

# **Productivity Commission Inquiry into the National Access Regime**

**Sydney Water submission**

**February 2013**



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# 1 Introduction

## Key points:

- Sydney Water considers that the overall legislative framework for the National Access Regime has performed as intended, from a water industry perspective.
- The only direct interaction Sydney Water has had with the regime was via the third party application by Services Sydney. In that case, the ACCC determined in favour of Sydney Water's approach to access pricing, which involved efficient cost recovery of efficient costs, and maintenance of 'postage stamp' pricing.
- The *Water Industry Competition (WIC) Act 2006* was introduced by the NSW Government with the twin objectives of the promotion of competition and recycling in the water sector. In 2009 the Act gained state-based certification under the National Access Regime.
- Sydney Water believes that the WIC Act, currently under statutory review, is broadly performing well, and is meeting the objectives as intended by policymakers.
- The Act has facilitated the emergence of licenced, localised private sector schemes, but not third party access. Sydney Water has, however, increased its preparedness in this regard with the preparation of a draft water infrastructure access undertaking.
- The establishment of the National Access Regime and the WIC Act are steps towards increased private sector involvement in the industry. Sydney Water supports competition in the industry and will be a willing participant as new opportunities emerge over time.
- Taking into account experience from the broader utilities sector, there may be a need to explore different regulatory models in the urban water industry, to achieve better cost recovery outcomes. These may involve the establishment of a national water sector regulator, and the introduction of merits reviews for regulatory determinations.

## 1.1 The National Access Regime

Sydney Water is pleased to provide a submission to the public inquiry by the Productivity Commission (PC) into the National Access Regime (NAR). The NAR is established under Part IIIA of the *Competition and Consumer Act 2010* (C&C Act).

The Act establishes a legislative framework to allow third parties access to monopoly infrastructure, where 'bottlenecks' occur in markets where competition is emerging, or has emerged naturally. A broader policy goal of the NAR is to "promote the economically efficient operation of, use of, and investment in, the infrastructure by which services are provided, thereby promoting effective competition"<sup>1</sup> in the wider economy.

Sydney Water's direct experience with the NAR framework was the 2004 application to the National Competition Council (NCC) by Services Sydney, a private company, for access to the services provided by Sydney Water's wastewater infrastructure. This matter, ultimately determined by the Australian Competition and Consumer Commission (ACCC), is discussed in further detail later in this submission. Since then, the NSW Government has established a state-based access regime which now operates in place of the NAR.

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<sup>1</sup> 2012, National Access Regime – Productivity Commission Issues Paper, Chapter 1

## 1.2 The NSW state-based access regime

In 2006, the NSW Government introduced the *Water Industry Competition Act 2006* (WIC Act), to promote competition and water recycling, in the urban water sector. Part 3 of the WIC Act establishes a state-based framework to facilitate third-party access in the water sector in NSW.

In 2009, after review by the NCC, the then federal Minister for Competition Policy and Consumer Affairs, the Hon Craig Emerson MHR, determined that the WIC Act third-party access regime be certified as effective under the NAR, for a period of 10 years.

As such, the water industry in Sydney, including Sydney Water, is regulated with respect to third-party access matters, under the WIC Act and not the NAR. Under this framework, future access seekers would seek declaration of monopoly infrastructure, and arbitration if necessary, through the NSW Independent Pricing and Regulatory Tribunal (IPART) rather than the federal regulatory authorities. Sydney Water's direct experience with the state-based access regime, under the WIC Act, is also discussed in further detail below.

## 1.3 Scope of this submission

This submission to the PC is limited to Sydney Water's direct experience with third-party access matters, under both the NAR, and the WIC Act. Sydney Water understands that a broader submission to the PC, discussing the wider policy implications of the NAR, including potential industry reforms to foster and promote competition in the water industry, will be submitted by the Water Services Association of Australia (WSAA).

