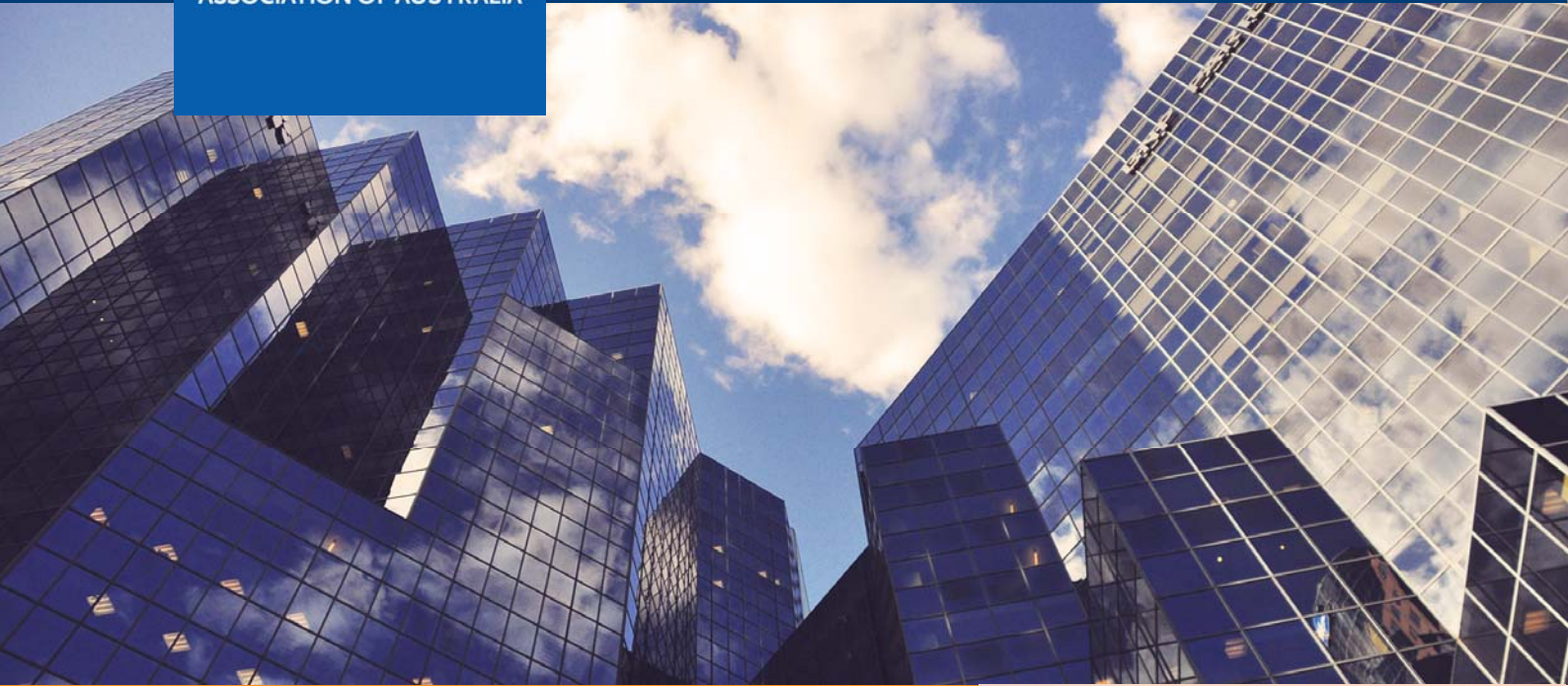




WATER SERVICES
ASSOCIATION OF AUSTRALIA



WSAA Submission

IPART Draft report on prices
for wholesale water and
sewerage services



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1.0 Introduction and overview

WSAA welcomes the opportunity to provide a brief submission in response to the Independent Pricing and Regulatory Tribunal's (IPART) draft report on wholesale sewerage and water prices for Sydney Water and Hunter Water.

Competition in the urban water industry is an important and complex issue. A growing number of players wish to enter the urban water market. They offer the potential of new, innovative services for customers. Yet the policy and pricing frameworks to facilitate entry on an efficient basis are lacking across Australia. IPART's inquiry into wholesale pricing is an important step in developing prices which support effective competition.

