



Submission
*Prices for wholesale water
and sewerage services*
*Sydney Water Corporation & Hunter
Water Corporation*

10 May 2017

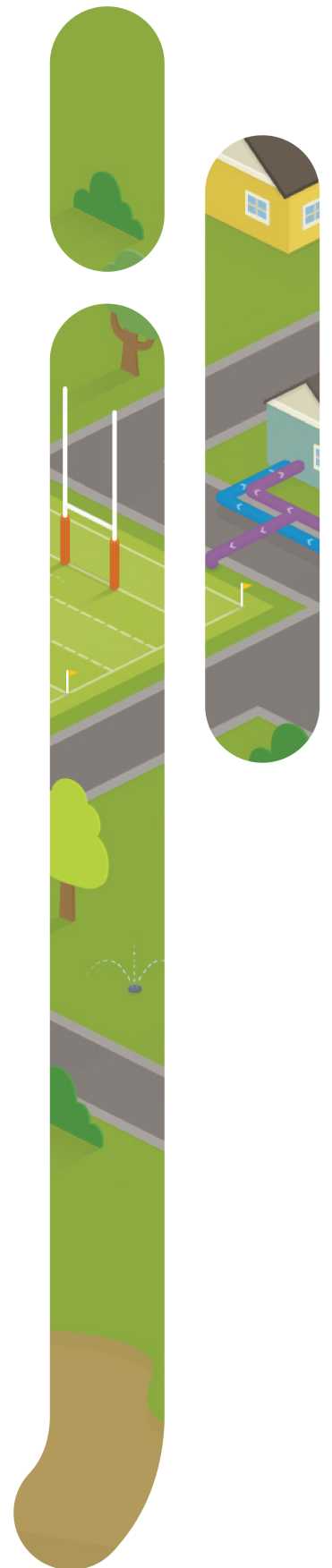


Table of Contents

1	Executive Summary	4
2	Flow recommendations	6
3	A threat to competition	6
4	Retail minus vs postage stamp pricing.....	7
5	Affordable housing sabotaged	8
6	Bad for NSW, consumers, liveability & resilience	8
7	The Impact of retail minus	9
7.1	Background.....	9
7.2	What IPART is proposing	10
7.3	Impact of the proposed wholesale prices	11
7.4	Margin squeeze	14
8	Retail minus is the wrong pricing method	15
8.1	Retail minus does not properly regard the need to promote competition.....	15
8.2	Retail minus does not properly regard cost and use of an actual service	15
8.3	Retail minus has been widely discredited	17
8.4	Reasonably efficient competitor form of retail-minus	19
8.5	The Supplementary Draft Determinations will hinder Competition	19
8.5.1	Competition is not limited to capacity augmentation to meet demand growth	20
8.5.2	Competition promotes economic efficiency	21
8.5.3	Legislation supports competition in the NSW water sector.....	21
8.5.4	Impact of competition on other customers	21
8.6	Postage stamp pricing does not justify anti-competitive pricing methodology	23
8.7	Incumbent's approach to recycled water is not relevant to IWCM	24
8.7.1	IPART's 2006 pricing arrangements for recycled water	25
8.7.2	Zero developer charges	26
8.8	Ignoring IWCM doesn't solve the problem	27
8.8.1	The definition of the 'services' bears no resemblance to real activities in the market	27
8.8.2	IWCM is not inherently inefficient	28
8.8.3	IWCM providers do not simply "onsell" sewerage services	28
8.8.4	IWCM providers do not use the same level of service as retail customers.....	29
8.8.5	IWCM is required to build redundancy	30
8.8.6	IWCM providers are not inefficient just because they have a higher WACC than Sydney Water	32
8.9	Ecological sustainability.....	32
8.10	SWC and HWC will receive a windfall gain	33
8.11	Arbitrage opportunity for onselling.....	34
8.12	The Supplementary Draft Report is not underpinned by facts	35
8.13	Conclusion	36
9	Facilitation costs do not fix the problem	36
9.1	The concept of "facilitation costs" is misconceived and too narrow	37
9.2	Scheme specific reviews provide no prospect of relief from IPART errors	39

9.3	The scheme specific determinations do not work	39
10	What pricing for wholesale water services should look like	41
11	What Sydney and the Hunter will miss out on if this pricing determination proceeds ..	42
11.1	Competition.....	42
11.2	Ecological Sustainability	43
11.3	Customer choice.....	43
11.4	Land release	43
11.5	IWCM projects.....	43
12	Conclusion.....	44

1 Executive Summary

The Independent Pricing and Regulatory Tribunal's (IPART) *Supplementary Draft Determinations* for wholesale water and sewage charges for Sydney Water Corporation (SWC) and Hunter Water Corporation (HWC) fail to take into consideration critical concerns raised consistently by the water innovation industry over the past 24 months – that a retail minus tariff will make the fledgling water innovation market uneconomic and will lock out new entrants from meaningful competition in retail water services.

IPART has ignored concerns set out in multiple IPART submissions and at public hearings since 2015 by Integrated Water Cycle Management (IWCM) proponents that many existing and proposed IWCM projects will become unviable if retail minus pricing is applied. While the November 2016 Draft Determination provided several concessions for the recycling of sewage, the *Supplementary Draft Determinations* adopt SWC's and HWC's shared position.

If adopted, the pricing methodology in the *Supplementary Draft Determinations* will render existing and future IWCM schemes uneconomic. It will:

- Destroy competition for water services in the SWC and HWC areas;
- Render existing urban infill schemes, like the iconic Central Park, uneconomic due to massive increases in wholesale sewerage charges;
- Make IWCM uneconomic in new precincts such as Green Square, Central to Everleigh, The Bays, Greater Parramatta Olympic Park (GPOP), The Orchards (in Sydney's North West);
- Force land release schemes on the edges of Sydney and Newcastle to resort to tinkering, even to achieve a positive operating margin. That margin is so thin the capital replacement works costs over the life of the project will not be able to be met.

Of significant concern is IPART's belief and credence in scheme-specific reviews. These reviews do not work and will not address the failings of retail-minus system-wide prices which send the wrong price signals to IWCM/recycled water customers.

Retail minus is the wrong methodology to apply to the pricing of IWCM and recycled water services. It results in excessive wholesale prices and a terminal margin squeeze.

While IPART's own estimates show wholesale sewerage service prices increasing by a minimum of **200 to 400 percent**, Flow modelling indicates increases in IWCM water costs starting at **380 percent and increasing to an unsustainable 1250 percent** for schemes like Green Square.

IPART has failed to provide any evidence as to why any price increases – let alone a 1250 percent price increase – are justified at all. A 1250 percent increase in price for a small number of globally-leading water recycling schemes cannot be justified.

Flow and other IWCM participants are not able to pass through water cost increases to end customers. Therefore, the margin squeeze will be terminal to schemes in many cases. Sewerage services downstream¹ from the points of interconnection would be rendered non-

¹ IWCM providers offer a sewerage recycling service that competes with SWC/HWC's deep ocean outfall (for coastal zones) and traditional sewerage treatment works (in western Sydney and the Hunter) as a method of sewerage treatment. The contestable service offered by IWCM providers includes both retail services, operation of infrastructure and sewerage treatment services. The pricing mechanism suggested in the Supplementary Draft Report has the effect of ruling out competition in treatment services downstream of retail wastewater load.

contestable as IWCM operators would have no revenue on which to sustain water recycling plant and operations.

The proposed increases in prices for sewerage services are not offset by proposed decreases in prices for drinking water. This is because of the asymmetry arising from IPART's draft determinations, where the on-selling view is applied to sewage while the input of production view is applied to water top up.

An IWCM proponent's operating income is primarily made up of revenue earned by providing sewage recycling services. The *Supplementary Draft Determinations* require that critical revenue to be passed through to SWC and HWC.

IPART is proposing to set wholesale prices based on a deemed **not actual level of service.** As a scheme matures, the actual use of any sewerage service from SWC/HWC will fall to between three percent and 22 percent of the scheme wastewater output.²

According to IPART, the portion of customer revenue from the provision of end-user wastewater services that wholesale customers are required to remit to wholesale suppliers increases from 32.3 percent to 77.1 percent (SWC) or from 21.6 percent to 78 percent (HWC).³ Flow's modelling indicates the impact is around 73 to 86 percent of retail water and sewerage revenue will be remitted to the wholesale service provider.

The Supplementary Draft Determination is based on erroneous information and a lack of understanding of IWCM business models and their broader benefits to the State economy. IWCM and recycled water scheme operators constitute a new class of customer that should be recognised by IPART.

As IPART itself has discovered, available data around this new infrastructure servicing approach is scarce. This is to be expected in a sector that is in its infancy. More time is required to understand the impact of these business models on the economy and their benefits to the wider water system before IPART kills off water innovation schemes in critical growth corridors through the introduction of a heavy-handed retail minus tariff.

IPART has itself recognised it has proceeded with a narrowly focussed review of wholesale prices⁴ and that a wider review is necessary to address market distortions. **The narrow, theoretical approach taken by IPART in its *Supplementary Draft Determinations* will lead to perverse outcomes that will undermine any future wider review. Additionally, the *Draft Determinations* are inconsistent with, and not supportive of, stated Government policy which IPART is required to ensure it takes into account in its pricing determinations.**

Flow requests a pause to the review and determination of prices for wholesale water and sewerage services (including services supplied to recycled water schemes) for the 2017 to 2022 pricing period pending a broader industry review.

² Data from 2016 shows that the recycled water plant at Central Park converted 78% of wastewater entering the plant to low total dissolved salts (TDS) recycled water. Schemes that produce high TDS recycled water (that is, those without cooling tower demand) can attain 97% efficiency. In earlier years of the scheme, while recycled water demand is filled (as is currently happening at Central Park), usage of any interconnection with a public utility sewer can be greater, but a lack of data on actual use (and reliance on theoretical discharge factors) makes this difficult to quantify. A worked example for Central Park is provided in the Confidential Annexure.

³ This is a simple average change in revenue across Tables 6.7, 6.8 and 6.9 of the Supplementary Report. In Flow's view, the diversion of customer revenue is between 73 to 86 percent.

⁴ Supplementary Draft Report, section 5.3, particularly statements made in section 5.3.1 on page 51.