## 2 Sydney Water's experience with the NAR

### 2.1 Services Sydney case

The single instance of direct interaction Sydney Water has had with the NAR was via the application by a private sector company for access to the Corporation's infrastructure. This was prior to the introduction of the WIC Act and as such the case was subject to regulation under the then *Trade Practices Act 1974 (TPA)*, now the C&C Act.

The private firm, Services Sydney Pty Ltd, sought access to the Bondi, North Head and Malabar sewage transport networks, which, it is understood, would have formed part of that organisation's plans for providing large-scale wastewater treatment and recycled water for retail purposes and environmental flows.

In 2004, Services Sydney applied to the NCC to have Sydney Water's transport networks declared under Part IIIA of the TPA. That same year, the Council recommended to the Commonwealth Government that the treatment systems be declared for a period of 50 years. In 2005, the Australian Competition Tribunal (ACT) declared the coastal treatment systems, for 50 years as recommended.

Over the course of 2005-06, the NSW Government developed a state-based access regime for the water industry, with a view to the new regime being accredited under the TP Act. The state based regime however, described later in this paper, was not certified under the federal Act until 2009, and the Services Sydney case preceded under the Commonwealth NAR framework.

Sydney Water continued to negotiate in good faith with Services Sydney, under the NAR framework, on the basis that Sydney Water's access price would recover the costs of providing the access service, and with a view to maintaining 'postage stamp' pricing across Sydney Water's area of operations. The continuation of postage stamp pricing was in accordance with NSW Government policy.

Services Sydney, with a differing view on how access to Sydney Water's networks should be priced, subsequently sought arbitration by the ACCC. This was the first arbitration process undertaken by the ACCC regarding access pricing methods in the urban water sector.

### 2.2 ACCC arbitration and implications

At the ACCC hearings, Sydney Water argued that under Services Sydney's proposal, private sector entrants could potentially seek access to infrastructure in the low-cost / high-revenue sections of Sydney Water's network. Sydney Water's customers would then potentially have had to bear the full costs of the high-cost / low-revenue parts of the network. As such, the current 'postage stamp' pricing system would have been at risk.

In 2007, the ACCC determined in favour of Sydney Water's approach to access pricing. Services Sydney subsequently discontinued its plans for providing large-scale water services in Sydney.

The application of the NAR in the Services Sydney case demonstrates the existence of 'checks and balances' in the regulatory regime. While the NCC determined that Sydney Water's infrastructure met the declaration criteria in Section 44G(2) of the then TP Act, the ACCC's final determination recognised the right of monopoly service providers to recover the fairly apportioned costs of providing access to third party entrants.

The ACCC determination establishes that a pricing framework for third party access should protect customers of the monopoly supplier from the adverse effects of 'cherry-picking' the network. The case also demonstrated that while access regimes provide a framework for third parties to access monopoly infrastructure, broader economic characteristics of the water sector are likely to ultimately determine the applicant's decision to proceed with a scheme.

## 2.3 Institutions and processes

As noted above, Sydney Water's experience with the NAR via the Services Sydney case did not result in any particular concerns about the current institutions and processes.

In relation to the PC's question<sup>2</sup> on whether there are other institutional structures or decision-making arrangements that might work better than those currently in place for Part IIIA, Sydney Water notes that some stakeholders believe there may be a case to consider a National Urban Water Access regime regulated by a national regulator.

Similar to electricity, an effective National Urban Water Access regime would require a fit for purpose regulatory regime that works seamlessly with non-economic regulation and reflects the particular characteristics of the urban water industry. The present state based regime reflects these considerations.

A National Urban Water Access regime may have the potential to enhance regulatory efficiency arising from: establishing a single national regulator which would have a robust depth of capability and improved efficiency arising from economies of scale in regulation; and reducing inconsistencies in state based regulation which create additional costs for national private sector third party participants.

From Sydney Water's perspective, with increasing involvement by the private sector in the urban water industry (for example the recent refinancing of the Sydney Desalination Plant) there may be net benefits to Australia in exploring further the potential for a national urban water regime administered by a national regulator.

