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National Water Reform 2020
Productivity Commission
Locked Bag 2, Collins St East
MELBOURNE Victoria 8003

By Email to: water.reform.2020@pc.gov.au

National Water Reform: Productivity Commission Issues Paper May 2020

Flow Systems Pty Ltd (**Flow**) welcomes this opportunity to provide input to the Productivity Commission to assist with its review of National Water Reform.

About Flow

Flow is a next-generation alternative utility providing water, wastewater and recycled water services in communities within the Sydney and Hunter Regions. Flow is a licenced retail supplier under the Water Industry Competition Act 2006 (NSW) (**WIC Act**) and Flow Group companies hold network operators' licences under that Act. Flow creates liveable communities, makes urban canopy possible and allows communities to keep precious water resources in a continuous re-use loop. Flow leads the integrated water management (**IWM**) industry in Australia with innovative technical and commercial solutions to ensuring long term sustainability within our metropolitan areas. Flow believes that private water utilities have a critical role to play in helping communities with their water needs, for the benefit of the environment, communities and consumers whether or not they are customers or Flow.

Urban Water Reform

The National Water Initiative established urban water reform as a key element to the goal of achieving the overall goals of the optimising economic, social and environmental outcomes from the water system. However, much still needs to be done in urban water regulation to access those benefits.

Competition in water supply, distribution and retail services will lead to the best long-term outcomes for communities and households in Australia's urban areas. Wastewater recycling is proven technology used across the world to supplement and compliment other water sources. Current wastewater recycling models provided by the private sector can help now to make communities more resilient. Getting the policy settings right to foster competition, private investment and innovation will also facilitate other technologies – both proven and emerging – that will further ensure sustainable and liveable urban areas.

The actions in the National Water Initiative to provide economically efficient and sustainable use of water resources, ensure sufficient revenue streams to allow efficient delivery of the required services and give effect to the principles of user pays have not been successfully implemented in the Nation's metropolitan areas. Instead we see:

- An uneven playing field between private and publicly owned water authorities, which incentivises the same outcomes identified as needing to change;

PO Box R455
ROYAL EXCHANGE NSW 1225

1300 803 803

contact@flowsystems.com.au | flowsystems.com.au

ABN 28 136 272 298 | ACN 136 272 298

- Anti-competitive pricing arrangements which fail to ascribe value to water conservation and reuse at all points in the value chain;
- The planning system for water infrastructure being overseen by the instrumentality responsible for delivering that infrastructure, creating a "closed shop" that makes private investment and alternative delivery models (including IWM) very difficult.

To get to the right place, the following principles need to form the backbone of reform:

- *Best practice institutional arrangements*: The planning system must break away from the assumption of traditional water servicing and allow for competition in utility servicing. This can only be successfully moderated by an operator that is independent of existing State water corporations and instrumentalities.
- *Best practice pricing arrangements*: Water needs to be valued at all points in the supply chain so that supply augmentation as well as demand behaviour can respond to pricing signals. Anti-competitive pricing structures need to be removed to allow for new entrants and private investment.
- *Integrated water management*: Instrumentalities and the private sector need to be regulated under a single level playing field to rationally evaluate the benefits and risks of each water source to maximise the value of water resources currently being wasted in our urban areas.

Best practice institutional arrangements

Current institutional arrangements and planning systems keep private investment on the sidelines. This means that new solutions, business models and integrated utilities (ones that provide a range of essential services to residents) are kept out – and the consumer suffers.

Best practice institutional arrangements would involve separating the planning and policy function of State-owned corporations from their service delivery function. The planning functions could then be carried out by an independent market operator, with government and private sector representation. This would allow WIC Act licence participants to be consulted on a level playing field with their State-owned competitors

Many of the issues that hamper water conservation and sustainability in metropolitan areas arise from:

- the State-owned water authority being both the planner and market participant in the water market;
- Lack of coordination across regulators and instrumentalities (for example, in Sydney, NSW Health, IPART, EPA and DPIE not having a coordinated vision);
- Lack of clear policy statements that instrumentalities are able to implement.

These should be overcome by instituting an independent water market operator (a little like AEMO or the old Gas Market Company) to ensure that policy and planning decisions are made in a coordinated fashion. The NSW Productivity Commission has recently identified this as an area for improvement in that State.¹ The NSW Auditor-General's recent review of institutional performance in metropolitan Sydney points to systemic failings that will need to be overcome to achieve water resource sustainability.²

Best Practice pricing

The private sector (including Flow) is not asking for handouts from Government. Instead, we are asking for a level playing field and the opportunity to solve problems that remain tricky for traditional State-owned Corporations to solve. Water must be priced and valued fairly at all levels of the value chain. In NSW, for

¹ See: Office of NSW Productivity Commissioner (2019), *Kickstarting the productivity conversation*, October 2019, Chapter 5 (pages 55-56 in particular).

