current capital program. This proportion will grow in the next period as we invest in our bulk water system. These are large, lumpy and discrete investments. The movement in costs of one or two large treatment plant projects could affect payments under the CESS scheme.

The CESS appears even more susceptible to scenarios that may generate unreasonable payments that do not reflect any actual change in efficiency.

Our concerns with the CESS scheme are mitigated, in part, by the application of a cap to the incentive schemes – discussed below. We also acknowledge IPART's statement about streamlined expenditure reviews for businesses that are subject to the EBSS and CESS.

4.2.1. Balancing incentives

IPART's Discussion Paper 3 points out the role of the CESS in complementing the EBSS and preventing inefficient shifts between operating to capital expenditure:[8]

> *"The EBSS only applies to operating expenditure savings. By itself, it creates an unequal incentive to pursue opex savings over capital expenditure (capex) savings."*

Hunter Water consider this concern is over-stated. This could only ever apply to a small fraction of our capital program: possibly shifting some maintenance costs into capital renewals. We have no ability to shift substantial costs in labour, energy, chemicals, laboratories, strategies and planning work from operating to capital to avoid a penalty or generate a windfall under the EBSS.

4.2.2. Sharing risk

Leading into each price proposal, Hunter Water prioritises a long list of prudent investments. We look to defer expenditure where possible and carry risk on behalf of customers. This helps ensure customer bills remain affordable.

Should risks change during the period, Hunter Water is able to respond by spending beyond our capital allowance and seeking to add this to RAB at the next price review – incurring financing costs to do so.

The CESS applies an additional penalty to the 'overspend', implying that such a cost was inefficient. Where expenditure is known, but not subject to an external trigger, it would not meet IPART's cost pass-through criteria. This could encourage businesses to propose a conservative base allowance to avoid a penalty under the CESS.

4.2.3. Exposure to cost increases set in competitive markets

Hunter Water, like all infrastructure businesses, has seen a sharp escalation of material, transport and construction costs over the past 12 months. These increases in projects costs far exceed the movement in household CPI.

Hunter Water has little control over construction cost movements. Because these costs are the output of a competitive market it is reasonable to assert the increases are efficient. If Hunter Water is unable to realise efficiencies in other projects, we must choose between doing fewer projects or exceeding the capex allowance and incurring a penalty.

4.2.4. Payments may simply reflect forecasting accuracy

The CESS scheme relies on forecasts of the capital program and projects over a five-year period. The planning and prioritisation work that leads into the capital expenditure proposal occurs one to two years out from the proposal. We are exposed to penalties for not accurately forecasting major capital projects six or seven years into the future. Under or overspends of a capital expenditure allowance may just reflect forecasting accuracy rather than how efficiently a water business is delivering its capital program.

4.2.5. Timing of incentives across the regulatory period

Under the CESS, water businesses are incentivised to achieve cost savings at the beginning of the price period, and present overspends at the end of the price period.

[8] IPART, May 2022, *Draft water regulatory framework, Technical Paper, Delivering customer value*, page 45.

To maximise rewards and minimise the risk of penalties, there may be incentives to:

1. defer cost saving initiatives to the next pricing period
2. slow project delivery as actual expenditure nears allowances
3. over-estimate CAPEX allowances to minimise potential losses (both within and outside of the utility's) control.

4.3. Outcome delivery incentive scheme

We recognise the role of an outcome delivery incentive (ODI) scheme in counter-balancing the EBSS and CESS. We agree with IPART's objective of ensuring water businesses do not underinvest in service quality to achieve a financial gain. IPART's proposed financial ODI scheme is not the only way to achieve this. A simpler method would make rewards under the EBSS and CESS schemes contingent on meeting customer outcome commitments.

The ODI scheme is a major change to the regulatory model. While IPART has provided high-level guidance, there is lot of work to do to clarify expectations around the detailed design. We will need to test real-world examples, and understand the power of the incentive mechanisms.

4.3.1. Measuring customer value relating to outcome commitments

The ODI scheme relies on two key inputs: performance targets that underpin the water businesses' outcome commitments, and the quantification of 'customer value' on which to base rewards and penalties.

Quantifying customer value will not be easy for some ODI measures. IPART's Technical Paper uses the example of investment to reduce water leakage. Leakage is a neat example because there is a robust pre-existing measure of value – the value of water. The value of water was set through an established process and the publication of our Economic Level of Water Conservation methodology and work to calculate the long-run marginal cost of water.