2 Flow recommendations

IPART's proposed retail minus methodology jeopardises the economic viability of existing IWCM projects and the development of further IWCM projects, removing competition for water and sewage services (contrary to the intention of the *Water Industry Competition Act 2006 (NSW) (WIC Act)*).

Flow submits that this is a relevant consideration for IPART under section 13A and 15 of the *Independent Pricing and Regulatory Tribunal Act 1992 (NSW)* given the seriousness of the consequences for Flow and other IWCM proponents if IPART adopts its *Supplementary Draft Determinations*. IPART has not had sufficient time to properly consider these issues prior to making a final determination to apply from 1 July 2017.

Accordingly, IPART should:

1. Suspend its current review of wholesale water and sewerage prices until an overall industry review is completed;
2. Participate in an independent industry review led by an expert taskforce to develop a holistic strategy for the water recycling market in order to unlock both public and private investment. The review must consider wholesale pricing in concert with other policy, pricing and regulatory issues; and
3. Ensure Sydney Water and Hunter Water continue to apply the current cost based non-residential prices based on the actual service, not a deemed service, and prevent the application of any type of retail-minus tariff to IWCM WIC Act licensees.

3 A threat to competition

Flow would like to re-emphasise key arguments raised in previous submissions to IPART.

Retail minus has never been applied under the IPART Act or any other regulatory application in Australia other than in telecommunications.

IPART omits to note that retail-minus ceased to apply to telecommunications, following a decision by the ACCC in 2010 to move to a cost building block pricing model. Similarly, retail-minus is no longer applied in the UK Water Sector. This followed the overturning of a decision, by the UK water regulator, Ofwat, to approve retail-minus prices between Albion Water/Welsh Water, by the Competition Appeal Tribunal (CAT) in a 2006 judgment (CAT 23 of 6 October 2006).

Following the CAT decision and subsequent upholding of this decision in a further appeal, substantial changes were made to UK water legislation in the Water Act 2014⁵. In particular, the 'costs principle,' on which Ofwat's use of the ECPR form of retail-minus pricing was based, was replaced.⁶

⁵ See Explanatory Notes, Water Act 2014.

⁶ See paragraph 329 of the Explanatory Notes, Op. Cit.

If the pricing envisaged in the *Supplementary Draft Determinations* were introduced, SWC and HWC would most likely have their previous monopolies restored. IPART's decision would destroy competition for water services in the SWC and HWC areas.

Neither Section 15 of the IPART Act nor the Section 41 of the WIC Act refers to the concept of setting wholesale prices on the basis the wholesale customer has an obligation to pay a wholesale price based on a purely deemed service, as if IWCM/recycled water facilities did not exist or operate. This is because both statutes seek to promote competition and cost based pricing.

The principle that competition in the water sector is supported by Parliament is enshrined in the WIC Act. Significant investments in water industry infrastructure including water recycling plant schemes have been made on the basis that the WIC Act enables competition.

Along with competition, innovation will also be extinguished by IPART's proposed pricing formula. Schemes to reduce drinking water use, including generation of fresh drinking water and water saving technologies need to be based on a cash flow that allows for research costs and capital to be recovered along with a reasonable return on investment. No revenue at all has been allowed to fund innovation and these costs will not be recognised in IPART's narrow 'facilitation costs' concept. Scheme specific determinations are not viable, as they are too lengthy and uncertain to allow for investment in innovation.

IPART's view fundamentally misconstrues and distorts the nature of competition. Competition takes place in the supply of services for existing demand, not merely for the supply for new demand. Competition may involve the substitution (in part or wholly) of existing capacity, not merely the construction of new capacity.

IPART appears to have formed a view that competition is only efficient when it relates to augmentation of a given part of a sewerage system, in response to demand growth (including from medium and high density urban infill). IPART provides no evidence whatsoever to support a view that existing or future competition with WIC Act licensees is not efficient. The basic premise of the Hilmer competition reforms, of which both the IPART Act and IPART itself are a product, is that short term productive inefficiencies necessarily associated with competition are more than offset by downward pressures on costs and prices, and improved dynamic efficiencies. Competition promotes economic efficiency and long term customer benefits.

4 Retail minus vs postage stamp pricing

Retail minus is not required by the existence of postage stamp retail pricing. First, current wholesale prices paid by Flow for existing schemes are also postage stamp prices. The structure of these prices does not vary by location or scheme. This means the available margin for Flow is not higher in areas where retail prices exceed efficient costs, or lower in areas where efficient costs exceed retail prices. As a consequence, opportunities for cherry picking do not arise due to retail postage stamp pricing.

Postage stamp pricing applies in a range of regulated and formerly regulated sectors of the economy. Aside from water, this includes electricity and gas networks, public transport, telecommunications and of course postal services.

Wholesale inter-connection prices exist for most of these services, similar to water. For example, interconnection prices exist for electricity and gas networks, telecommunications and postal services. Where wholesale price regulation remains in these sectors, retail-minus pricing methods are never used to set regulated prices.

There is good reason for this; retail minus is completely at odds with the standard regulatory frameworks in Australia for the regulation of strategic assets and utilities, including water. The only example of retail minus cited in the IPART decision was removed by the ACCC in 2010.

IPART's *Supplementary Draft Report* states that SWC and HWC have a legal right to incorporate the cost of complying with a directive to SWC and HWC, to set developer charges at zero, into postage stamp prices. There appears to be no legal basis for IPART allowing the recovery of the cost of complying with the directive on zero developer charges in regulated retail prices. Accordingly, the existence of the zero developer charges directive does not represent a sound reason to adopt a retail-minus approach.

5 Affordable housing sabotaged

The impact of retail minus wholesale pricing will directly erode the NSW Government's affordable housing objectives. New more affordable ways of providing and managing water are critical to faster land release and more affordable homes. The *Supplementary Draft Determination* will:

- Delay land release
- Restrict urban renewal
- Stop recycled water for new homes
- Stop world-leading IWCM schemes like Central Park and Barangaroo. They could never afford to be built under this tariff and will operate at a loss if it is applied.

There is no doubt IWCM schemes provide clear benefits to the NSW economy through value-add and transformative water services. These have clear and measurable value to the State, to customers and the broader community. IPART has ignored these benefits in this draft determinations.

Removing barriers to cost-effective water recycling will improve housing affordability by accelerating the delivery of new sustainable housing supply by up to five years, and bringing on new sustainable water communities that may never have been serviced. It will also continue downward pressure on water bills for homeowners while reducing network water prices through the deferral of major new water and sewerage infrastructure. Cost-effective water recycling reduces demand on drinking water supplies, diversifies water supply and enhances liveability and community health through drought-resilient greening and urban cooling. In western Sydney, the application of recycled water schemes will reduce wastewater discharges to the Hawkesbury-Nepean River system, thereby enabling housing growth.

6 Bad for NSW, consumers, liveability & resilience

The *Supplementary Draft Determinations* are contrary to the objectives of the NSW Government and Premier, Gladys Berejiklian, spelt out in the 2017 Metropolitan Water Plan (Plan). The Plan's vision is to provide a diversified resilient water supply for growing Sydney. It recognises water is a limited resource but identifies the challenges on this resource of rapid urbanisation and more liveable, greener cities.

The Plan builds on previous Metropolitan Water Plans which set a path for more non-rainfall dependent water supplies, the development of more recycled water schemes, more water innovation and of course the conception of the WIC Act. Flow founded its business on this vision

and is excited by the opportunity it creates to deliver more sustainable water management practices in NSW.

Importantly, the Plan also acknowledges the challenges facing the new water innovation market, calling out pricing and regulatory settings that bias towards traditional water servicing models:

“many of the current pricing and regulatory settings can bias investment toward traditional servicing models, such as centralised water and wastewater networks. This occurs even where integrated solutions (including recycling) are shown to be as cost effective.”⁷

The Plan sets out *“an independent inquiry into barriers and enablers to the uptake of cost-effective water recycling, including consideration of potential regulatory and pricing reforms.”⁸*

IPART claims to have:

“had regard to the existing legislative framework and current NSW Government policies. This legislative and policy environment affects what we are able and required to do in making our pricing decisions, as well as what we need to consider to meet our objectives for this review.” (IPART, p20)

IPART’s proposed retail-minus pricing approach clearly represents a bias towards SWC and HWC.

7 The Impact of retail minus

7.1 Background

IPART’s review of Wholesale water and sewerage services pricing commenced following SWC’s unilateral decision to increase prices via a retail-minus tariff and to introduce a third party access regime for WIC Act proponents. Flow and other industry participants requested IPART’s intervention to set clear and reasonable pricing for wholesale water services for industry.

Flow and other wholesale water customers have always maintained that they should be considered in the same category as other non-residential customers, on the basis that their use of wholesale water services, once IWCM services are in operation, is no different from that of any other non-residential customer.

Application of primarily non-residential pricing to WIC Act schemes has allowed the industry to give growth precincts a new choice of water service provider. Flow brings new levels of service, faster and development-led land release and urban infill, and improved ecological sustainability to the table for consideration by developers of innovative urban precincts and land release communities.

Flow acknowledges that significant resources have been employed by IPART and industry to attempt to formulate a pricing regime applicable to wholesale service providers. However, in doing so, IPART appears to have lost sight of the statutory requirements and pricing principles it is required to apply.

⁷ <https://www.metrowater.nsw.gov.au/2017-metropolitan-water-plan> p48

⁸ Ibid

7.2 What IPART is proposing

The major change in IPART's March 2017 Supplementary Draft Report relative to its November 2016 Draft Report is the application of retail minus prices to wholesale customers using SWC or HWC sewerage treatment services including sewage transportation, treatment and disposal, regardless of whether the wholesale customer operates a recycled water plant.

The effect of applying a retail-minus pricing methodology to wholesale customers for all sewerage services is that any interconnected IWCM projects proposed and currently operating will be uneconomic. IWCM proponents that are connected to the SWC and HWC sewerage networks and who provide any form of sewerage service to their retail customers must transfer more than three quarters of the revenue earned from these customers to SWC and HWC for a purely deemed level of service. These prices bear no relation to the actual services supplied and received at the point of interconnection between the retail customer and the wholesale supplier.