This is WSAA's second submission to the inquiry. We also provided a submission in response to the Discussion Paper. That submission examined more broadly the issue of competition in the urban water industry and the context for IPART's inquiry. WSAA's members strongly support integrated water management and the development of policy frameworks to support the right outcomes for customers across the whole water cycle. This includes a role for decentralised recycled water schemes where they are cost effective. Members also recognise that innovation can occur through new players entering the market. However, they consider this should not be at the expense of existing water and sewerage customers.

This submission examines the key decisions set out in the draft determination. Like the determination, this submission deals with technical and complex issues. It does not attempt to repeat the material in the first submission. Therefore, WSAA's two submissions should be read together.

In response to the discussion paper we recommended adopting a retail-minus approach to setting wholesale water and sewerage charges. The retail-minus approach is the only pricing approach that is consistent with a policy of postage stamp pricing. Without a retail-minus approach existing utilities would not retain sufficient revenue to service high cost areas and there would be incentives for high-cost inefficient investment in infrastructure. This is not in the long term interests of all water and sewerage customers.

IPART's draft decision is to adopt the retail-minus approach, and its reasoning for adopting a retail-minus approach is sound.

However, two of IPART's other draft decisions significantly erode the foundations of the retail-minus approach. These include:

- The pricing arrangements for recycled water, which effectively deem a recycled water scheme to be a sewerage scheme. This will allow entrants to collect full sewerage charges from customers (including the contribution to postage stamp pricing), while not having to provide sewerage services or pass contributions for postage stamp pricing for these services onto the existing utility. This will increase costs to Sydney and Hunter Water's customers and make inefficient infrastructure investment financially attractive.
- Adopting a *reasonably efficient competitor test* in the retail-minus method, which will increase total costs faced by water and waste water customers, with no guarantee of long term benefits for customers.

These decisions mean that the draft report is not internally consistent. It is also not consistent with other determinations by IPART, including its recycled water determination applying to public utilities. As a result, if adopted, the draft report would not promote the efficient outcomes envisaged under a retail-minus approach. It would cross subsidise new entrants and lead to inefficient investment, and higher costs to existing water and sewerage customers.

The remainder of this submission expands on why this would occur.

2.0 The logic of the retail-minus approach

WSAA supports IPART's objective in setting wholesale prices. This is setting prices that 'allows 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 customers.' (p.19)

IPART explains that this involves both encouraging efficient entry, but also discouraging inefficient entry where it would result in higher prices for end-use customers.

As noted, WSAA's previous submission set out the case for a retail-minus approach to pricing water and wastewater services to meet these objectives.¹ It is not necessary to repeat that submission as IPART have set out the arguments for a retail-minus approach very well.

Our draft decision is to set a retail-minus price for services a wholesale customer purchases for the purposes of on-selling water and/or sewerage services. Given the current retail postage stamp pricing policy that applies to water and sewerage services provided by Sydney Water and Hunter Water to end-use customers, retail-minus pricing would enable efficient entry and competition for the benefit of end-use customers over time. (p.6)

Section 5.2.1 is entitled *Cost of service pricing is inferior to retail-minus pricing where a postage stamp price is applied*. The section explains that bottom up cost of service pricing would:

... lead to cherry-picking, where entry occurs only in low cost areas, potentially by inefficient utilities. Cherry-picking increases Sydney Water's and Hunter Water's average cost by reducing the low cost customer base while leaving the high cost customer base unchanged. This would push up the postage stamp price as higher than average costs need to be recovered over a smaller number of customers. In turn, this could lead to further cherry-picking. The regulated customers of Sydney Water and Hunter Water would be worse off, having to pay higher water and sewerage prices than they would otherwise face. (p.46)

In the following section IPART sets out why using non-residential prices for the services in question could encourage inefficient arbitrage opportunities:

This means that if Sydney Water or Hunter Water were to charge wholesale customers the non-residential service charge (based on meter size at connection) and wholesale customers were then able to charge individual houses and/or apartments Sydney Water's residential service charges, an arbitrage opportunity may exist (see Table 5.2).

Such an arbitrage opportunity could make it profitable for wholesale customers to enter the market without providing any additional services or improving overall system efficiency. That is, wholesale customers could enter the market through the arbitrage opportunity rather than by being as or more efficient than the wholesale service provider. Overtime, this could increase the revenue Sydney Water and Hunter Water need to recover from their wider customer bases, which would increase prices to all their remaining retail customers, without any offsetting system-wide efficiency gains from the new entry.

Thus IPART has fully articulated why a retail-minus method is required to promote efficient infrastructure investment. It has also set out the costs to water customers and the broader community if a retail-minus approach is not used.