We seek guidance from IPART about expectations for monetising customer value to support the ODI scheme, including the role of stated preference studies or other non-market valuation techniques. We note the difficulties of valuing particular service attributes in isolation for individual outcome measures.

4.3.2. Nexus between expenditure and outcomes

For some forms of expenditure, like investment in renewing water network infrastructure, the relationship between expenditure, asset condition and customer outcomes can be readily measured. For other outcomes, the relationship may be indirect and harder to observe, weakening the nexus between expenditure levels and ODI performance. This could be due to:

- A difference in timing between costs and benefits, where there is a lag between observable outcomes.
- Investment to reduce exposure to high consequence, low likelihood events.

While we are not arguing against the ODI scheme, we note that a substantial share of expenditure may not be covered by outcome metrics. The AER relies on simple measures of the frequency and duration of supply interruptions. We are planning to capture a wider range of measures in our outcome commitments across water, wastewater and drainage services.

4.3.3. Design questions

In our submission to *IPART's Discussion Paper 3 – Encouraging Innovation*, we summarised lessons learnt from Ofwat and the AER. IPART's Draft Report does not provide new information on the design of the ODI scheme.

We welcome clarification of a few key questions on the ODI scheme:

- Do ODIs apply to all customer outcomes and measures, or only a subset?
- Should ODI payments be counted on an individual outcome and measure basis? Should ODI payments be individually capped or measured as weighted proportion of a total possible payments?
- Do ODIs only apply to areas where the business commits to performing above a regulatory standard?
- Should the sharing rates applied depend on the specifics of the outcome measure?
- Is there scope for contingencies and exclusions in exceptional circumstances where continuing to apply the scheme may be contrary to the scheme's objectives?

4.4. Scheme caps and collars

We note IPART's comments on capping the size of the revenue adjustment:[9]

> *"We will ask the businesses to propose how much revenue they risk in the incentive schemes as part of demonstrating their commitment and confidence in costs. … As a default position, limiting the combined incentive payment to 1 per cent of the revenue requirement may be appropriate."*

IPART's global cap across all three schemes should encourage businesses to focus on areas where they believe gains can be made rather than to stop when an individual cap is reached. If the rewards were perfectly balanced, a global cap would provide the greatest incentive to maximise customer value.

The EBSS appears more powerful than the CESS. A material opex efficiency in the final year could absorb the global cap and overwhelm any payments in the CESS. If the ODI scheme is more powerful than the EBSS, it could drive us towards preferring gains in customer outcomes over operating cost reductions. If it is less powerful, it could drive us towards preferring operating cost savings at the expense of outcome performance.

We have a lot of work to do over the next two years in understanding the interaction of the various incentive schemes and finalising a suite of ODI measures and payments. We may propose a different global cap or individual scheme caps. We would explain the reasons for departing from IPART's 1% default.

[9] IPART, May 2022, *Draft water regulatory framework, Technical Paper, Delivering customer value*, page 38.

5. MANAGING CHANGING REVENUE NEEDS

Hunter Water welcomes IPART's guidance on the interplay of the expenditure incentive schemes and the cost pass-through arrangements:[10]

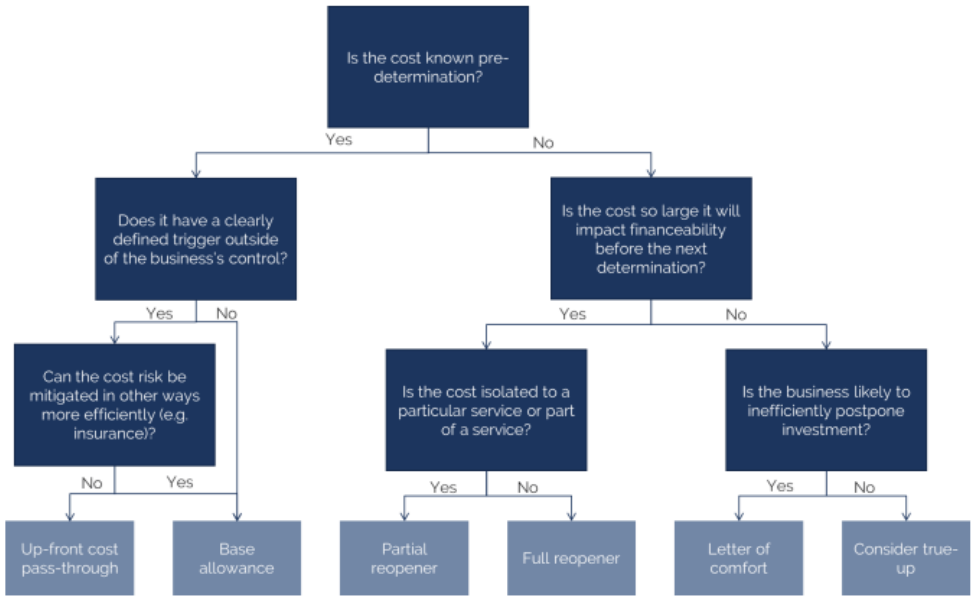
> *"If a cost pass-through, or another method for accommodating an uncertain or unforeseen cost is triggered, we propose adjusting the financial incentive schemes so that they apply to the 'revised' expenditure profile. This approach maintains the underlying incentives of the schemes, ensuring that they continue to promote customer value, while adjusting revenues for cost uncertainty."*