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<sup>2</sup> 2012, National Access Regime – Productivity Commission Issues Paper, page 22



# 3 Access framework in Sydney's urban water industry

## 3.1 The regulatory framework for competition in NSW urban water

The WIC Act was introduced by the NSW Government in 2006 with the twin objectives of the promotion of competition in the urban water industry, and the promotion of recycling.

The first objective of the WIC Act related to the need to provide for an effective state-based framework for emerging competition in the water sector. The state-based framework encapsulates a licencing regime for new entrants into the market, as well as an access regime to provide a framework under which competitors could seek access to monopoly infrastructure, including Sydney Water's networks, for the provision of water services.

The second objective of the Act, designed to promote new recycled water infrastructure development, was primarily in response to the severe and prolonged drought experienced in Sydney from around 2003 onwards. This objective was also in line with the NSW Government's Metropolitan Water Plan policy framework, established in 2004, which aimed to secure Sydney's water supply through diversified measures including recycled water, desalination and water efficiency programs.

## 3.2 Performance of the WIC Act so far

The WIC Act is currently subject to a five-year review process being undertaken by the Metropolitan Water Directorate (MWD) of the NSW Department of Finance and Services (DFS). Sydney Water is due to provide a submission to the review in February 2013.

While Sydney Water's detailed comments on the WIC Act access framework will be included in the submission to MWD, the Corporation believes that the Act is broadly performing well, and is meeting the objectives as intended by policymakers. The Act, through its licencing regime, has facilitated the emergence of nine new localised schemes, in which private sector market entrants have some level of retail relationship with customers.

Sydney Water is aware of further schemes likely to be licenced under the Act, some in which Sydney Water will potentially have an interface with the licensee, but have no on-going role or relationship with customers at the retail level.

## 3.3 Third party access under the WIC Act

While no applications for third-party access to drinking water infrastructure have yet been received, Sydney Water is prepared for this form of competition to develop in future. Sydney Water has prepared a draft third party access undertaking, which serves as the basis under which the Corporation and private sector entrants may negotiate access to infrastructure for the provision of drinking water.

The Corporation remains willing to negotiate with any applications for access to the networks, in accordance with the current regulatory framework. Only after working through a detailed access negotiation in future, however, will the Corporation be in a position to provide detailed comment on the workings of the current state-based regulatory arrangements with respect to a specific access application.

In light of Sydney Water's experience with the NAR and the WIC Act, the Corporation believes that the most appropriate regulatory arrangements for administering 'third party access' in urban water is the current arrangement whereby an industry-specific scheme is certified under the C&C Act. This mirrors industry-specific arrangements in other comparable infrastructure industries.

# 4 Access frameworks and the promotion of competition

## 4.1 Evolving private sector involvement in urban water

Over recent decades, the water industry in Australia has seen significant increased private sector involvement in the provision of public services and infrastructure. This has been primarily fostered through moves away from day-labour to market models of service delivery, through private sector franchising of key components of the supply chain, and through private sector delivery of capital works among other measures. In more recent times in Sydney, the disaggregation of the bulk and distribution components of the supply chain has established new opportunities for emerging competition.

The creation of the Sydney Catchment Authority (in 1999) and the private sector refinancing of the subsidiary company operating the Sydney Desalination Plant (in 2012), has opened up the prospect of an emerging competitive market in bulk water supply. Water balance arrangements involving the newly diverse sources of supply are determined through the NSW Government's Metropolitan Water Plan policy framework.

The recent licencing under the WIC Act of Sydney Desalination Plant (SDP) Pty Limited, to provide retail supply and network operation services at the desalination plant at Kurnell, goes some way towards opening up new competitive markets at the bulk supply and retail levels – effectively, both upstream and downstream markets.

Sydney Water discussed these matters in more detail in its submission to the PC's review of the urban water sector in Australia, in November 2011. In its 2012 report on the urban water sector, however, the PC recognised the presence of some natural economic barriers to true competition at all levels in the urban water industry.