For all the failings of the retail-minus pricing approach (which have been the subject of Flow's submissions to date), there was at least recognition by IPART in their November 2016 Draft Report that retail minus pricing should be applicable to IWCM proponents only to the extent that they use the service⁹ (whether that be on time-based, or volume-based measures as submitted by Flow¹⁰). For example, at the public hearing held by IPART on 28 November 2016, Matthew Edgerton IPART Executive Director water stated:

".... Under our draft determination, to the extent your recycled water plan[t] (sic.) is operating and all waste is going through your recycled water plant, retail-minus is not relevant. You are subject to the non-residential price. The more you are using the plant, the greater, potentially, the facilitation cost savings, but also the less relevant retail minus is.

*I wanted to confirm to what extent is the waste going through your plant? Is the majority of the waste going through your plant for the majority of the time? In that instance, retail-minus is not relevant; it is non-residential prices"*¹¹

And later:

"On the question about how you measure proportion bypass versus proportion through the recycled water plant, again that is something that we are working on between now and the final report.

*There are two things: first of all, if you have any views about how that should be measured, we are all ears. Secondly, there is a fundamental question, though, in terms of how proscriptive (sic) we may or may not want to make the determination. There is obviously a risk with being too proscriptive (sic) as well"*¹²

⁹ IPART Review of Wholesale Water Pricing - Draft Report, November 2016 page 77; IPART Presentation to Public Hearing on 28 November 2017, slide 15

¹⁰ [Flows 16 December 2016 submission, page 14]

¹¹ IPART Review of Wholesale Water Pricing, Public Hearing Transcript, 28 November 2016 at 10am, page 57, lines 9-27

¹² IPART Review of Wholesale Water Pricing, Public Hearing Transcript, 28 November 2016 at 10am, page 68, line 46 to page 69, line 9

The Supplementary Draft Report dismisses those practicalities in favour of an approach that fails to deal at all¹³ with the issues that the water industry had requested IPART to consider. The determination gives no concessions for the treatment of sewage and production of recycled water and does not discriminate between a WIC Act licensee treating sewage and producing recycled water and a wholesaler that does nothing apart from directly onselling services.

IPART explains that it has moved from an input of production view to an onselling view, with respect to sewage treatment by recycled water plants:

“ In our November 2016 Draft Report we acknowledged that the wholesale service of waste disposal from a recycled water system could be viewed in two ways:

1. Under the ‘input of production’ view, the wholesale customer is similar to any other non-residential customer that relies on waste disposal from Sydney Water or Hunter Water to sell a product to end-use customers (in this case recycled water). Taking this view suggests wholesale customers receiving this service should be treated similar to any other non-residential customer and levied a non-residential (retail) price.
2. Under the ‘onselling’ view, wholesale customers are using the wholesale service provider’s network to provide sewerage services to end-use customers. Taking this view suggests wholesale customers receiving this service should be treated as competitors for end-use sewerage customers and levied a retail-minus price.”¹⁴

IPART states that it has considered whether a recycled water plant leads to any additional avoided costs for the wholesale service provider that should be reflected in a system-wide determination via an estimate of standard negative facilitation costs. It has concluded there would be no negative facilitation costs in the system-wide wholesale price.¹⁵ Negative facilitation costs would therefore be addressed under a proposed scheme-specific review mechanism.

7.3 Impact of the proposed wholesale prices

Before we address the issues arising from an attempt to implement retail-minus pricing in respect of IWCM proponents, we outline below our analysis of the key impacts of the pricing methodology set out in the Supplementary Draft Report.

Modelling the impact of the revised wholesale prices

To best understand the impact of the wholesale prices proposed by IPART, Flow has adapted its detailed project cash flow model to reflect the wholesale prices proposed by IPART in November 2016 and again for the wholesale prices proposed in the Supplementary Draft Report.

This base financial model was then independently reviewed by EY to ensure that its calculations were appropriate and reflect IPART’s decisions. The model was then run for

¹³ Unregulated negotiation of facilitation costs and ‘scheme-specific review’ do not deal with the issues

¹⁴ Supplementary Draft Report, page 50

¹⁵ Supplementary Draft Report, Page 87

three example projects across the non-residential, November 2016 and March 2017 draft determinations.

EY then reviewed all nine iterations of the model and a dashboard that extracted data from each base model to allow comparison between the types of project and pricing methodologies. EY's review letter has been provided to IPART as a confidential annexure to this submission.

The model reviewed by EY was then run with actual and forecast data for Flow's existing Central Park IWCM scheme.

The pricing proposed by IPART would render current and future IWCM schemes within metropolitan areas unviable. This is because wholesale water pricing would cause operating costs to exceed revenue in all years of those schemes.¹⁶

Schemes on the fringes of metropolitan areas would have their operating margins significantly eroded (to a point where capital recovery becomes unviable) and would be forced to tanker the small amount of wastewater that they produce rather than connect to any available SWC or HWC sewerage infrastructure (despite capacity being available).

Schemes involving potential innovation, such as a scheme currently under development by Flow in conjunction with a progressive developer in Sydney's west, will be curtailed. New technologies that could allow a residential precinct to supplement drinking water and reduce drinking water use cannot be proposed where there is no certainty of being able to earn a return on those technologies.

For example, in Flow's IWCM scheme at Central Park in Sydney, where in 2016 flows to SWC's sewer were reduced by at around 60% compared to what would have been the case without the IWCM scheme in place,¹⁷ Flow's sewerage charge will be at least 260 percent of current non-residential pricing if IPART's Supplementary Draft Report pricing methodology were applied.

Central Park

The world's largest membrane bioreactor recycled water plant in the basement of a residential building will treat one million litres per day of wastewater for a total community of 7500 people working and living in the internationally-acclaimed Central Park precinct. The use of recycled water enabled One Central Park to be awarded a 5-star Green Star rating by the Green Building Council of Australia, making it the largest multi-residential building in Australia to receive such a designation. According to former NSW Minister for Primary Industries, Lands and Water, Niall Blair, "companies like Central Park Water are demonstrating what is possible and are changing the way existing utilities think about traditional water delivery strategies."

¹⁶ Further detail has been provided to IPART in a confidential annexure.

¹⁷ See Confidential Annexure for calculations. As set out above, as recycled water demand grows (including with the future connection of UTS to recycled water produced at Central Park), this will increase to at least 78% and probably more as the proportion of low TDS water required to be produced falls as a percentage of overall recycled water production.

Flow has provided further detail on three additional proposed schemes which will be rendered uneconomic in light of the pricing outlined in the Supplementary Draft Report. Please refer to the Appendix 1: Confidential Impact on Flow schemes.

In summary, the impact on the three proposed Flow schemes is as follows:

Scheme	Type	Wholesale water bill increase (%)
Scheme A	Urban Infill – Sewage Recycling	~1200
Scheme B	Urban Infill – Full IWCM (Sewage & Drinking Water)	~370
Scheme C	Land Release (Urban Fringe) – Full IWCM (Sewage & Drinking Water)	~250

All schemes would have their operating margins cut by more than 100% (that is, all would have a negative operating margin). For Scheme C, tankering all waste from the recycled water plant would allow a positive operating margin, but not to a level to meet ongoing capital replacement works.

The impact of the proposed pricing regime will devalue all IWCM projects. Drawing on IPART's own analysis,¹⁸ IPART's proposed retail minus approach would result in a substantial increase in sewerage wholesale prices.

As shown in the table below, the portion of customer revenue from provision of end-user sewerage services that wholesale customers are required to remit to wholesale suppliers increases from 32.3 per cent to 77.1 per cent (SWC) or from 21.6 percent to 78 per cent (HWC).¹⁹ Flow's modelling indicates the impact is around 73 percent to 86 percent of retail revenue will be remitted to the wholesale service provider.

Percent of retail revenue	Table 6.7 High density		Table 6.8 Greenfields low density		Table 6.9 Greenfields low density		Av. SW	Av. HW
Non-residential	27.0%	20.6%	36.5%	24.5%	33.5%	19.6%	32.3%	21.6%
Retail-minus wholesale	86.0%	84.5%	72.6%	74.6%	72.6%	74.8%	77.1%	78.0%

Contestable margin	Table 6.7 High density		Table 6.8 Greenfields low density		Table 6.9 Greenfields low density		Av. SW	Av. HW
Non-residential	73.0%	79.4%	63.5%	75.5%	66.5%	80.4%	67.7%	78.4%
Retail-minus wholesale	14.0%	15.5%	27.4%	25.4%	27.4%	25.2%	22.9%	22.0%
Difference	59.0%	63.8%	36.0%	50.1%	39.1%	55.2%	44.7%	56.4%

IPART's Supplementary Draft Report proposes diverting substantial customer revenue, currently used by wholesale customers to fund IWCM facilities and operations, to SWC and HWC. The average contestable margin for a scheme in the SWC area would decrease from 67.7 per cent to

¹⁸ Supplementary Draft Report, pages 67 to 69

¹⁹ This is a simple average change in revenue across Tables 6.7, 6.8 and 6.9 of the Supplementary Report. In Flow's view, the diversion of customer revenue is between x and y.

22.9 per cent. The average contestable margin for a scheme in the HWC area would decrease from 78.4 per cent to 22 per cent. This has the effect of rendering the equivalent wholesale services and operations provided by wholesale suppliers to be non-contestable services. Revenue would be diverted to fund deemed or notional services that bear no relationship to the services provided to the wholesale customer. Please refer to Flow's previous submissions covering this matter.

7.4 Margin squeeze

The retail minus pricing referred to in the Supplementary Draft Report results in a significant margin squeeze:

- Sewerage services wholesale prices will substantially increase by:
 - 44.8 percent from 32.3 per cent of estimated revenue to 77.1 per cent in the SWC area
 - 56.4 per cent from 21.6 per cent of estimated revenue to 78 per cent in the HWC area
- Consequently, contestable margins would substantially decrease by:
 - 44.8 percent from 67.7 per cent to 22.9 per cent in the SWC area
 - 56.4 per cent from 78.4 per cent to 22 per cent in the HWC area

Given Flow and other IWCM participants are not able to pass through wholesale water cost increases to end customers, the margin squeeze will result in many schemes becoming uneconomic and failing.

The impact of this significant input cost change will mean that existing IWCM schemes may be forced to close²⁰ and new schemes will need to be shelved. As a result, any later system-wide review of the water industry will be ineffectual, with many of the issues that would have been under consideration rendered moot by the absence of viable competing schemes.