We seek clarity on specific areas of the cost pass-through guidance.

5.1. Cost pass-through arrangements

IPART's Technical Paper presents a framework outlining when it would provide for a cost pass-through allowance, incorporate costs into the base allowance, reopen all or part of a determination, provide a 'letter of comfort' or consider a true-up for cost recovery at the next price determination. This framework is outlined in Figure 7.

Figure 7: IPART's framework for managing changing revenue needs



Source: IPART, *Draft Water Regulatory Framework: Technical Paper*, May 2022, page 51.

5.1.1. Is the cost known pre-determination?

The rationale for this requirement is presumably so that IPART can assess the cost to be passed through and be assured that it is efficient.

However, even if a cost is unknown pre-determination, there may be ways for a water business to provide assurance that the value passed through represents efficient costs. The value could be transparently determined in a competitive market, by another regulator or similar authority, or via government taxation. Even though changes to these costs may not be known at the time of a determination, passing them through within a determination period, in response to a specified trigger event, is consistent with cost-reflective pricing.

[10] IPART, May 2022, *Draft water regulatory framework, Technical Paper, Delivering customer value*, page 39.

IPART adopted this approach in the WaterNSW determination of bulk water prices to Sydney Water. IPART allowed a cost pass-through mechanism for WaterNSW to pass costs to Sydney Water for an amount equal to its actual volumes of water pumped from the Shoalhaven multiplied by a benchmark energy price published by AEMO.

IPART noted that the pass-through was important in signalling the additional costs: [11]

> *"We are introducing a cost pass-through mechanism in the 2016 Determination for Shoalhaven transfers. This recognises the uncertainty associated with forecasting the incidence of the transfers, and will provide a signal to Sydney Water about the costs of supply augmentation in times of increased water scarcity."*

5.1.2. Is the cost so large it will impact financeability before the next determination?

We welcome IPART's decision to allow in-period reviews and adjustments to cost allowances where warranted, including a partial reopening of the determination.

IPART's framework indicates that the determining factor as to whether it would partially or fully reopen a determination is limited to considering the 'financeability' impact on the business. There may be factors, other than financeability, that relate to the long-term interests of customers. For instance, a re-opening of the determination where it improved cost reflectivity of prices or reduced price variability over time (rather than a steeper adjustment at the next price reset).

5.1.3. Is the cost isolated to a particular service or part of a service?

We are unclear why a partial reopener would only apply to "a particular service or part of a service", as opposed to potentially applying to a particular cost that may impact more than one service. For example, if a full price review is deferred, there may be a case to partially reopen the determination to simply adjust prices by CPI – which would maintain prices in real terms and may help to smooth prices between the current determination and the next full determination. We would welcome clarifying text in the IPART's final report.

5.1.4. Is the business likely to significantly postpone investment?

IPART seems to present a letter of comfort and its consideration of a true-up as alternative options under its framework, depending on whether the business is likely to significantly postpone investment. Our understanding is that a letter of comfort should result in a true-up at the next price determination. We would welcome some additional clarifying text in IPART's final report.

Hunter Water supports an approach whereby IPART would adjust both the allowance and actual expenditure by the value of the pass-through or true-up. In this way, the business is not penalised under the EBSS or CESS for an 'additional' cost that is ultimately deemed efficient by IPART.

[11] IPART, June 2016, *Review of prices for WaterNSW, From 1 July 2016 to 30 June 2020*, *Final Report,* page 72.

