

Review of recycled water prices for public utilities: Issues for public hearing

23 November 2018

WHAT

IPART is reviewing pricing arrangements for recycled water, sewer mining and stormwater harvesting services for Sydney Water, Hunter Water, the Central Coast Council and Essential Energy (Essential Water in Broken Hill). The review includes developer charges for recycled water.

We released an Issues Paper on 4 September 2018 and invited stakeholders to comment. We received [submissions](#) from a number of stakeholders, which were published on our website on 12 October 2018.

We are holding a public hearing to provide stakeholders with additional opportunity to provide comment on the questions and issues in the Issues Paper.

HOW

The public hearing will be structured around four sessions:

- ▼ **Stakeholder key issues**
- ▼ **Cost recovery framework**
- ▼ **Form of regulation**
- ▼ **Assessing avoided costs and external benefits**

Stakeholders are invited to attend and participate in each session relevant to their interests in recycled water.

WHEN

Key dates for this review:

4 September 2018	IPART released Issues Paper
12 October 2018	Submissions to Issues Paper closed
4 December 2018	Public hearing
Early April 2019	IPART releases Draft Decisions
Late April 2019	Submissions due on Draft Decisions
June 2019	IPART releases Final Decisions

WHERE

IPART will hold a public hearing at the **SMC Conference and Function Centre, 66 Goulburn Street** on **4 December**. You can register to attend at IPART's [website](#).

WHAT NEXT?

We will release a **Draft Decision** and call for submissions from all interested parties in **early April 2019**.

1 Overview of regulatory framework for recycled water

Table 1 presents a summary of the current regulatory framework for recycled water that we are reviewing. We are revisiting our 2006 Guidelines and the accompanying determination of recycled water developer charges.¹

Table 1 Summary of the regulatory framework

	Mandatory schemes	Voluntary Schemes
Pricing objectives	<p>The 2006 Guidelines established six pricing objectives for pricing recycled water, which we consider remain relevant for both mandatory and voluntary schemes. The objectives are that prices should:</p> <ul style="list-style-type: none"> ▼ achieve economic efficiency ▼ facilitate competition ▼ provide revenue adequacy ▼ have regard to customer impacts ▼ be transparent and simple, and ▼ reflect the National Water Initiative principles and other relevant water review matters 	
Pricing principles	<p>The 2006 Guidelines established six principles for regulating prices for recycled water. The pricing principles are:</p> <ol style="list-style-type: none"> 1. IPART should regulate prices for recycled water services and sewer mining only if there is an opportunity for water agencies to exercise monopoly power and it is confident that price regulation would improve economic efficiency. 2. Pricing arrangements should reflect the specific market and other characteristics of recycled water and sewer mining schemes. 3. Pricing arrangements for recycled water and sewer mining must be consistent with maintaining the current framework for water and sewerage pricing. 4. Pricing arrangements for recycled water should reflect the fact that the services form part of an integrated urban water system. 5. Recycled water prices should recover the full direct cost of implementing the recycled water scheme concerned unless: <ul style="list-style-type: none"> – the scheme gives rise to avoided costs that benefit the water agencies and users other than the direct users of the recycled water, and/or – the scheme gives rise to broader external benefits for which external funding is received, and/or – the Government formally directs IPART to allow a portion of recycled water costs to be passed on to a water utility’s broader customer base. 6. The structure of prices should ensure that appropriate signals are sent to recycled water users and should entail appropriate allocation of risk. 	
Form of regulation	<p>Mandated schemes are defined as recycled water schemes to which customers are required to connect due to a government policy:</p> <ul style="list-style-type: none"> ▼ Prices for mandatory schemes are set in accordance with detailed pricing guidelines found in the 2006 Guidelines. ▼ IPART will only determine prices for mandatory schemes where there is sufficient information for it to set efficient prices. 	<p>Voluntary schemes are where customers can choose to connect at their own discretion. We apply a less intrusive form of regulation to voluntary schemes:</p> <ul style="list-style-type: none"> ▼ Prices are negotiated between utilities and customers. ▼ The 2006 Guidelines provided some high-level principles to guide negotiations.

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. IPART, *Assessment Process for Recycled Water Scheme Avoided Costs*, January 2011.