By eliminating private competition and capital from the water market, the proposed pricing regime will deny the benefits of competition to the wider water system.

On the other hand, removing barriers to cost-effective water recycling and removing excessive regulated wholesale prices will improve housing affordability by accelerating the delivery of new housing supply by up to five years and bringing on new sustainable water communities that may never have been serviced. It will also continue downward pressure on water bills for homeowners while reducing network water prices through the deferral of major new water and sewerage infrastructure. Cost-effective water recycling will reduce demand on drinking water supplies, diversify water supply and enhance liveability and community health through drought-resilient greening and urban cooling. In western Sydney, the application of recycled water schemes will reduce wastewater discharges to the Hawkesbury-Nepean River system, thereby enabling housing growth.

The water industry as a whole recognises the benefits of IWCM. For example, Mr Jim Bentley, Managing Director of Hunter Water expressed during IPART's public hearing:

²⁰ This is despite the "grandfathering" concepts outlined in the Supplementary Draft Report, for reasons that are explored below in this submission.

“One thing that I think we need to consider for the long term, and this might come into the wider review, is that there is a lot of thinking around integrated water management and the benefits that could have for health, the environment and all those sorts of things. Somehow we need to make sure that whatever we are doing here does not make it harder to have an integrated approach to water management...”²¹

Similar views have been expressed by Sydney Water’s Managing Director, Mr Kevin Young:

“I think virtually everyone in the room would be in favour of our cities having more recycled water and of creating more liveable cities. At the moment, I think we are fragmented. That is for another day. We can look at it from a drought perspective, but there is also the nutrient issue in the Hawkesbury-Nepean. If you talk to Health, they will talk about the effects that you can get. There is a value for people living there, from a developer viewpoint, in having water as part of the community. There are wider economic benefits that we have approached...”²²

The WIC Act legislation has catalysed world-leading IWCM schemes which provide clear benefits to the NSW economy through value-add and transformative water services. These have clear and measurable value to the State, to customers and the broader community.

These system-wide benefits should be better understood before any pricing regime is introduced that could irreparably damage competition and innovation in the provision of water services.

8 Retail minus is the wrong pricing method

Flow accepts that it is not sufficient to point to the significant impacts of the pricing methodology set out in the Supplementary Draft Report. Flow continues to maintain that the retail minus pricing methodology set out in the Supplementary Draft Determinations is fundamentally flawed.

8.1 Retail minus does not properly regard the need to promote competition

Neither the Section 15 of the IPART Act nor the Section 41 of the **WIC Act** pricing principles refer to the concept of setting wholesale prices on the basis the wholesale customer has an obligation to pay a wholesale price based on a purely deemed service, as if IWCM facilities did not exist or operate. This is because both statutes seek to promote competition and cost based pricing.

IPART’s proposed approach has the effect of imposing a margin squeeze on wholesale customers, for both existing and potential water recycling schemes currently under negotiation. This squarely conflicts with the requirement in Section 15(1)(i) of the IPART Act that IPART is to have regard to, among other things ‘the need to promote competition in the supply of the services concerned.’

8.2 Retail minus does not properly regard cost and use of an actual service

Similarly, under Section 15(1)(a), IPART is to have regard to the cost of providing the services concerned. IPART is instead proposing to set wholesale prices for a deemed service (a deemed maximum sewage volume at the point of interconnection) that exceeds the service actually supplied (the actual maximum sewage volume at that point) by at least 2.5 times²³ for

²¹ IPART Public Hearing transcript, page 22, lines 36 to 43

²² IPART Public Hearing transcript, page 17 lines 16-26

²³ Details provided in a confidential annexure

urban schemes with high cooling tower needs and limited irrigation opportunities and potentially much higher where only general purpose recycled water is required and excess recycled water can be easily used for green space irrigation. Further details are provided in the Confidential Annexure.

By adopting a retail minus price, IPART is forcing wholesale customers (and their clients and customers) to subsidise capital decisions made by SWC and HWC which were made in the absence of consideration of IWCM at the scheme. This is regardless of the level of use of that installed capital by wholesale customers.

IPART's proposed decision implies that current non-residential prices are between half and a quarter of actual and efficient costs borne by SWC and HWC. However, IPART has provided no evidence or analysis in the revised Draft Determinations that SWC and HWC are delivering current non-residential wholesale services at between half and a quarter of actual or efficient costs. Instead, this seems to be simply assumed by IPART.

Similarly, IPART has provided no evidence to support a conclusion that SWC is delivering 77.1 percent and HWC is delivering 78 percent of the average value of the retail services being supplied to IWCM customers. The consultant's report referred to in the *Supplementary Draft Determinations* does not appear to consider whether existing non-residential prices are between half and a quarter of current actual costs to SWC and HWC. Instead, the report focuses on the extent IWCM schemes may reduce current and future costs to SWC and HWC. That is a different issue. Nothing in the consultant's report addresses the question of whether non-residential pricing of wholesale services is inequitably imposing costs to SWC and HWC.

Even if SWC/HWC costs did exceed current non-residential prices, this could merely reflect inappropriate operating licence conditions that presuppose that SWC/HWC must size their capacity as if they were monopolies rather than subject to competition under the WIC Act. This highlights Flow's repeated arguments that wholesale pricing should follow, not precede, essential revisions to operating licences to reflect the existence of competition.

Thus, retail minus pricing will not lead to better service outcomes or more efficient capital investment, instead will continue to incentivise wholesale service providers to plan out their competition. That is, by building and planning for infrastructure that would be more efficiently be installed and run by the private sector and having IPART allow a regulatory return on that infrastructure through retail minus pricing, incumbents are able to entirely lock out new entrants. The problem is with SWC and HWC operating licence conditions being set as if competition does not exist – this is clearly contrary to the WIC Act.

On this point, IPART has misconstrued Flow's previous submission²⁴ which was about the measurement of onselling versus non-onselling services rather than pricing, and was not an argument for retail-minus pricing to apply regardless of use of the wholesale service being provided. In its November 2016 submission, Flow said:

"While the clause in the Draft Determination [regarding proportional charging] is helpful, Flow suggests that the Final Determination could usefully provide further clarification of the delineation between onselling and non-onselling services, and in particular, on the

²⁴ Supplementary Draft Report, page 51

avoidance of double recovery of fixed charges where properties switch from SWC/HWC to IWCM suppliers or where a portion of wastewater produced in a precinct is discharged to the SWC/HWC sewer at the same time as the recycled water plant is operating (as may be required for water balance purposes). An appropriate way of dealing with this issue would be to measure the sewerage on-sale service according to the portion of the waste stream that is serviced by SWC/HWC, rather than on the times at which the service is provided.”

IWCM providers will never be compensated (regardless of adjustments in future pricing reviews) for this subsidy to SWC and HWC and will not receive compensation in any pricing review.

8.3 Retail minus has been widely discredited

There is no precedent for applying retail-minus price regulation under Sections 11 and 13A of the IPART Act. IPART states that the Efficient Component Price Rule (ECPR – an alternative term for retail-minus) has been used in a number of contexts for access pricing.²⁵ However, IPART does not cite any examples of retail-minus approaches being used to set regulated prices in any part of the Australian water sector.

The only example cited in the Supplementary Draft Report is the Australian telecommunications sector (for fixed line services). IPART omits to note that, as mentioned above, retail-minus pricing ceased to apply following a decision by the ACCC in 2010 to move to a cost building block pricing model. The ACCC noted that the shift to a building block approach also delivers on a long standing commitment by the ACCC to replace the "Retail Minus Retail Cost" approach used to price wholesale voice line rental and wholesale local calls.²⁶

Similarly, retail-minus (also referred to as the Baumol-Willig rule) has been expressly prohibited in the context of regulation of telecommunications services in New Zealand. Schedule 1 of the Telecommunications Act 2001 (NZ) states that:

“2(1) To avoid doubt, the Baumol-Willig rule does not apply in respect of any applicable initial pricing principle or any applicable final pricing principle that provides for a forward-looking cost-based pricing method as a possible pricing principle; and 2(2) For the purposes of subclause (1), the Baumol-Willig rule means the pricing rule known as the Baumol-Willig rule as referred to in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* (1994) 6 TCLR 138, PC.”

In addition, retail-minus is no longer applied in the UK water sector. This followed the overturning of a decision, by the UK water regulator, Ofwat, to approve retail-minus prices between Albion Water/Welsh Water, by the Competition Appeal Tribunal (CAT) in a 2006 judgment (CAT 23 of 6 October 2006). The CAT rejected arguments that ECPR should be applied in setting access prices, in order to allow recovery of the wholesale suppliers’ infrastructure and related costs, including the cost of funding cross subsidies (i.e. the equivalent of postage stamp pricing and zero developer contributions). The CAT found that, in the course of the extensive international evidence submitted to it, the CAT had found no examples of ECPR being successfully used.

“[Paragraph 738] The evidence before the Tribunal is to the general effect that ECPR is in fact a controversial methodology, both in the academic literature and as a matter of regulatory

²⁵ Supplementary Draft Report, page 112

²⁶ See <https://www.accc.gov.au/media-release/accc-proposes-new-simpler-approach-for-wholesale-fixed-line-telecommunications-services-pricing>

practice, a fact that is not referred to in the [Ofwat] Decision [permitting application of ECPR]. The NERA reports, referred to in paragraphs 321 and 322 of the Decision, and prepared for Northumbrian Water, do not in our view fully bring out the extent of that controversy. We have been provided with no examples or case studies of ECPR being successfully used.”

In addition, the CAT suggested that use of retail minus ran a strong risk of breaching a prohibition on misuse of market power.

“[paragraph 803] At the very least, a pricing policy which insulates the incumbent in perpetuity from competition; which requires the new entrant to support the incumbent’s overheads as well as its own, and to indemnify the incumbent indefinitely against any loss of revenues (except as regards “avoided costs”); and which requires the new entrant to be “super-efficient” as compared with the incumbent requires close scrutiny under the Chapter II prohibition [on any conduct ... which amounts to the abuse of a dominant position in a market, such as directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions – Section 18 of the UK Competition Act 1998.]”

Following the CAT decision (and subsequent upholding of this decision in a further appeal), substantial changes were made to UK water legislation in the Water Act 2014 [Explanatory Notes, Water Act 2014]. In particular the ‘costs principle,’ on which Ofwat’s use of ECPR was based, was replaced [paragraph 329 of Explanatory Notes].

