

Our reference: 17/138

Contact Matthew Edgerton

19 October 2017

Professor Jane Doolan
Commissioner
National Water Reform inquiry
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

Dear Professor Doolan,

SUBMISSION TO NATIONAL WATER REFORM DRAFT REPORT

I write on behalf of the Independent Pricing and Regulatory Tribunal (IPART). Thank you for the opportunity to provide a submission on the Productivity Commission's National Water Reform Draft Report.

In general, we support the findings and recommendations made in the Draft Report.

We have identified three matters that we wish to comment on based on work that we have undertaken in this area. These issues are:

- ▼ regulation of Local Water Utilities
- ▼ Integrated Water Cycle Management (IWCM), and
- ▼ competition in the urban water sector.

Regulation of Local Water Utilities

IPART considered the regulation of water supply and sewerage services by councils in regional NSW (ie, Local Water Utilities or 'LWUs') in our *Review of reporting and compliance burdens on Local Government*. We consider this to be an important area, where significant gains in efficiency and service delivery can be made.

Our January 2016 draft report for this review included findings that are broadly consistent with those set out in the Productivity Commission's Draft Report and outlined recommendations that aimed to tailor the regulatory framework for LWUs to:

- ▼ reflect the capacity of each utility
- ▼ enable optimal water resource planning, investment and use, by conducting planning at a catchment or regional level rather than within the boundaries of an individual LWU's operations, and
- ▼ reduce the regulatory burden on LWUs.

Feedback from stakeholders indicated a wide range of views as to who should undertake water planning. IPART considered these views before delivering the final report to the NSW Government in April 2016 (not yet released).

Details of the review, including our draft report and stakeholders' submissions, can be found here:

<https://www.ipart.nsw.gov.au/Home/Industries/Local-Government/Reviews/Local-Government-Regulatory-burdens/Review-of-reporting-and-compliance-burdens-on-Local-Government?qDh=2>

Integrated Water Cycle Management

IPART broadly supports the discussion, findings and recommendations made in the Draft Report in relation to Integrated Water Cycle Management (IWCM).

The Draft Report discusses a range of issues in relation to IWCM. Some of these issues are addressed in Draft Finding 6.3 (relating to the removal of material barriers and distortions to the adoption of IWCM approaches) and Draft Recommendation 6.4 (ensuring that IWCM approaches are considered on an equal footing alongside other approaches). As discussed in the Draft Report, in some cases, there are general challenges for IWCM created by the complexity and multiple beneficiaries of these approaches. We note that the Draft Report does not include a recommendation or finding that relates to the principles or approaches that should be used for determining how IWCM projects are funded or, in other words, who pays for them. We consider that the Productivity Commission could add value by providing guidance on this issue.

In this context, we further note that under IPART's 2006 Guidelines for recycled water prices, recycled water schemes operated by Sydney Water and Hunter Water are to be ring-fenced and self-financing (ie, their costs are to be recovered from recycled water customers, rather than the broader water and/or sewerage customer base), unless they can demonstrate avoided costs to water and/or sewerage customers.¹ As outlined further below, we also adopted the same approach in our recently completed review of Sydney Water's and Hunter Water's wholesale water and sewerage prices.

Under our 2006 Guidelines, recycled water customers should pay prices that reflect the costs of the recycled water scheme, unless:

- ▼ the scheme gives rise to **avoided water and/or sewerage costs** (ie, cost savings) that benefit the water utility and the broader customer base (ie, other than the direct users of the recycled water)
 - where avoided costs are demonstrated, Sydney Water and Hunter Water can recover some of the costs of the recycled water scheme from their regulated water and sewerage customers
- ▼ the scheme gives rise to broader **external benefits** for which **external funding** is received, or

¹ IPART, *Pricing arrangements for recycled water and sewer mining – Sydney Water Corporation, Hunter Water Corporation, Gosford City Council and Wyong Shire Council - Final Report*, September 2006.

- ▼ the Government **formally directs** IPART to allow a portion of recycled water costs to be passed on to a water agency's broader customer base.²

Competition in the urban water sector

As outlined in our submission to the Issues Paper, IPART considers that competition in the urban water sector can promote efficient service delivery. We therefore support the Productivity Commission's views on this issue.

We have recently completed our first review of wholesale water and sewerage prices for Sydney Water and Hunter Water. The provision of wholesale water and sewerage services enables competition for the delivery of water and sewerage services to end-users (or 'retail' customers).

Notably, wholesale pricing arrangements, which go beyond third party access arrangements³, have been necessary to facilitate new entry and competition in the water and sewerage services markets in NSW - even with the presence of a separate third party access regime. The *NSW Water Industry Competition Act 2006* has a third party access regime, which allows new entrants to seek access to Sydney Water's or Hunter Water's declared monopoly water and/or sewerage distribution networks. However, to date, new entrants have not sought to engage with this access regime, and instead have entered the market via wholesale pricing arrangements.