However, later decisions in the draft report undermine the basis of the retail-minus approach, exposing the customers of Sydney Water and Hunter Water to the risks that IPART has outlined.

The two aspects of the determination that would lead to inefficient outcomes are:

- Charging non-residential prices for disposal recycled water sewage into Sydney and HWC's networks; and

¹ We note that the South Australian Government has set a retail minus approach for transport of water and sewerage services in its Third Party Access regime for the Water industry

- Adopting a reasonably efficient test as the minus component in the retail-minus approach.

While both decisions are likely to lead to inefficient outcomes, it is the first issue — the blurring of the distinction between recycled water and sewerage services — that would lead to the greatest level of inefficient investment and the highest costs to customers.

3.0 Recycled water charging and pricing of sewerage services

The most difficult decision in the draft determination to understand is draft decision 11. The decision states that:

We have decided that waste from recycled water plants should be subject to non-residential retail prices (including trade waste charges, where applicable) for sewerage services.

While on its own the decision is relatively clear, it is the interaction of this decision with pricing of sewerage services that it would promote inefficient outcomes. The decision appears to mean that if new entrants provide a recycling service they are not subject to retail-minus pricing for sewerage services. The implications of this are easiest to see in an example of new entrant into a low cost (for the utility) infill area.² In an infill area the entrant would:

1. Collect sewerage revenues from residential customers (including the often substantial profitable component that is necessary to cover losses in high cost areas);
2. Undertake a recycled water service which will generate a revenue stream, or financial savings to the entrant from reduced purchases of potable water
3. Pay non-residential charges to continuously dispose of all waste from the recycling plant into the existing utilities sewerage network for transport, treatment and disposal.
4. Not pass onto the utility the revenue necessary to maintain postage stamp pricing in high cost areas. It is this revenue transfer that IPART has correctly identified as being necessary for efficient pricing.

The retention by the entrant of the revenue intended to support services in high cost areas undermines the determination's grounding in a retail-minus approach. It generates the internal inconsistency referred to in the introduction.

Whether it is the intention or not, the decision to charge non-residential prices for discharges from the recycled water plant to the sewerage network has the effect of deeming a recycled water service to be a sewerage service.

This misunderstands the nature of the two services. While they can occur together, there are many examples where utilities provide a full sewerage services without providing a recycled water service. There are also many examples where water recycling (such as sewer mining) does not fulfil the functions of a sewerage service. An entrant discharging all customer sewage (albeit in a more concentrated form out of a recycling plant) into the utilities network for transport, treatment and disposal cannot be said to constitute providing a sewerage service.

Indeed, this separation between recycled water and other services is at the heart of IPART's previous determinations on the method for recycled water pricing by public water utilities. In this determination IPART requires recycled water schemes to directly recover costs from the customers benefiting from the scheme (unless there are avoided costs in the wider water or sewerage systems). It also requires recycled water costs and revenues to be ring-fenced from regulated water and sewerage revenue. Unless directed by the government recycled water assets cannot be included in the asset base for sewerage.

Therefore, in addition to the internal inconsistency, the draft determination is also inconsistent with the separation between recycled water services and sewerage services that is enforced in the rest of the urban water market for Sydney and the Hunter.

In summary, the effect of the determination is to adopt a *cost of service* (rather than a retail-minus) approach to sewerage pricing, whenever an entrant undertakes recycling. IPART's draft report itself sets out the impact of this approach in the excerpt previously quoted above from page 46 —the title of which

² The same broad logic applies in a high cost greenfield area. Reducing the revenue from sewerage services to the utility while leaving its costs unchanged will increase the losses on that system, driving up costs for all other consumers.

was *Cost of service pricing is inferior to retail-minus pricing where a postage stamp price is applied*. In short the effects will be:

- cherry picking of profitable areas;
- inefficient investment; and
- higher and higher prices for the existing customer base.

Significantly, IPART has not provided estimates of the differences between charging non-residential prices and a retail-minus approach (p. 82). However, it is likely that the difference is high enough to act as a strong financial incentive for inefficient investment. The incentive will be greatest in infill areas where density of unit development provides strong contributions to funding high cost services.