It is easy to understand why the UK would have rejected retail-minus pricing. When translated into the Australian context, by reducing the margin recoverable by wholesale customers by the extent discussed above, IPART is allowing pricing that would, under normal trade and commerce, be prohibited by the *Competition and Consumer Act 2010* (Cth). For example, changing the price in such a manner in trade and commerce would, given the SWC/HWC monopoly position, amount to unconscionable conduct to wholesale customers (under Sections 20 and 21 of the *Australian Consumer Law*) and would also amount to misuse of market power (under Section 46 of the *Competition and Consumer Act 2010* (Cth)) in respect of wholesale customers as competitors.

Given that the determinations must be of the maximum prices for wholesale water and sewerage services, assuming the final Determinations reflect the draft Determinations, would SWC or HWC contravene the above legislative constraints if they were to charge wholesale customers the maximum prices (given that they can, if approved by the Treasurer, charge less than the maximum prices determined by IPART)?

ECPR was adopted by the ACCC in a controversial access pricing arbitration decision, dated 19 July 2007, cited in IPART’s April 2016 Issues Paper (for example footnote 41 of the Issues Paper). As noted in Flow’s June 2016 submission in response to this issues paper, the ACCC decision is not relevant in the present context.

Among other things, the ACCC decision was never implemented. This is because the retail price upon which it was based had already been overturned by the NSW Premier in a 13 June 2007 letter formally initiating an IPART review of the then prevailing retail price one year earlier than otherwise, on the basis the prevailing retail price was not sufficient to fund entry of new supply.

It is difficult to see how IPART's obligation under section 15 of the IPART Act to have regard to the protection of consumers from the abuses of monopoly power and the need to promote competition has been applied in the *Supplementary Draft Report*.

8.4 Reasonably efficient competitor form of retail-minus

IPART appears to consider it has addressed the objections to applying a standard retail-minus approach by calculating the minus component using estimated costs for a reasonably efficient competitor, rather than the avoided costs for the wholesale supplier. This does not, however, come close to overcoming the objections to retail-minus.

This is because IPART only deducts what it determines to be the "contestable" components of the supply chain, which it defines to be retail servicing and local reticulation (to or from the point of interconnection). By applying the onselling view instead of the input of production view, IPART does not consider sewage treatment/recycling to constitute a contestable service.

The impact of IPART's proposal would be to render the corresponding wholesale services (that sewage recycling seeks to replace) to be non-contestable services. Accordingly, the use of a reasonably efficient competitor standard does not overcome or address the fact that the resulting wholesale price exceeds the efficient cost of the service that is actually supplied and results in a margin squeeze on wholesale customers.

8.5 The Supplementary Draft Determinations will hinder competition

The Supplementary Draft Report fails to demonstrate that retail minus pricing in the form proposed will not substantially hamper competition.

IPART suggests that its proposal is necessary to retain competitive neutrality:

"To ensure a level playing field between wholesale service providers (incumbents) and wholesale customers (new entrants), and therefore efficient entry and competition for the benefit of water consumers, wholesale prices for onselling water and sewerage services need to reflect the regulated retail prices for these services."²⁷

However, the examples cited above (and detailed in the Confidential Annexure) show that retail-minus pricing does not encourage competition or efficiency. Instead, it protects the revenue that SWC/HWC believe they are entitled to, in order to subsidise their inefficient last century infrastructure approaches that cannot meet the needs of the rapidly growing Sydney and Hunter regions. Centralised water infrastructure approaches are ageing and reaching the end of their lifespan. They have contributed to slow land release, poor housing supply solutions, vastly unequal property value distribution, continuation of poor environmental outcomes, and antiquated service standards

IPART further states that it is necessary to dampen competition:

"If the retail non-residential price were to apply to these wholesale services, the wholesale customer could use the difference between its wholesale price (retail non-residential) and Sydney Water's and Hunter Water's regulated retail prices (residential and non-residential) to ... Out-compete' Sydney Water and Hunter Water for services to retail sewerage customers by charging lower retail prices, but not necessarily on the basis of lower cost or

²⁷ Supplementary Draft Report, page 45

better service, just by virtue of the difference between Sydney Water and Hunter Water's regulated retail prices for their residential and non-residential customers. In turn, this would increase the costs for Sydney Water and Hunter Water's remaining customers (and/or owners, being the Government), with little benefit in terms of lower overall costs and/or better services to water consumers."²⁸

Imposing retail minus pricing is not necessary to address this concern. The concern that SWC and HWC might be out-competed on price appears to be seeking to address a theoretical entrant into a 'reselling' market, but neglects to consider that in a market where retail meters are not contestable, there can be no such entrant. The only path to market for private sector water retailers is through property developers. Of course, as developers are not the ultimate user of retail water services, their decisions are not driven by retail prices and there *is* no avenue to enter the market on an arbitrage model. Instead, wholesale customers must demonstrate additional value *relevant to developers*. That is, value brought about by IWCM,²⁹ including faster lot release, lower capital costs for the developer (in areas requiring augmentation of existing utility networks), BASIX certifications, green star ratings, value uplift in land and the potential to support higher floor space ratios in urban infill projects. None of these value items go to lower retail costs or mere arbitrage, but instead indicate that competition is already on a real value/service basis.

8.5.1 Competition is not limited to capacity augmentation to meet demand growth

IPART appears to have formed a view that competition is only efficient when it relates to augmentation of a given part of a sewerage system, in response to demand growth (including from medium and high density urban infill). This appears to be the basis for its view that negative facilitation costs can only be assessed on a scheme specific rather than a system wide basis. This is related to its efficiency concern that, where sewage recycling systems duplicate wholesale supplier sewerage infrastructure, this would be inefficient from a society wide perspective.

IPART's view fundamentally misconstrues and distorts the nature of competition. Competition takes place in the supply of services for existing demand, not merely for the supply for new demand. Competition may involve the substitution (in part or wholly) of existing capacity, not merely the construction of new capacity. In particular, competition may involve the replacement of a business model or product or service type by an alternative business model, product or service type.

Competition necessarily leads to a degree of duplication and even waste, and hence some short term productive inefficiencies. There are multiple providers and associated fixed assets instead of one provider and one set of fixed assets in a given market or location. In addition, some assets may become partly or fully stranded even though they are still technically serviceable and capable of continuing to operate for decades into the future. This process is not dependent on

²⁸ Supplementary Draft Report page 52

²⁹ For this reason, as will be further explained below, failing to consider the existence of IWCM facilities operated by the wholesale customer means that the pricing methodology set out in the Supplementary Draft Report will not fulfil IPART's legislated mandate.

the identity of the provider and should not assume (as appears to have been so assumed by IPART)³⁰ that the incumbent infrastructure is the most efficient.

8.5.2 Competition promotes economic efficiency

The basic premise of the Hilmer competition reforms is that short term productive inefficiencies necessarily associated with competition are more than offset by downward pressures on costs and prices, and improved dynamic efficiencies. Competition promotes economic efficiency and long term customer benefits.

8.5.3 Legislation supports competition in the NSW water sector

The principle that competition in the NSW water sector is valid is enshrined in the WIC Act. Significant investments in water industry infrastructure including best practice recycled water schemes have been made on the basis that the WIC Act enables competition.

As IPART's proposed decision would be a substantial barrier both to existing and future competition, it would be inconsistent with the policy and principles of the WIC Act.

8.5.4 Impact of competition on other customers

IPART states it is concerned that investment in and use of recycled water would increase the costs for SWC's and HWC's remaining customers (and/or owners, being the NSW Government), with little benefit in terms of lower overall costs and/or better services to water consumers.³¹ It is the case that competition can be expected to reduce the value of the incumbents' business' and associated assets. This is because, at the point after markets are opened to competition, the vertical supplier is likely to have excess capacity and investment relative to the previous market share and demand assumptions, on which it previously invested in infrastructure capacity and services.³²

This is reflected in IPART's first major pricing decision, Electricity Prices, March 1996. In that decision, IPART optimised the assets of existing electricity suppliers, in recognition of the effect of competition for existing capacity and previous inefficient investment.

A distinguishing feature of competitive markets is that suppliers, not customers, bear the risk of asset stranding or optimisation as a consequence of market or technology change, such as is currently occurring in some NSW water/sewerage services markets. The existence of optimisation risk in competitive markets is also reflected in the recoverable amounts (Impaired Assets) test under *International Financial Reporting Standards* (IFRS), and associated provisions for accelerated depreciation charges.³³

There is no evidence that, in setting the Weighted Average Cost of Capital (WACC) for SWC/HWC, IPART has applied a significant discount to reflect a transfer of asset optimisation risk from suppliers to customers. For example, in IPART's March 2016 Draft Determination for Sydney

³⁰ For example, page 52 of the Supplementary Draft Report, where IPART states: "This could provide incentives for inefficient over investment in recycled water projects, at the expense of Sydney Water's and Hunter Water's customers"

³¹ Supplementary Draft Report, page 52

³² This problem is reduced to the extent there is demand growth. It would be reduced to the extent competition was somehow limited to serving increased demand. But the clear intent of the Hilmer reforms was that competition would not be so limited.

³³ See IAS 36 under IFRS available at <http://www.iasplus.com/en/standards/ias/ias36>

Water, no provision is made (for example by way of redefining the set of comparator companies for deriving an asset beta) to discount the capital charge building block to reflect a transfer optimisation risk from supplier to customer. This is further evidence that proposed retail minus wholesale prices exceed efficient wholesale prices.

Significant stranding of electricity generation assets is currently underway, in part due to the strong uptake of distributed rooftop solar generation, which significantly reduces maximum annual demand. IPART itself recognises the value of this generation, in the context of its decisions regarding the benchmark solar feed in tariff.

In principle, small solar generation has some similarities with sewage recycling in that small solar generation owners remain grid connected. As is the case for most IWCM services, small solar generation has (so far) only reduced the volume of the services provided by incumbent suppliers, rather than bypassing those suppliers entirely. There is however, no serious suggestion that small solar generation households should pay the same annual price for wholesale electricity as their neighbours without solar, whose maximum and average demand for remote generation output is typically far greater than for solar customers. This analogy highlights that IPART's proposals for setting wholesale sewerage prices in its *Supplementary Draft Determinations* are inconsistent with sound regulatory practice and economic efficiency.