6. COST PRINCIPLES AND CRITERIA

We agree with IPART that administrative effort can be streamlined if the scope and focus of expenditure reviews is informed by the quality of a water business's proposal, with less intensive scrutiny for proposals that demonstrate higher levels of customer value.

We support IPART's proposed changes to expenditure review processes to reduce administrative burden and focus on elements that matter most to customers. In particular, we support:

- Tailoring expenditure reviews for proposals that deserve earned-autonomy
- Adopting a base-step-trend approach to operating expenditure
- Only reviewing historic capital expenditure by exception
- Streamlining information returns
- Simplifying the building black model without compromising the quality of outcomes.

6.1. Achieving a tailored expenditure review process

The draft new water regulatory framework tailors price reviews, and other regulatory mechanisms, to the grading of a water business's proposal. We support the concept of providing a level of earned autonomy, particularly through a tailored expenditure review process, as a strong incentive to submit a high-quality proposal.

We have assumed that the reform agenda outlined in IPART's draft report describes the vision for the 'future state' – once the new framework is fully implemented – which will be transitioned over several price periods. This is particularly relevant for the suite of cost criteria and information provision.

The major metropolitan water businesses, Hunter Water, Sydney Water and WaterNSW, must submit pricing proposals in around two years. While we welcome the majority of the foreshadowed changes to improve the expenditure review process, we note that much detail remains to be resolved. We suggest the transition arrangements outlined in Table 4 as a starting point.

Table 4: Implementing changes to the expenditure review process

HUNTER WATER PRICE REVIEW 2024-25	REGULATORY PERIOD 1 2025-30	HUNTER WATER PRICE REVIEW 2029-30
Adopting a base-step-trend approach to operating expenditure	Working with water businesses to develop predictive models of longer-term capital expenditure needs	Making greater used of predictive models for capital expenditure needs
Only reviewing historic capital expenditure by exception	Working with water businesses to develop benchmarking	Making greater use of cost benchmarking
Streamlining information returns	Financial incentive schemes – EBSS, CESS, ODI	
Tailored expenditure reviews for advanced and leading proposals		

Source: Hunter Water, based on IPART, May 2022, *Draft Water Regulatory Framework: Delivering customer value*, Box 3, page 20.

The draft report and draft technical paper state that:

- IPART will *"streamline the expenditure review process where there is clear evidence of customer support for expenditure proposals if they lie within appropriate benchmarks"*[12]
- Financial incentives, such as the EBSS and CESS, *"allow future review processes to be streamlined because they allow businesses to demonstrate they're acting efficiently (reducing IPART's reliance on expenditure review consultants)".*[13]

We would welcome further engagement with IPART on transition planning, with a particular focus on the criteria water businesses would need to meet for IPART to commit to a streamlined expenditure review for the 2024-25 price review.

6.2. Base-step-trend

We seek further clarity on the base year in IPART's new base-step-trend approach. With a price proposal due at the end of September 2024, does IPART expect our revenue modelling and operating costs to include 2023-24 actuals? We would welcome discussions with the Secretariat on how this would work in practice, noting we will not have completed financial reporting for 2023-24 and the associated activity-based costing allocation of costs to services by the time we have finalised key parts of our proposal.

[12] IPART, May 2022, *Draft water regulatory framework: Delivering customer value*, page 19.
[13] IPART, May 2022, *Draft water regulatory framework: Delivering customer value*, page 24.

7. SIMPLIFYING THE BUILDING BLOCK MODEL

IPART's Technical Paper recognises that the building block model used to calculate revenues has become increasingly complex over time. IPART proposes various simplifications "*that would not compromise the overall integrity of the prices we set or the incentives we provide to promote better outcomes*".[14]

Hunter Water supports IPART's aim of removing and minimising unnecessary complexity. Any pursuit of precision on elements of the building block model and the various adjustments must be balanced by considerations of materiality and administrative effort. We acknowledge that Hunter Water and the utilities have a role to play as well. We should only raise or propose changes to the model where the matter has significant financial impacts. There will always be assumptions and many small ups and downs in any proposed revenue requirement.

7.1. Estimating asset lives

Hunter Water supports IPART's proposed changes to the approach for calculating assets lives.

Regulatory depreciation accounts for about 20% of Hunter Water's current revenue requirement. Our past experience shows that, if not estimated accurately, defaulting to older, longer lives can materially impact free cash flow and adversely affect the business's credit metrics.