The solution to the inconsistencies in the determination would appear to be to adopt a retail-minus approach to sewerage services regardless of whether the entrant operates a recycled water plant. Under this approach the contribution to postage stamp pricing would be incorporated into the wholesale price and no further charges for recycled water discharge would need to be imposed. In this way recycling would be profitable when the revenue or savings it generates are greater than the costs. Wider system benefits can be incorporated as facilitation costs as envisaged in the determination.

3.1 Concern with inefficient bypass

One of the justifications given by IPART for a cost-based approach to recycled waste disposal is to avoid inefficient bypass. It considers that if prices are set too high it could lead entrants to dispose of their own waste rather than use the existing systems.

However, this concern highlights the basic problem with the cost-based method. Under the method recycled water schemes are effectively deemed to be sewerage schemes. This provides a strong incentive for inefficient entry in order to capture sewerage revenue while continuing to rely on the incumbent's sewerage service. It also denies utilities the full revenue necessary to operate the sewerage schemes on which the entrant relies.

Sewerage services may well be contestable in some areas. However, the cost based method would provide entrants with little incentive to go beyond a recycling service. Maintaining the separation of sewerage services from recycled water services under a retail-minus approach would also eliminate an incentive for inefficient bypass and create the right incentive for entry into provision of sewerage services.³

³ IPART's approach to facilitation costs appears to be a reasonable way of giving incentives to entrants to undertake cost reducing investments in the absence of access to developer charges.

4.0 The reasonably efficient test

IPART has decided that the minus component in the retail-minus approach should be based on the costs of a reasonably efficient competitor. While not as serious a problem as the pricing of recycled water services, it will nevertheless increase the costs faced by water customers.

The basic objective of competition is to allow more efficient providers to enter the industry and ultimately reduce customers' bills. Competition should be cost-reducing.

IPART's intention in adopting the test is to encourage entry into urban water and to hopefully trade off short-term cost efficiency against long-term dynamic efficiency.

However, it is worth spelling out how far from cost-reducing the reasonably efficient cost test is.

A strictly cost-neutral test would be the retail price less the *costs actually avoided by the utility* when entry occurs. This would often be very small when existing systems had capacity, but could be much larger if a water or wastewater system was at capacity. As IPART note, entry under this test would be difficult and it would be unlikely to promote competition.

It may be thought that the retail less *efficient costs* would also be cost reducing. But this is not always the case, at least in the short run. Under this test a competitor can generally enter when they are more efficient than the utility. However, 'more efficient' is defined as when the average cost per customer of the entrant is equal to or below the average cost of the utility (or in some formulations when long run incremental costs (LRIC) are less than the utility's LRIC. In each formulation, the minus component in the retail minus method will be larger than the costs that the existing utility actually avoids. For example, if the average cost per customer for the utility to provide retail services is \$30, the *additional* cost of serving a new customer may only be \$10 (because the call centre and other infrastructure already exist). If the retail minus efficient costs method is the retail price less \$30, entrants will be encouraged to enter if they can provide retail services at \$30 or less. Yet this is \$20 dollars per customer higher than if the utility provided the retail service. If the cost the entrant incurs to service its customers is higher than the amount that the existing utility saves by not serving that group, it follows that entry will increase total industry costs.

Nevertheless, it is difficult to argue against this test on fairness grounds. There is intuitive appeal to allowing entry when a competitor is equally or more efficient than the incumbent. But it should be recognised that this method is a pro-competitive test that to some extent favours entrants over incumbents and future consumers over current consumers.

However, IPART has gone beyond this test to set the minus, not at that of an efficient competitor, but a *reasonably efficient competitor*. A reasonably efficient competitor is less efficient than the existing utility. Obviously this will increase industry costs when entry occurs. It raises the question, will costs ever fall to make consumers better off.

IPART suggests that as the entrant grows in size, scale efficiencies will reduce its costs and ultimately benefit consumers. This should rightly be seen as a highly pro-competitive approach significantly favouring entrants over competitors.

It is an empirical question as to whether scale efficiencies will ever deliver cost reductions. Hunter Water suggested in its response to the Discussion Paper that there is little evidence that economies of scale exist in the contestable parts of the industry (quoted in Draft report p. 51).

Moreover, the argument bears a strong resemblance to the discredited argument for protecting Australian industry – the infant-industry argument. Proponents of this approach argued that Australian industries should be protected from imports from more efficient producers until they reach the necessary scale to compete on world markets. However, the evidence is that few if any industry transitioned from protected industry to world competitive industries.

5.0 Contact Details

WSAA welcomes the opportunity to discuss this submission further.

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