	Mandatory schemes	Voluntary Schemes
	<ul style="list-style-type: none"> Where there is insufficient information, prices are set by utilities in accordance with the 2006 Guidelines. 	
Additional pricing principles and pricing guidelines	<p>The 2006 Guidelines include pricing guidelines for mandatory schemes that aim to assist agencies in establishing:</p> <ul style="list-style-type: none"> The maximum cost that should be recovered from a recycled water scheme Any offsets against this total cost to account for avoided costs or deferred costs, subsidies received, a government directive that costs of recycled water projects should be recovered from potable water or sewer customers, or up-front costs paid by a party other than the water agency or the customer The total cost that can be recovered from recycled water customers, and How costs should be recovered using different price structures, for example: <ul style="list-style-type: none"> The usage component is capped at the potable water price, and must be set at a level that sends appropriate consumption signals aimed at equating supply and demand. If the potable water top-up exceeds 10%, usage charges are calculated as an escalating % of the potable water price. Prices may include a fixed component, which should not be so high as to act as an incentive for customers to disconnect. Prices must be reviewed at least every 3 years, and may be indexed for inflation. 	<p>The 2006 Guidelines established four additional principles for voluntary schemes:</p> <ul style="list-style-type: none"> Recycled water prices should recover the costs of providing the recycled water service, unless there are clearly identified avoided costs or public benefits Costs of recycled water schemes are to be recovered from recycled water customers unless: <ul style="list-style-type: none"> costs of investment in water and sewerage systems are deferred or avoided due to the implementation of the scheme, and/or a subsidy has been paid to reflect public benefits resulting from the recycled water scheme, and/or the Government formally directs the Tribunal to allow a portion of the recycled water costs to be recovered from non-recycled water customers. The structure of prices should ensure that appropriate price signals are sent to recycled water users with the aim of balancing supply and demand, and should entail an appropriate allocation of risk Any costs to be recovered from parties other than recycled water customers must be calculated in accordance with the <i>Guideline for Calculation and Treatment of Avoided and Deferred Costs for Recycled Water</i>.
Developer charges	<ul style="list-style-type: none"> Developer charges are up-front charges levied on developers to recover the costs of providing recycled water infrastructure for new developments. They recover the remaining costs of a recycled water scheme not recovered through cost offsets and periodic charges to recycled water customers. Water utilities must calculate recycled water developer charges for mandatory schemes in accordance with the methodology and procedural requirements set out in the 2006 Recycled Water Developer Charges Determination. 	<ul style="list-style-type: none"> Not applicable

	Mandatory schemes	Voluntary Schemes
Cost offsets	<ul style="list-style-type: none"> ▼ Recycled water schemes may provide economic benefits to the broader customer base beyond end-users. These cost offsets are defined as either avoided or deferred costs (such as cost savings from delaying or avoiding the need to augment the network), or external benefits (positive externalities such as environmental, health and liveability benefits). ▼ Avoided and deferred costs can be recovered from the broader customer base (via an adjustment to the regulatory asset base (RAB)), and are estimated according to the methodology outlined in our 2006 Guidelines and assessment process in our 2011 Guidelines, which include: <ul style="list-style-type: none"> – Definitions of avoided costs – Discount rates – Requirement for a business case to claim for avoided costs – A post-adjustment mechanism. ▼ The value of external benefits is recovered from either: <ul style="list-style-type: none"> – An explicit payment from Government – The broader customer base, following an explicit directive from Government. ▼ For both mandatory and voluntary schemes, the total amount of avoided and deferred costs and external benefits are recovered from the broader customer base. 	

2 Summary of public hearing sessions

The public hearing will be structured around four sessions:

1. Stakeholder key issues
2. Cost recovery framework
3. Form of regulation
4. Assessing avoided costs and external benefits

Session 1: Stakeholder key issues

The first session will provide an opportunity for each stakeholder to identify their most important concern or concerns related to recycled water. Stakeholders will be invited to outline how the issues relate to the review. They are encouraged to identify important elements of the regulatory approach that should be amended through the review, and elements that should be retained.

Questions

- ▼ What are your key issues of concern for this review?
- ▼ How do these issues relate to the review?
- ▼ Which aspects of the regulatory framework for recycled water prices for public utilities should we amend?
- ▼ Which aspects of the regulatory framework should we preserve?