Hunter Water's 2019 price proposal included a disaggregation of RAB categories and the calculation of remaining useful lives for all existing assets. Up until this time, IPART and Hunter Water had agreed to use a single asset life for all new assets of 100 years and a single asset life for all existing assets of 70 years.

Hunter Water now has 41 RABs as well as a separate building block model for discretionary projects.

Hunter Water and IPART explored many of the methodology questions associated with calculating asset lives throughout the 2019-20 price review. IPART engaged two consultants to review Hunter Water's work in allocating assets to categories using our fixed asset register, estimating and updating the costs attributable to these assets and the method for weighting assets within a category.

IPART's consultants found that Hunter Water's lives allocated to each individual asset generally represented the effective useful life of each asset, and were consistent with other reference standards. IPART concluded:[15]

> *"We consider that this finding alleviates our concerns around the maintenance of data in the FAR. As such, the asset life data on individual assets in FAR can be used to derive weighted average lives for each sub-category with some confidence."*

Hunter Water welcomes IPART's decision in this review to allow the businesses to propose remaining lives of existing assets based on evidence of economic lives from a well-maintained fixed asset register. Hunter Water uses independent valuers to update asset values and remaining lives, on a five-yearly rolling basis by asset type. As discussed with the Secretariat, we intend to use our depreciation replacement cost register, with adjustments, when preparing our next price proposal.

7.1.1. Weighting method

Hunter Water's 2019 price proposal calculated average asset lives in each category based on the relative depreciation of each of the individual assets, as opposed to weighting based on the relative values of each asset. IPART observed:[16]

> *"Our view is that this method does in fact produce the most accurate reflection of aggregate depreciation, at a point in time. As such, it is likely to produce the most accurate reflection of a utility's overall depreciation profile."*

[14] IPART, May 2022, Draft water regulatory framework, Technical Paper, Delivering customer value, page 62.
[15] IPART, 2020, *Review of prices for Hunter Water Corporation from 1 July 2020, Final Report*, page 225.
[16] IPART, 2020, Review of prices for Hunter Water Corporation from 1 July 2020, Final Report, page 225.

IPART decided to retain the weighting by asset value method given concerns about the rate at which a group of assets depreciates “if not regularly reset”.

We welcome IPART’s decision to allow the business’s the ability to propose the weighting method.

We agree with IPART that weighting by depreciation requires the business to re-calculate and update all existing asset lives at each price review. We are more than comfortable putting in the time and effort to reset asset lives every five years given the importance of this building block. We intend to get our next set of detailed calculations independently tested prior to the price review.

For new assets, we will need to account for the cumulating nature of the new capital expenditure over the regulatory period under the weighting by deprecation method (e.g. year 2 will include the weighting of new capital expenditure for both year 1 and year 2).

7.1.2. Two asset categories

Hunter Water currently allocates assets within the RAB for each service into five categories: civil, electrical and mechanical, equipment, intangibles and non-depreciating.

IPART’s proposes to use two categories of assets per service: depreciating and non-depreciating.

Hunter Water welcomes and supports this approach. Classifying assets by component category is not always straightforward, particularly when sorting through a fixed asset register with almost 100,000 assets. This step complicates the analysis without improving the accuracy of the forecasts when assets lives are reset at each price review.

7.2. Discretionary projects

Hunter Water supports IPART’s decision to remove the requirement to separately model discretionary expenditure.

Hunter Water acknowledges the work that IPART undertook in the 2019-20 price review to establish regulatory guidance when considering expenditure on projects that are not driven or required by some form of regulatory requirement.

IPART’s 3Cs framework incorporates and supersedes the discretionary expenditure framework. The principles and project assessment steps remain relevant when assessing whether customers support particular outcomes or projects. We recognise that we will need to test willingness to pay, particularly for material investments that go beyond a basic service where we ask all customers to contribute to costs. The discretionary expenditure framework sets out a logical process for considering such expenditure.

Hunter Water agrees with ceasing the discretionary expenditure RAB and the setting of discretionary expenditure prices. IPART’s 2020 determination set a separate discretionary charge for two projects representing 2% of our allowed capital program. Hunter Water has billed residential water customers a separate ‘Environmental Projects Charge’, currently set at $0.59 cent per bill. While we’ve made customers aware of the benefit of our stormwater amenity and water recycling projects, few customers would understand the purpose of this charge.