The pricing regime described in the Supplementary Draft Report will, if implemented, lock out new entrants from urban infill areas and is also designed to discourage new entrants in 'fringe areas':

"We maintain our position throughout this review, that to remove this advantage and allow competition on a level playing field, it is necessary to extend an equivalent subsidy to wholesale customers. However, this needs to be done in a way that does not create incentives for wholesale customers to operate in high-cost fringe areas (which would ultimately increase the price for all water users)." ³⁴

This statement does not take into account the actual impact of IWCM projects in those high-cost fringe areas. IWCM schemes should be encouraged in those areas because:

- IWCM schemes allow for development at a much lower capital impost to the SWC and HWC systems than would be incurred otherwise; and
- they would provide revenue to SWC/HWC above and beyond their projected capital return by bringing on new customers much sooner than SWC/HWC would have been able to do in the equivalent timeframe, with no/deferred need to augment existing SWC/HWC infrastructure.

Instead, Flow's modelling indicates, instead, that IPART's proposed pricing regime would force IWCM operators to either abandon their schemes or, in some limited cases, use road tankering to dispose of their modest levels of wastewater output rather than connect to existing SWC/HWC infrastructure (further details are provided in the Confidential Annexure). This indicates that the cost of connecting to the SWC/HWC is prohibitively high such that it is not able to operate at its maximum efficiency.

³⁴ Supplementary Draft Report page 84

8.6 Postage stamp pricing does not justify anti-competitive pricing methodology

IPART considers that allowing wholesale customers to use their retail customer revenue to fund water recycling facilities and activities would result in inefficient cherry picking, undermining the effectiveness and efficiency of postage stamp pricing.

Postage stamp pricing applies in a range of regulated and formerly regulated sectors of the economy. Aside from water, this includes electricity and gas networks, public transport, telecommunications and of course postal services. Wholesale inter-connection prices exist for many of these services, similar to water. For example interconnection prices exist for electricity and gas networks, telecommunications and postal services. Where wholesale price regulation remains in these sectors, retail-minus pricing methods are not used to set regulated prices.

Postage stamp pricing is not unique to wholesale water services. IPART has not referred to examples in any other sector where postage stamp pricing has led to the adoption of retail-minus instead of cost based approaches to regulated price setting.

Under postage stamp pricing:

“Sydney Water and Hunter Water generally charge all their retail customers in their area of operations the same drinking water, sewerage and stormwater prices – regardless of differences in the cost of supplying different locations and other site-specific factors.”³⁵

IPART is concerned that, as a result of postage stamp pricing, there is a risk wholesale customers could cherry-pick by selectively targeting low cost areas.

“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 [Page 48].”³⁶

However, postage stamp pricing cannot be a justification for retail-minus pricing. Postage stamp pricing already applies to non-residential as well as residential pricing across the SWC and HWC areas. In charging Flow and other wholesale customers a non-residential tariff, SWC and HWC are already getting the benefit of a cross-subsidy across their respective areas.

Postage stamp pricing, as defined in the pricing principles section of the WIC Act, does not mean a uniform price for every customer within the territories serviced by SWC and HWC. Section 41(3) of the WIC Act states:

“(3) These principles must be implemented in a manner that is consistent with any relevant pricing determinations for the supply of water and the provision of sewerage services, including (where applicable) the maintenance of “postage stamp pricing” (that is, a system of pricing in which the same kinds of customers within the same area of operations are charged the same price for the same service).”

³⁵ Supplementary Draft Report page 47

³⁶ Supplementary Draft Report page 48

Retail customers of WIC Act licensees are not necessarily receiving the same service as customers of SWC/HWC, nor are they necessarily in the same area of operations. For example, WIC Act licensees may:

- operate in an area where the local water and/or sewerage networks are neither owned nor managed by SWC or HWC; and/or
- provide an alternative service that cannot be provided by SWC/HWC (eg. recycled water).

Actual differences in service levels vary substantially between Flow and SWC/HWC areas of operations, to the extent a Flow scheme may completely or partially bypass the infrastructure and services provided by SWC/HWC.³⁷

Furthermore, the fact that postage stamp pricing applies to SWC and HWC, does not absolve IPART of the duty to consider the most efficient pricing to apply to wholesale customers. Simply because SWC has made certain decisions about applying capital and has sought to recover a return on that investment from customers of WIC Act licensees, does not make SWC's capital decisions the most efficient decisions or ones which align with the matters that IPART must consider in Section 15 of the IPART Act.

As set out in section 7 of this submission, the introduction of a pricing regime in the form described in the Supplementary Draft Report will:

- Lock out wholesale customers from 'low cost' areas altogether even if their infrastructure solutions are at least as efficient as the incumbent's solution – because the minus element does not allow for recovery of cost of capital, meaning that capital decisions of the incumbent (whether or not efficient) are paid for by the wholesale customer (whether or not they use those capital assets); and
- Lock out wholesale customers from 'high cost' areas where they could potentially provide a way to facilitate provision of services at a much lower cost to SWC and HWC than would be otherwise spent by them to supply the end-user retail customers, and provide windfall gains to SWC and HWC in the case of precincts where they would not otherwise have been able to invest capital in a timely manner because of the higher cost of SWC/HWC's servicing solution.

The inconsistencies and challenges of trying to impose a wholesale pricing regime in the context of postage stamp pricing are an indication that this process should be paused while a whole-of-system review is completed. Proceeding otherwise risks the impacts set out in section 2 of this submission.

8.7 Incumbent's approach to recycled water is not relevant to IWCM

SWC has misconstrued IPART's role both in respect of determining wholesale prices that SWC can charge, as well as by seeking to have IPART apply regulatory instruments that apply to SWC and HWC to private IWCM operators.

³⁷ While there is some variation between Flow schemes in this regard, all schemes involve substantial bypass of the relevant wholesale supplier's infrastructure and services.

8.7.1 IPART's 2006 pricing arrangements for recycled water

IPART considers that allowing wholesale customers to use their retail customer revenue to fund water recycling facilities and activities would be inconsistent with regulation of SWC and HWC recycled water schemes.

“Under our 2006 Guidelines for recycled water prices, recycled water schemes operated by Sydney Water and Hunter Water are to be ring-fenced and self-financing. This means that recycled water customers should pay prices that reflect the costs of the recycled water scheme. Under these Guidelines, the exceptions to this, however, are where:

- the scheme gives rise to avoided water and/or sewerage costs that benefit the water agencies and users other than the direct users of the recycled water – where such avoided costs are demonstrated, Sydney Water and Hunter Water can add the avoided costs to their water or sewerage cost bases (and hence prices) to make up any shortfall between recycled water customers’ willingness to pay and the costs of the recycled water scheme;
- the scheme gives rise to broader external benefits for which external funding is received; or
- 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.”³⁸

Reference to these 2006 pricing arrangements determined by IPART for SWC, HWC, Gosford City Council and Wyong Shire Council seems to have been prompted by a submission by SWC:

“...recycled water plants need to be funded by revenue from the service they provide to end users (recycled water) and should not be funded by retail sewerage service revenue.’ It is concerned that, otherwise, wholesale customers could use revenues from retailing sewerage services to subsidise its recycled water business. This could provide incentives for inefficient over-investment in recycled water projects.”³⁹

These statements reveal that, in its Supplementary Draft Report, IPART is wedded to a view of the industry that is based on the incumbent’s business model where water treatment, on the one hand, and sewage treatment, on the other, are entirely separate undertakings [see Figure 2.1 on page 19]. This overlooks the fact that water recycling plants have a dual function and partly replace both water treatment and sewage treatment functions. Moreover, IPART’s model of the industry seems to assume that large scale remote treatment is more productively efficient than a combination of large scale remote treatment (water and sewage) and smaller scale remote recycling. There is, however, no evidence presented in the Supplementary Draft Report to support any such conclusion.

In addition, it is unclear what relevance IPART’s 2006 Guideline has to wholesale water services pricing – it doesn’t go to the efficiency of new entrants or the other matters to be considered under section 15 of the IPART Act. Instead, IPART appears to be taking into account an earlier non-binding regulatory decision of IPART (which IPART could itself change). For IPART to consider this guideline, IPART would need to justify the continued operation of that guideline under the matters set out in the IPART Act. IPART cannot ‘bootstrap’ its decision about wholesale pricing by

³⁸ Supplementary Draft Report page 25

³⁹ Supplementary Draft Report page 53

referring to a guideline that is over 10 years old and which is within its power to change. Flow submits that this guideline is irrelevant for the purposes of determining wholesale water and sewerage prices.

Furthermore, requiring those providers to be understood through IPART's guidelines applicable to SWC and HWC is a fundamental error.

In any event, there is nothing inherently anti-competitive or inefficient in cross subsidisation of water, recycled water and sewerage services in an IWCM scheme – the three work in balance to achieve the whole of system benefits for customers and the broader network.

IWCM providers already face significant barriers to entry due to a lack of level playing field and the challenges of extracting revenue streams from multiple water sources. As a result, they would not install capital that is not efficiently deployed. Retail minus pricing would simply incentivise and/or cause inefficient capital decisions by SWC and HWC as they continue to be rewarded for installing infrastructure that is not justified given the current and future entry of IWCM providers in the system.

IPART does not have the power to legislate how private IWCM operators run their business and does not have the statutory power to determine those operator's business models. IPART should not try to "fix" SWC and HWC by locking out competition and more appropriate business models.

8.7.2 Zero developer charges

IPART now considers that SWC and HWC have a legal right to incorporate the cost of complying with a directive to SWC and HWC, to set developer charges at zero, into postage stamp prices.

"...in 2008, the then NSW Government directed Sydney Water and Hunter Water to set developer charges for water, sewerage and stormwater assets to zero.

*The combined effect of postage stamp pricing and zero developer charges is that Sydney Water and Hunter Water can use revenue from the broader customer base to cross-subsidise growth infrastructure in areas that are higher than average cost to service. That is, provided IPART considers this expenditure prudent and efficient, Sydney Water and Hunter Water can recover the costs of servicing new development areas through their retail postage stamp prices."*⁴⁰

As the Supplementary Draft Report acknowledges, there are actually no such prevailing directions for HWC. For SWC, the actual directions are limited to the Sydney desalination plant and certain small flood protection schemes.