The final decisions in our review established a regulatory framework for wholesale prices comprised of:

- ▼ system-wide prices for on-selling water and sewerage services for new wholesale arrangements where there is no recycled water plant (to apply from 1 January 2018 to 30 June 2021)
- ▼ scheme-specific price reviews and determinations, and
- ▼ unregulated pricing agreements.

Our main objective for the review was to ensure that wholesale prices allow new entry to the market for end-use water and sewerage services to occur where this is efficient, to promote competition for the benefit of consumers. This means wholesale prices should:

- ▼ encourage efficient entry where it would result in lower prices (at the same or better service levels) or enhanced service levels⁴ over time for end-use customers, and
- ▼ not encourage inefficient entry where it would result in higher prices over time for end-use customers.

² Under section 16A of the IPART Act, IPART may be directed to include in an agency's maximum prices an amount representing the efficient cost of complying with a specified regulatory requirement.

³ Under wholesale pricing arrangements, new entrants purchase water (comprised of bulk water, treatment and transportation services) and sewerage services (comprised of sewage transportation, treatment and disposal services) from Sydney Water or Hunter Water, and then on-sell these services to end-use customers. Whereas, under access arrangements, new entrants often just purchase access to the monopoly transportation or distribution network(s).

⁴ That match customers' willingness to pay.

We recognised that, to ensure a level playing field between wholesale service providers (incumbents whose retail prices are regulated) and wholesale customers (new entrants), and therefore efficient entry and competition for the benefit of water consumers, wholesale prices for on-selling water and sewerage services need to reflect, or have regard to, the wholesale service provider's regulated retail prices for these services.

We favoured retail-minus pricing for wholesale services that are on-sold. Retail-minus pricing creates a margin for the new entrant (the minus) that reflects an estimate of the cost of the contestable services. This ensures the wholesale service provider (incumbent) and wholesale customer (new entrant) are competing on a level playing field (and on the basis of the costs of supplying contestable services), and that the new entrant is not advantaged or disadvantaged by the nature of regulated retail prices (eg, postage stamp pricing policies).

A key issue that we considered was how to incorporate the impact of a wholesale customer's recycled water plant in wholesale prices. Our framework provides for wholesale customers or wholesale service providers to ask us to set prices on a scheme-by-scheme basis to consider cost savings from recycled water schemes (eg, avoided water supply augmentation and/or wastewater treatment and disposal costs), and reflect these in wholesale prices.

Under our framework, the greater the cost savings to a wholesale supplier from a wholesale customer's recycled water plant, the lower the wholesale price (all else being equal).

Our decisions in the wholesale pricing review and the above-mentioned 2006 Guidelines for public water utilities' recycled water schemes treat the funding of recycled water plants in the same way - regardless of whether they are operated by a wholesale customer or Sydney Water/Hunter Water, to ensure investment in cost-effective recycled water schemes. That is, recycled water schemes should be self-financing (ie, their costs should be recovered from recycled water customers, rather than the broader water and/or sewerage customer base), unless they can demonstrate avoided costs to water and/or sewerage customers.

Further information on our wholesale pricing review, including our Final Report, is available here:

<https://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Metro-Pricing/Wholesale-pricing-for-Sydney-Water-and-Hunter-Water?qDh=2>

We have also recognised that to complement wholesale and access pricing regimes, and help drive efficiency gains, better information is required on the costs of the supply chain components of vertically integrated monopolies (eg, for water: bulk water, treatment, transportation and retail costs; and for wastewater: sewage transportation, treatment and disposal costs). We therefore plan to undertake further work on component pricing for Sydney Water and Hunter Water.

The development of competition also requires the consideration of factors other than prices, including:

- ▼ obligations on incumbent water utilities to service wholesale customers within their areas of operations
- ▼ the level of service provided to wholesale customers, and
- ▼ any other consumer protection measures required for wholesale customers.

In our recently completed review of Hunter Water's operating licence, we recommended a requirement for Hunter Water to extend the obligation to provide services to customers other than property owners, namely licensees under the *Water Industry Competition Act 2006* (NSW). Hunter Water may impose lawful conditions on these customers to ensure the provision of services is safe, reliable and financially viable. These recommendations were included in the Hunter Water Corporation Operating Licence 2017-2022, which commenced on 1 July 2017. A review of Sydney Water's operating licence is expected to begin in 2018.

If you would like to discuss our submission further or have any questions, IPART's contact officer for this submission is Matthew Edgerton, Executive Director Water Pricing,

Yours sincerely

Hugo Harmstorf
Chief Executive Officer