## 4.2 Future scope for competition

Sydney Water supports and encourages the emergence of competition in the urban water sector. The Corporation in particular has supported the removal of regulatory barriers to entry in the market in recent years. The PC has noted that unlike in other major infrastructure sectors in Australia, there are natural economic barriers hindering the development of competitive water markets. Nonetheless, Sydney Water believes the industry will continue to explore opportunities for competition to expand, as they arise over future years.

In line with the PC's findings, Sydney Water considers that the establishment of licencing frameworks and access regimes are not the only precursors to a new competitive framework in the sector. They are necessary steps, but the next steps to fostering effective competition may involve market design and rules, and institutional change brought about through legislative reform.

The establishment of the NAR, and later the WIC Act, have been encouraging steps towards the next level of private sector involvement in the industry. As noted above, the WIC Act licencing regime provides a regulatory framework through which new players can enter the market. Sydney Water has prepared a draft undertaking to facilitate future opportunities that may arise.

Major components of water and wastewater networks are natural monopolies. As determined by the ACCC in the Services Sydney arbitration, monopolies such as Sydney Water need to charge fair access prices that recover the costs of service provision, prevent cherry-picking, and protect the interests of the majority of consumers.

As noted in the introduction, Sydney Water understands a submission to the PC by WSAA will discuss future institutional change that may be required to further progress competition in urban water, in more broad policy terms.



# 5 The Practice of Economic Regulation

## 5.1 Pricing principles and determinations by the AER

The PC has asked about the appropriateness of the pricing principles for regulating access prices under Part IIIA and the level of certainty they provide.<sup>3</sup>

Sydney Water believes that the pricing principles establish the right intent, however, it notes that in practice the determination by regulators of what are the efficient costs and the commensurate return on investment can be problematic due to ambiguity arising from the specific rules. For example, in the electricity industry, recent decisions made by the Australian Energy Regulator (AER) on return on investment have been subject to a number of merits reviews with the ACT finding a number of reviews in favour of service providers.

Sydney Water understands that the 2012 review by the Australian Energy Markets Commission<sup>4</sup> (AEMC) on electricity and gas network regulation resulted in rule changes with the aim of removing ambiguity between the intent of the pricing principles and practical application by the AER in its pricing determinations, particularly on rate of return.

Sydney Water notes that the matters which IPART is required to consider<sup>5</sup> when making a price determination are not completely consistent with the Part IIIA pricing principles. The PC may want to consider whether any changes could be explored that encourage a greater degree of consistency between pricing principles for state based access regimes and the Part IIIA pricing principles.

## 5.2 Is merits review appropriate?

Sydney Water supports the current judicial and merits review mechanisms that are available under Part IIIA.

Sydney Water notes that the WIC and IPART Act do not provide merits review mechanisms to water businesses, customers or access seekers in relation to IPART regulatory decisions. The Ministerial Council on Energy (MCE) determined in 2006<sup>6</sup> that there was a need for the electricity and gas industry regulatory frameworks to “promote the efficient investment in and use of energy infrastructure, such that economic regulatory decisions provide a balanced outcome between competing interests and to protect the property rights of all stakeholders.”

The MCE set out the following criteria for a review scheme

- maximising accountability
- maximising regulatory certainty
- maximising the conditions for the decision maker to make a correct initial decision
- achieving the best decisions possible
- ensuring that all stakeholders’ interests are taken into account, including those of service and network providers, and consumers
- minimising the risk of gaming
- minimising time delays and cost.

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<sup>3</sup> 2012, National Access Regime – Productivity Commission Issues Paper, page 19

<sup>4</sup> Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 and National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012, 29 November 2012

<sup>5</sup> As set out in section 15 of the IPART Act

<sup>6</sup> (2006) “Review of Decision-Making in the Gas and Electricity Regulatory Frameworks”, Decision, May 2006

Sydney Water believes that there are two reasons why an appropriate merits review should be considered for regulators' decisions (either a national regime noted above, or the current NSW regime).