Session 2: Cost recovery framework

The second session will focus on issues relating to the cost recovery framework for recycled water, including which costs are recovered, and who they are recovered from. Table 2 provides a summary of some the important issues relating to the cost recovery framework.

Table 2 Cost recovery framework

Issue	Preliminary position in Issues Paper	Summary of stakeholder comments
Ring-fencing recycled water	<ul style="list-style-type: none"> ▼ Currently, recycled water schemes are ring-fenced from other regulated services provided by water utilities. There are two main reasons for this. <ul style="list-style-type: none"> – Protecting customers, by ensuring that recycled water schemes are not unduly subsidised by the broader customer base – Supporting competition, by levelling the playing field for public utilities and private providers of recycled water. ▼ Ring-fencing does not mean that schemes need to be financially viable on a standalone basis. Cost offsets for avoided and deferred costs, and external benefits, may be recovered from the broader customer base in some circumstances. ▼ We consider these reasons remain relevant and appropriate. Our Issues Paper proposed to retain the approach to ring-fencing. However, if a scheme is part of a least cost water or sewerage servicing solution then there is a case for the asset to be included in the general water or sewerage cost base (RAB) to be recovered from water or sewerage prices. 	<ul style="list-style-type: none"> ▼ A number of stakeholders submitted that the ring-fencing arrangements disincentivise investments in recycled water in favour of traditional servicing approaches. ▼ Stakeholders raised that ring-fencing can expose water utilities to significant demand risk for individual schemes.
Funding hierarchy	<p>There is a funding hierarchy that determines how the costs of recycled water schemes are recovered from various parties. There are some differences for mandatory and voluntary schemes.</p> <ul style="list-style-type: none"> ▼ For mandatory schemes: Cost offsets are considered first, with any residual costs recovered from usage charges and then developer charges. ▼ For voluntary schemes: Cost offsets are only recovered from the broader customer base, where usage charges (based on customer willingness-to-pay) are not sufficient to make the scheme financially viable. 	<ul style="list-style-type: none"> ▼ Overall, stakeholders agreed that it is appropriate to share the costs of recycled water between end-users and the broader customer base. ▼ However, some stakeholders submitted that the treatment of cost offsets should be consistent for mandatory and voluntary schemes. They suggested that cost offsets be applied to all voluntary schemes, rather than only in cases where there is a funding shortfall from end-users.

Questions

- ▼ How should the regulatory framework, and in particular, the ring-fencing arrangements, balance the objectives of:
 - ▽ Providing a level playing field for private and public service providers?
 - ▽ Putting recycled water on level footing with traditional servicing solutions?
- ▼ Should we change the funding hierarchy to put offsets first in the hierarchy for voluntary schemes as well as mandatory?
- ▼ We are proposing to update our developer charges methodology for consistency with water and sewerage services. Are any other changes needed?

Session 3: Form of regulation

The third session will focus on issues relating to the form of regulation applied to recycled water, including the differing treatment of mandatory and voluntary schemes.

Table 3 Form of regulation

Issue	Preliminary position in Issues Paper	Summary of stakeholder comments
Mandatory schemes – overall approach	<ul style="list-style-type: none"> ▼ Mandatory schemes are defined as those where customers lack effective choice whether to use the scheme. For mandatory schemes, we currently regulate prices through guidelines to protect consumers. ▼ In the Issues Paper, we set out that it remains appropriate to regulate prices for customers of mandatory schemes. 	<ul style="list-style-type: none"> ▼ Stakeholders supported the updated definition of mandatory schemes based on effective customer choice. ▼ Some stakeholders proposed that a less intrusive form of regulation could be applied to mandatory schemes in the first instance, with utilities setting prices in accordance to pricing principles and IPART only stepping in to set prices under a scheme specific review by exception.
Mandatory schemes – pricing structures	<ul style="list-style-type: none"> ▼ Pricing arrangements are currently required to meet a range of requirements set out in the guidelines. ▼ Usage charges cannot exceed potable prices and prices may include a fixed component that is not so high to act as an incentive to disconnect. ▼ We proposed to remove certain restrictions on tariff structures and procedural requirements we consider are no longer required, but retain the restrictions on fixed and usage charges. 	<ul style="list-style-type: none"> ▼ Stakeholders supported the proposed changes to simplify pricing arrangements. ▼ Some stakeholders submitted that further changes could be made to remove the restrictions on tariff structures, including the limitations on the usage component and fixed component. The stakeholders considered that consumers are sufficiently protected by the requirement not to collect more than efficient costs, and that further restrictions do not provide value and reduce efficiency in some instances.
Voluntary schemes	<ul style="list-style-type: none"> ▼ Less intrusive form of regulation. ▼ Scheme specific review where required. 	<ul style="list-style-type: none"> ▼ Stakeholders supported using less intrusive form of regulation where possible.