IPART states that wholesale suppliers are entitled to fund the cost of meeting a government directive to SWC/HWC, to set developer charges at zero, from contributions to postage stamp pricing.

*"Currently, with water and sewerage developer charges set to zero, when Sydney Water or Hunter Water supplies a new development area, it recovers all its additional system costs from its wider customer base through an uplift to the postage stamp price."*⁴¹

⁴⁰ Supplementary Draft Report page 21

⁴¹ Supplementary Draft Report page 36

The Treasurer's 2008 letter is an approval under Section 18(2) of the IPART Act of the fixing of the price below the maximum price determined by IPART. It does not confer on either SWC or HWC a right or obligation to pass on the cost associated with the approval to customers (and any requirement for additional postage stamp recoveries). The fact the approval is issued by the Treasurer, not the portfolio Minister (under section 20 (P) of the SOC Act) or the Premier (under section 24FB of the IPART Act), suggests the principle is the cost being approved by the Treasurer would be borne by the shareholders of the corporation (Treasurer and Portfolio Minister). This would take the form of a reduction in the performance of the corporation (lower returns and lower dividends).

The existence of the Section 18(2) approval does not appear to impose any obligation on IPART, in making its pricing determinations, to pass these costs through as if there has been a direction under Section 16A of the IPART Act (i.e. to apply postage stamp pricing). Indeed, it suggests IPART need not (and should not) make any consequential changes to its pricing decision.

There appears to be no legal basis for IPART allowing the recovery of the cost of complying with the directive on zero developer charges in regulated retail prices. Accordingly, the existence of the zero developer charges direction does not represent a sound reason to adopt a retail-minus approach.

8.8 Ignoring IWCM doesn't solve the problem

IPART has attempted to avoid having to make a decision by pretending that IWCM is not relevant to the setting of prices for wholesale water services. This results in several fundamental errors:

8.8.1 The definition of the 'services' bears no resemblance to real activities in the market

First, the definition of wholesale services is fundamentally flawed. At points in its Supplementary Draft Determinations, IPART specifically includes IWCM providers within the definition of wholesale customers. However, IWCM providers do not buy the services set out in the definition of wholesale services and customers. IPART cannot include IWCM providers in the definition of wholesale customers without properly understanding their role and services provided. If IPART does, it is fundamentally failing in its attempt to properly define wholesale services in a way that could be said to have discharged IPART's responsibilities under the IPART Act.

Flow is not aware of any WIC licensee who merely on-sells sewerage and/or drinking water services. For example, of the WIC Act licensees that were listed in IPART's Supplementary Draft Report,⁴² all of them have been licensed on the basis of some level of recycled water facility..

This is not a surprise, as it would be difficult to see how such a licensee would be able to enter the market without it being integrated with a greater service offering.

IPART appears to exclude sewage recycling as a contestable service, identifying only local reticulation and retail as the two contestable services.

"The contestable service(s) is the service the wholesale customer is providing (or seeking to provide) to retail customers 'upstream' or 'downstream' of the wholesale services it has purchased from the wholesale service provider. That is, the service(s) between the wholesale

⁴² Draft Supplementary Report Appendix B, Table B.1

connection point and the end-use (retail) customers. They often include reticulation and retail services.”⁴³

Accordingly, the proposed sewerage wholesale price would incorporate just two minus components [Table 6.1 Page 60]:

- *Retail (\$80/customer/year)*
- *Reticulation (\$7,742/kilometre/year)*

As previously submitted by Flow and other industry participants, the result is an inadequate pricing structure that fails to recognise the nature of competition in the retail water market, which is necessarily underpinned by water recycling.⁴⁴

8.8.2 IWCM is not inherently inefficient

The assumption implicit and explicit in the Supplementary Draft Report that inefficiency lies with the recycled water projects is not based in any facts or data. Any inefficiency is just as likely to lie with SWC and HWC’s infrastructure plans and reflect operating license conditions that no longer make sound economic sense. As IPART points out, IWCM solutions are new in the market – the fact that SWC and HWC’s infrastructure plans (and, the resultant customer pricing) have been set without due regard to new market entrants is not a function of the inefficiency of the new entrants, but the inefficiency of SWC and HWC. **Why should potential new entrants have to pay the cost of SWC’s and HWC’s earlier infrastructure decisions made without due regard to IWCM scheme operations (including the engineered redundancy in those schemes)?**

IPART’s error has two parts:

- First, IPART has assumed that implementation of IWCM or other schemes would add to existing costs – whereas IWCM schemes actually allow for lowering existing costs on existing infrastructure, i.e. inefficient spend on traditional water infrastructure can be reduced, offsetting costs overall.
- Secondly, IPART has not provided any factual evidence that shows that IWCM implementation will increase costs overall, if incumbent water service providers respond in an efficient way to this change in the market and community expectations. It also assumes (without evidence) that the previous capital decisions of SWC/HWC have been efficient and have properly taken into account growing competition in the supply of services to end users.

8.8.3 IWCM providers do not simply “onsell” sewerage services

IWCM is fundamentally different to the service that SWC and HWC offer. Requiring IWCM providers to pay SWC and HWC as if IWCM were simply removing revenue base from the incumbents **fundamentally misunderstands the value that IWCM brings, not only to the incumbents, but also the wider community.**

IPART is required under the IPART Act to take into account those broader impacts, but has failed to do so in its *Supplementary Draft Determinations*. The wholesale sewerage service provided to an IWCM operator is fundamentally different to a mere on-sale arrangement. The maximum

⁴³ Supplementary Draft Report page 45

⁴⁴ As discussed above, IWCM is the only path to market for competitors in this space.

sewage volumes are substantially lower and any solids/pollutants resulting from the water recycling process are already accounted for by way of the industrial trade waste charges.

By way of example, the *Supplementary Draft Determinations* (at Section 3.4 of Schedule 2) state that wholesale customers must count any commercial trade waste charges that they levy as part of the ‘retail’ element of the retail-minus sewerage on-sale charge. IWCM proponents are also required to pay an industrial trade waste charge for the effluent load present in their recycled water plant waste stream. Given that most (if not all in mature schemes) of the wastewater on which the wholesale provider has levied a commercial trade waste charge to an IWCM operator is treated through the recycled water plant, it is difficult to see how the *Supplementary Draft Determinations* do not result in SWC/HWC receiving a service that they haven’t actually paid for (i.e. treatment of upstream commercial trade waste) and double charging (with the commercial trade waste “retail” element and the industrial trade waste charge covering much of the same effluent load).

IWCM providers necessarily and easily outperform incumbents in terms of levels of service, taking into account what service is being provided with the majority of their customer’s wastewater. **To say otherwise would be like saying a garbage service is essentially no different if the provider took your garbage and dumped it into the harbour as if the provider takes your garbage to a sorting and recycling facility.**

8.8.4 IWCM providers do not use the same level of service as retail customers

The service provided to an IWCM scheme is fundamentally different to a mere on-sale arrangement. The volumes are significantly lower, and any solids/pollutants are charged for by way of the industrial trade waste charge. As Flow submitted in IPART’s public hearing on this review, Flow’s IWCM schemes are sized to wastewater servicing requirements.

This is because IWCM providers such as Flow are required to treat all sewage in a precinct and they often need to do so for the development to achieve its sustainability goals. For example, in Flow’s Box Hill North community, Flow is obligated to deliver a water recycling plant and infrastructure that will meet the sewerage treatment capacity and recycled water supply services required by the development. Similarly, at Central Park, Flow is obliged to install sufficient wastewater treatment infrastructure to service the community.⁴⁵

They also need to achieve benefit both for themselves and their customers in having capacity available to meet recycled water demand outside the precinct (e.g. for irrigating open spaces or green walls, use in universities, irrigating recreational spaces (including golf courses, etc) and new homes.

In some schemes, a portion of untreated sewage will enter SWC’s system all year around, but it is always significantly less than would without a recycled water plant in place. Central Park is a good example of where the volume discharged to sewer without treatment has steadily decreased over time and will reduce to a small portion (less than a quarter of overall wastewater generated) as recycled water demand increases and the scheme matures. The Confidential Annexure provides details of actual sewerage service use in Flow’s schemes.

⁴⁵ Further details of the contractual terms are set out in the confidential annexure.

Significantly, Flow's existing arrangements with Sydney Water already restrict wastewater outflows from recycled water plants to a small portion (less than 15% on average) of expected wastewater flows to that plant. The Confidential Annexure provides details of Flow's arrangements at Central Park.

SWC and HWC are already paid by wholesale providers for the full effluent load through the application of an industrial trade waste charge. **Charging both retail minus and industrial trade waste charges is double charging for the same service.**

The language used by IPART in the Supplementary Draft Report illustrates the confusion IPART is facing regarding IWCM in this regard:

"Impact of recycled water plants – the key factor that we have considered in relation to recycled water plants is whether they are being used for the purposes of on-selling sewerage services (ie, providing a retail sewerage service). This has informed our draft decisions on the pricing approach to apply to these services.

– Where the wholesale customer is using the wholesale sewerage service (regardless of whether a recycled water plant is present) to provide retail sewerage services (ie, on-selling the wholesale sewerage service), our draft decision is to apply retail-minus pricing.

– In cases where SWC and HWC are providing a waste disposal service for a recycled water plant that is being used to supply a recycled water service only (ie, the wholesale customer is not on-selling the sewerage service but sewer mining), the draft determinations applies the non-residential prices."⁴⁶

On the one hand, IPART says the "key factor" is whether the recycled water plan is on-selling sewerage services, but then goes on to say that regardless of whether there is a recycled water plant (and, by extension, regardless of whether that plant is being used to "on-sell" sewerage services), the wholesale customer needs to pay the retail minus price.

This will mean that even if the wholesale sewerage service were a minor 'input cost' for the service provided by the recycled water plan as an input into an overall integrated scheme. The wholesale customer would have to pay the whole of the retail minus price because it is offering a sewage recycling service. This disregards that a sewage recycling service and a recycled water service are not simply 'on selling' a sewage service.