The first is the net benefits that are likely from promoting improved economic regulation decision making through improved accountability, maximising the conditions for the decision maker to make a correct initial decision; and achieving the best decisions possible.

The second is the trend to increased private sector investment in the water sector. As noted, private investment in the water sector is already affected by regulatory decisions. In future, privately owned monopoly infrastructure could potentially be subject to regulated price access determinations. This suggests that strengthened protections of property rights would be appropriate by creating an appropriate form of review to IPART regulatory decisions.

Sydney Water notes that while there has been significant debate about the detailed design of the Limited Merits Review regime for electricity and gas, a recent review has recommended that a form of Limited Merits Review should be retained.<sup>7</sup>

Sydney Water notes that in order for a merits regime to work effectively, the regulatory framework needs to be consistent with the intent of the merits review regime (such as providing clear objectives and criteria as to how a regulator is make its decisions).

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<sup>7</sup> Review of the Limited Merits Review Regime, Stage Two Report, Professor George Yarrow. The Hon Michael Egan, Dr John Tamblyn, 30th September 2012

## 6 Conclusion

### 6.1 Observations on the NAR

Taking into account the Corporation's direct experience with the NAR via the Services Sydney case, as well as the recent emergence of competition facilitated by the WIC Act, Sydney Water considers that the overall legislative framework for access to infrastructure has performed as intended, from a water industry perspective.

In the time that the NAR has been in place, Sydney Water notes that it has facilitated competition mainly in the form of new, small-scale market entrants, through the state-based accredited (WIC Act) scheme in NSW.

In regards to third-party access, however, regulators determined in the Services Sydney case, that while monopolies should facilitate access to new entrants, natural monopolies are still required to set access prices at a level necessary to recover the efficient costs of providing the service, and to prevent adverse impacts on consumers through cherry-picking.

Sydney Water also considers that the ACCC's finding in the access pricing arbitration was critical from a public policy perspective. This is because the configuration of wastewater systems in Sydney, and the distribution of the population, means the departure from postage stamp pricing could have disadvantaged customers in some areas and benefitted customers in other areas.

Sydney Water notes the statement in the 2003 Dixon Review by the PC of the then *Trade Practices Act 1974*, the reviewing Commissioners state in the final report:

*"Whilst competition is an important means whereby an economy can achieve economic efficiency, competition is not an end in itself. The achievement of economic efficiency is the ultimate goal, because it results in high productivity, which in turn sustains economic welfare. Maximising competition is the means to that end."*

While competition is emerging in the urban water industry in Sydney, competition is, as per the Commission's finding above, not an end in itself. The goal of policymakers in regard to fostering competition in the sector should be to achieve a more economically efficient industry. Competition, including from third-party access seekers, is not effective if it leads to reduced economic efficiency.

That said, recent developments including the private refinancing of SDP, and its licencing under the WIC Act, are encouraging signs that new competitive markets are starting to emerge.

### 6.2 The next stage of emerging competition

Sydney Water recognises the benefits of competition, and supports its emergence in line with the framework established under both the NAR and the WIC Act in NSW. The licencing framework and access regime are important steps in facilitating the emergence of competition in the water sector. As noted above, there is positive scope for competition in bulk water and at the retail level, with the disaggregation of the Sydney Catchment Authority and SDP.

At the same time, it must be recognised that a significant proportion of the value-chain in the sector is captured in natural monopoly elements, namely, water and wastewater transport, and wastewater treatment. The inherent characteristics of the sector were recognised in the ACCC's findings during the Services Sydney arbitration.

As the PC has noted in its recent review of urban water, further market reforms including institutional and legislative change, may be the next steps towards opening up new competitive markets in the urban water industry. Sydney Water will be a willing participant as the industry continues to explore opportunities over the medium to long-term.