² Audit Office of New South Wales (2020), *Water conservation in Greater Sydney*, 23 June 2020

example, pricing regulation is failing to provide the necessary environment for the goals of the National Water Initiative to be met:

- **Bulk Water is not given a meaningful value:** The way that IPART sets prices for bulk water purchased from WaterNSW by Sydney Water (and a small number of other customers) means that there are no meaningful price signals at the “wholesale” market for water. Put simply, IPART’s pricing methodology for water is broadly as follows:
 - Calculate WaterNSW’s notional revenue requirement (**NRR**) using the building block method (including operating expenses, return on the regulated asset base (**RAB**) (i.e. opportunity cost of capex) and “return of assets” (i.e. depreciation of the assets in the RAB) and other costs like tax and return on working capital);
 - Determine what portion of the NRR is due to the long term marginal cost of supplying water – allocate this revenue to variable charges; and
 - Allocate the remaining NRR to fixed charges.

Because bulk water “generation” is historically very lumpy (for example, you build one very expensive dam very infrequently), the ratio of fixed costs of supplying a litre of water to the marginal costs of doing so is very large. In the 2015-2019 pricing period, IPART set that ratio at 80:20 fixed to volumetric charges. In the 2020 pricing period, IPART proposed to increase that ratio – potentially to 100:0. In defence of that proposal, IPART says:

We note that, unlike Sydney Water, the signalling effect of low (or no usage charge) is less pertinent in WaterNSW’s case. This is because the volumetric (or usage price) that WaterNSW charges to Sydney Water does not directly feed through to consumer demand behaviour.

Even if one agrees with IPART’s assertion around end consumer behaviour, IPART completely overlooks the potential for bulk water pricing to send price signals to alternative water source providers. That is, IPART has failed to recognise the value that competition could bring to the bulk water market. Setting a high fixed price for bulk water means that there is no incentive for Sydney Water to find and reward providers or solutions that offset the need for it to draw on WaterNSW’s bulk water supply. This flows through the system to the way that pricing structures for district-based local water utilities work.

- **Anti-competitive pricing structures have prevailed:** In 2017 IPART introduced retail-minus pricing for private sector water utilities that connect to Sydney Water infrastructure. Retail-minus price structures are inherently anticompetitive and are designed to protect the revenue of established incumbent utilities. The problems with retail-minus pricing and its impacts on private entry into water markets are extensively discussed in Flow’s submissions to IPART, which can be found at: <https://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Metro-Pricing/Wholesale-pricing-for-Sydney-Water-and-Hunter-Water?qDh=3>. Pricing for WIC Act licensees who connect to existing infrastructure should be cost-based, not based on protecting an incumbent’s market position. Integrated water management providers should be charged for the cost of providing them services, just like any other wholesale customer. Retail Minus is anti-competitive and will not lead to the best outcomes long term. “Information sharing” is not practical and means that WICA licensees will be relying on their competitor to provide them information about opportunities. A review of economic barriers to water recycling by Frontier Economics in 2018 took retail minus wholesale as a “given” and didn’t address the underlying problems with that pricing methodology.
- **Retail pricing is not truly cost reflective:** Water is chronically under-priced by deferral of infrastructure that is needed now to secure supply to metropolitan areas and by the current very cheap cost of capital applicable to State-owned instrumentalities. This means that other water supply solutions and the private sector are artificially frozen out of the market and that the risk of large price hikes in the future is increased. Policy direction should be clearly set so that pricing regulators can apply an appropriate risk-weighted approach to approving retail prices. Flow’s submissions on retail pricing can be found on the relevant IPART website pages.

Integrated Water Management

Flow agrees that effective IWM will unlock substantial and sustainable benefits for urban communities. Many urban planning frameworks need a root and branch review to ensure that policy settings, legislation, regulations and State instrumentalities are pulling together to improve water conservation through IWM. “Low hanging fruit” ready for reform include:

- **Water must be recognised as a resource:** Currently, high-quality recycled water is treated as waste and an environmental pollutant. Even putting aside (direct or indirect) potable reuse, recycled water should be treated as a valuable resource for irrigation and environmental flows but is currently treated as a pollutant. Access to stormwater for treatment is difficult and involves dealing with multiple authorities.
- **Artificial legislative boundaries stop recycled water getting to where it is needed:** Abundant recycled water available during the winter could be used for irrigation, but this is often not possible within existing licencing and health risk assessment requirements –not because there are any additional risks – just because of the geographical boundaries placed around activities by the licencing regime. This could be achieved by eliminating the geographic boundaries from licences and streamlining risk assessment processes.
- **Disconnects between water and environmental legislation create an uneven playing field:** Disconnects between different pieces of State legislation mean that State instrumentalities, regulators and private participants need to duplicate work and add risk and cost to implementing what should be straight forward IWM projects.
- **Access to land and “easements in gross”:** While State-Owned Corporations have these rights and some private companies do too (e.g. Jemena, Telstra, etc.), WIC Act licenced network operators have been excluded (for no apparent reason). This could be achieved by a simple amendment to the Conveyancing Regulations in NSW to add duly licenced network operator licensees to the current list.

Next Steps

We thank the Productivity Commission for the opportunity to provide our feedback to your review and look forward to engaging further as the review progresses.

Yours faithfully

Mark Edler

Executive Manager – Corporate Services
Flow Systems Pty Ltd