Questions

- ▼ Should we adopt a less intrusive approach to regulating prices for mandatory schemes? What are the pros and cons of doing this?
- ▼ Do pricing principles for mandatory schemes need more prescription?
 - ▽ Should we continue capping recycled water prices at the potable water price?
 - ▽ Do ‘top-up’ pricing thresholds remain appropriate where demand for recycled water exceeds supply?
- ▼ If we adopt a common set of pricing principles for mandatory and voluntary schemes, what should these principles be?
- ▼ What is needed for stormwater harvesting and sewer mining? Should the pricing approach (and principles) be the same as that for recycled water?

Session 4: Assessing avoided costs and external benefits

The fourth session will focus on issues relating to the assessment of avoided costs and external benefits for cost offsets.

Table 4 Assessing avoided costs and external benefits (cost offsets)

Issue	Preliminary position in Issues Paper	Summary of stakeholder comments
Avoided costs	<ul style="list-style-type: none"> ▼ We proposed to improve our guidance for estimating avoided costs, such as by providing a methodology to calculate the public water utilities' long run marginal cost of supply (LRMC) and, potentially, LRMC estimates for water and wastewater 	<ul style="list-style-type: none"> ▼ Stakeholders generally supported the provision of more guidance around cost offsets. ▼ There was some support from stakeholder submissions to provide a methodology for estimating LMRC, but mixed support for providing the LRMC estimate itself. ▼ Stakeholders generally did not agree that LRMC should be used to estimate sewerage infrastructure offsets
Post-adjustment mechanism	<ul style="list-style-type: none"> ▼ We use a post-adjustment mechanism to correct for errors in avoided cost forecasts, and ensure that the broader customer base does not pay for benefits that do not occur. ▼ We proposed to refine, and potentially limit, the application of the post adjustment mechanism (for example, by allowing only one post adjustment) 	<ul style="list-style-type: none"> ▼ Stakeholders submitted that the post adjustment framework increases risks relative to other servicing solutions, and proposed that IPART remove it.
External benefits	<ul style="list-style-type: none"> ▼ We proposed to broaden our framework to treat external benefits similarly to how we treat avoided costs (by also allowing external benefits to be recovered from the broader customer base without the need for a Government directive). ▼ External benefits should have a clear relationship to the wider customer base as demonstrated through evidence of the broader customer base's willingness to pay. ▼ We proposed that external benefits be additional to those already mandated by Parliament and/or Government. In this way, external benefits derived from recycled water would be treated the same way as those derived from traditional servicing solutions. ▼ We also proposed that external benefits should exclude localised benefits, on the basis that the broader customer base should not subsidise benefits that accrue mainly to recycled water customers 	<ul style="list-style-type: none"> ▼ Stakeholders generally supported the position to bring the treatment of external benefits in line with avoided costs ▼ Submissions on the exclusion of localised benefits were mixed, with some questions on how we would define 'localised benefits'.

Questions

- ▼ What guidance is needed for calculating cost offsets to reduce uncertainty?
 - ▽ Should we provide additional guidance on avoided and deferred costs, such as the LMRC methodology and estimates?
 - ▽ What guidance should we provide on estimating external benefits?
- ▼ Cost offsets need to be 'additional' to the costs or benefits that would occur anyway in the absence of the recycled water scheme. Should we provide further guidance on additionality?
 - ▽ Should we distinguish between localised benefits (eg, local greening) and other non-use benefits (eg, security of supply)?
- ▼ Should we make changes to our assessment of cost offsets?
 - ▽ Provide assessments within regulatory periods?
 - ▽ Amend the post-adjustment mechanism?
 - ▽ Provide more guidance on business cases and capital planning?