Under the 3Cs framework, water businesses are responsible for engaging with customers on the outcomes that matter the most and proposing prices that allow the recovery of costs, including through customer choice pricing. We agree that IPART should not pursue false precision by separating out costs from broader charges for immaterial amounts. This can have perverse effects: negative RABs and separate working capital calculations for discretionary.

7.3. Simplify asset disposals

Hunter Water does not have any significant holdings of surplus land or other surplus assets.

We support IPART’s proposed approach to simplify the assessment of asset disposals by applying a default 50:50 sharing ratio for the proceeds from asset sales, net of efficient asset selling, capital gains tax and rehabilitation costs.

We are comfortable with supporting this approach recognising that IPART would consider exceptions where the business can demonstrate reasons and there was a material impact on prices.

7.4. Simplify working capital calculation

We agree with IPART's proposal to simplifying the working capital calculation.

Under the current method, IPART calculates receivables revenue off current year building blocks, with the exception of the tax and working capital building blocks which are from the prior year. We understand this is to avoid a circular reference in the calculation. Referring to the previous year complicates the calculation in the first year of a new price period due to the roll forward of actual capital expenditure. We suggest it may be possible to simplify this calculation as well.

7.5. Sharing of non-regulatory income

IPART proposes applying a 50:50 sharing ratio between a water business and its customers for all non-regulated revenue. This is unregulated revenue derived from using regulated assets for anther commercial purpose.

Hunter Water considers that a 50:50 sharing ratio is a simple and reasonable default position. However, we do no support this is a mandatory default to apply in all circumstances. There should be some regulatory acceptance to deviate from equal sharing, where warranted.

IPART's 2020 Final Report for Hunter Water's prices noted:[17]

> *"We encourage water utilities to optimise the use of their assets and seek ways to generate revenue in ways other than from traditional services – provided this does not compromise the delivery of their core services. We typically share this revenue with the customers that have paid for the asset. Sharing the revenue encourages the utilities to pursue non-regulated revenue, while ensuring customers also benefit from the arrangements where they have paid for the assets. In the past, we have typically applied a 50:50 sharing ratio of the revenue."*

Notably, IPART's 2020 determinations of Hunter Water and Sydney Water's prices allowed flexibility in terms of the proportion of the business's non-regulated revenue to be shared with customers. It agreed with Hunter Water and Sydney Water's proposals to only give customers 10% of its forecast non-regulated revenue from bio-banking credits (while still maintaining the 50:50 share for rental income).

IPART stated that its decision to allow Hunter Water to keep a larger than normal share of the forecast revenue from bio-banking credits recognised that: [18]

> *"Hunter Water would bear non-negligible scheme participation costs (such as setup and ongoing costs) and responsibilities of the scheme that create increased revenue risk. Scheme participation requires set up costs, as well as enters the business into perpetual agreements with ongoing costs and responsibilities."*

If IPART had not recognised these additional costs and risks to Hunter Water, we would not have the pursued these projects. If a project does not proceed because of an arbitrary cost sharing rule, customers receive no benefit at all.

We are currently investigating the possibility of a floating solar farm on the Grahamstown Dam. This would be a large-scale renewable energy project that relies on wholesale electricity revenues and the sale of renewable energy certificates. A large-scale solar farm would be a significant investment, possibly many tens of millions. The project is likely to have the co-benefit of reducing evaporation. We would not do further work on this project if IPART applied a hard rule of 50:50 sharing for all commercial revenues derived from the use of regulated assets.

[17] IPART, 2020, *Review of prices for Hunter Water Corporation from 1 July 2020, Final Report*, page31.
[18] IPART, 2020, *Review of prices for Hunter Water Corporation from 1 July 2020, Final Report*, page 240.

To create incentives to maximise the value of regulated assets for the benefit of customers, IPART should maintain a flexible approach to the sharing of non-regulated revenue. We support a default position of a 50:50 sharing rule, provided there is the opportunity to make the case for variations. We would need to demonstrate materiality and explain the costs and risks involved. We would propose a different revenue sharing ratio or different approach. In the Grahamstown Dam solar example, this could be as simple as calculating an equivalent commercial leasing cost for the site and allocating that amount to customers in full.

Hunter Water

ABN 46 228513 446

Customer enquiries 1300 657 657

enquiries@hunterwater.com.au

hunterwater.com.au

Version: 1.0
Date: 26 August 2022