8.8.5 IWCM is required to build redundancy

As IPART is aware through its licensing function, recycled water providers are already required to build in redundancy to their systems as part of their WIC Act licensing. For example, Flow's Infrastructure Operating Plan is required under the WIC Act Regulations to include details of redundancy built into its system. This is particularly true for recycled water schemes in land housing developments which typically don't have any access to a public utility sewer (eg. Pitt Town, Wyee, Huntlee, Cooranbong (post-Feb 18), Box Hill, Glossodia, Bellbird North etc). If IPART is satisfied to licence these schemes with zero public utility dependency then why would it be any different for schemes in high rise communities such as Central Park:

⁴⁶ Supplementary Draft Report page 36

“Part 3 Additional conditions for licences for sewerage infrastructure

13 Infrastructure operating plans

(1) Before commencing to operate sewerage infrastructure commercially, the licensed network operator for the infrastructure must prepare, and forward to IPART, an infrastructure operating plan that indicates the arrangements that the licensee has made, or proposes to make, in relation to:

(a) the design, construction, operation and maintenance of the infrastructure, including particulars as to the life-span of the infrastructure, the system redundancy built into the infrastructure and the arrangements for the renewal of the infrastructure, and

(b) the continued safe and reliable performance of the infrastructure, and

(c) the continuity of sewerage services, and

(d) alternative sewerage services when the infrastructure is inoperable, and

(e) the maintenance, monitoring and reporting of standards of service.”

IPART have reviewed and approved Flow’s Infrastructure Operating Plan as part of its WIC Act licensing applications.

Making wholesale customers pay twice through both their own required capital investment and SWC and HWC’s capital decisions, is not efficient and ignores the factors that IPART must consider under the IPART Act.

In this regard, IPART has failed to take into account relevant submissions on this matter made by Flow. For example, there is no reference to page 6 of Flow’s December submission, which directly addresses the erroneous assertions of SWC⁴⁷ regarding redundancy:

“SWC have argued that the minus component is too low on the basis that they are not able to avoid costs of downstream infrastructure. This is patently incorrect. As previously submitted by Flow at the November 28, 2016 public hearing, IPART regulation of Flow’s projects ensures that redundancy is built into IWCM infrastructure such that ‘emergency events’ of the type foreshadowed by SWC simply do not require additional infrastructure to be built or maintained downstream of the connection point to SWC’s sewerage infrastructure.”

IPART is aware, through its regulatory role under the WIC Act, of the requirements for redundancy. It is surprising that SWC’s assertions regarding a lack of redundancy in IWCM schemes has been so readily accepted. It is disingenuous and irresponsible to suggest that IWCM providers are somehow unregulated in this regard.

This brings into stark relief one of the key failings of retail-minus pricing, which is that it structurally “assumes” that any lack of efficiency is on the part of the wholesale customer. However, if that wholesale customer is an IWCM provider, how is it efficient that SWC and HWC plan and expend capital on the basis that no IWCM schemes exist? This inherent assumption by

⁴⁷ Which have been referred to by IPART on page 51 of the Supplementary Draft Report

IPART can only serve to facilitate and encourage inefficient overinvestment downstream of IWCM schemes.

8.8.6 IWCM providers are not inefficient just because they have a higher WACC than Sydney Water

The methodology used by IPART bears no resemblance to the reality of what a wholesale customer does. By trying to ignore IWCM (including, but not limited to, recycled water), and by using the incumbent's WACC rather than an estimate of what a reasonably efficient competitor's WACC would be, IPART has attempted to implement a confused and inconsistent methodology, which bears no resemblance to any possible real-world wholesale customer.

The inability of a wholesale customer to meet the WACC of SWC is not an indication of inefficiency.

There are a number of structural reasons why a wholesale customer will have a higher WACC than SWC:

- The wholesale customer will have proportionately high capital expenditure compared to their balance sheet and operating revenue, reflecting the construction and commissioning phase (and associated construction risk) of a high proportion of their schemes
- Wholesale customers will not enjoy a regulated guarantee of return (unlike SWC/HWC)
- Wholesale customers have no implicit or express NSW government guarantee (unlike SWC/HWC)
- Wholesale customers have nowhere near the scale of SWC or HWC and will not have that scale in the foreseeable future
- Wholesale customers do not have the benefit of a mature, guaranteed and non-contestable market enjoyed by SWC and HWC (especially if retail minus pricing is adopted).

8.9 Ecological sustainability

IPART is required to consider the need to maintain ecologically sustainable development by appropriate pricing policies that take account of all the feasible options available to protect the environment. However, IPART has, in this regard, declined to carry out its legislated function.

IPART has failed to have proper regard to Section 15(1)(f) of the IPART Act, which requires it to look to the POEA Act when considering the need to maintain ecologically sustainable development. "Ecological sustainable development" is defined in the POEA Act, not by reference to SWC and HWC complying with their EPA licence as IPART seeks to define it:

"We primarily factor relevant liveability considerations, such as environmental sustainability, into Sydney Water's retail prices through the following process:

- 1. Parliament passes legislation and government (including through agencies such as the Environment Protection Agency, Department of Primary Industry - Water and the Department of Planning and Environment) sets policy and regulatory requirements to reflect the relevant legislative requirements. This includes requirements imposed on Sydney Water, amongst other entities.*
- 2. Sydney Water develops a plan and estimates the level of expenditure required to deliver its services and meet its obligations. Sydney Water then makes a pricing proposal to IPART.*

3. *We review Sydney Water's pricing proposal to ensure that Sydney Water's prices reflect the prudent and efficient costs of delivering its services and meeting its mandated obligations as set out in point 1 above.*

We adopt the same approach for Hunter Water and for other water utilities that we regulate."

"As our draft prices are based on our 2016 retail prices, we do not consider that they will impact either Sydney Water or Hunter Water's ability to undertake their regulatory responsibilities, including complying with Environment Protection Authority (EPA) licence requirements."⁴⁸

In both instances, IPART must be guided by Section 15 of the IPART Act, which requires IPART to consider the effective integration of economic and environmental considerations in decision making processes, including that environmental factors should be included in the valuation of assets and services.⁴⁹

This, necessarily would involve considering the ecological sustainability of IWCM and other wholesale customer offerings and how wholesale pricing may further or adversely affect environmental outcomes. Instead, IPART has started with SWC/HWC's environmental licences and determined, on the basis that its draft decision has no impact on their compliance with those licence requirements, that it has met its statutory obligations to consider ecologically sustainable development.

The WIC Act legislation has catalysed world-leading IWCM sustainability schemes and is the result of more than a decade of efforts to make recycled water cost effective at a precinct level.

8.10 SWC and HWC will receive a windfall gain

In addition to the proposed uplift in wholesale pricing, SWC and HWC will make above and beyond any allowed regulated revenue. This is because wholesale customers' schemes:

- Allow for lot release and housing supply a lot earlier than would have been achieved under SWC/HWC's planned network extension: For example the Box Hill North community, serviced by Flow, recently began lot release, achieving release 5 years earlier than would have been possible under a SWC servicing solution.
- Unlock areas that would not have been serviced at all by SWC and HWC: For example, Flow is capable of servicing areas in the newly proposed land release that would never have been serviced by SWC⁵⁰.
- Allow greater density in urban infill projects than could have been achieved under the incumbent's water servicing model: For example, at Central Park the developer was allowed an additional 20,500 square meters of gross floor area, revised building envelopes and an increase in site area of 396 square meters. Critical to the grant of those concept plan modifications was the implementation of a comprehensive sustainability strategy that necessarily included an integrated water recycling scheme. That is, IWCM

⁴⁸ Supplementary Draft Report page 62

⁴⁹ Protection of the Environment Operations Act 1991, section 6

⁵⁰ Please refer to Confidential Annure

has enabled additional retail customers which could never have been supported by SWC's traditional water servicing.

In each case, the private sector (including wholesale customers as well as developers and home owners) take the risk on capital investment to provide retail water services quickly to unlock housing supply. IWCM means that augmentation costs that would have been spent by the incumbent service provider no longer need to be spent. The pricing proposed in the Supplementary Draft Report however, would see SWC/HWC receive all of the private sector's revenue for these projects, less only the two minus elements allowed by IPART.

SWC/HWC would not have recouped these windfalls had they serviced the same communities with their standard centralised non-sustainable solutions.

The result is that under IPART's proposed retail-minus pricing methodology, IWCM providers will now be subsidising SWC/HWC's inefficient and outdated water infrastructure and associated services.

8.11 Arbitrage opportunity for onselling

IPART now considers that allowing wholesale customers to use their retail customer revenue to fund water recycling facilities and activities would create arbitrage opportunities for onselling.

"Residential customers' service charges are set on a per dwelling basis (ie, an apartment serviced by Sydney Water is charged the same as a house, regardless of the size of the meter servicing the apartment block); whereas non-residential customers' service charges are based on the actual meter size at point of connection. 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 5.1).

*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."*⁵¹

IPART has formed a view that, unless revenue currently funding water recycling and other IWCM initiatives is diverted to the wholesale supplier, the wholesale customer would be able to 'out-compete' SWC and HWC but not necessarily on the basis of lower cost or better service, just by virtue of the difference between regulated retail prices for residential and non-residential customers.⁵²

The relevant non-residential price for recycled water disposal is a price for a trade waste service. No evidence has been provided in the Supplementary Draft Report to suggest this price is not cost reflective for wholesale customers operating recycled water plants. This is, however, the unstated implication of IPART's position.

The basis for IPART's concern over an arbitrage opportunity for onselling is unclear. There is no evidence cited by IPART that any current WIC Act licensees simply provide onselling services of the nature outlined in the example contained in the Supplementary Draft Report. If this were a

⁵¹ Supplementary Draft Report page 49

⁵² Supplementary Draft Report page 52

valid concern, it could be readily addressed by limiting access to non-residential prices, to WIC Act licensees. These WIC Act licences are administered by IPART and could readily be specified in greater detail if required.

In addition, the proposed retail-minus pricing *encourages* arbitrage operators. The outcome of the pricing methodology suggested in the Supplementary Draft Report is that the only basis for wholesalers to enter the market is an arbitrage opportunity on the retail cost to serve. By refusing to give any credit to IWCM providers, IPART has removed the possibility of IWCM providers entering the market and providing valuable services that could compete with incumbent providers.

Retail-minus doesn't address and/or solve the arbitrage problem. Retail-minus makes it more viable for 'pure' onsellers (ie. non-IWCM providers) to arbitrage on the basis of the "minus" element – in fact, the minus element clearly sets out the level of the arbitrage. Wholesale customers under retail-minus will be incentivised to underspend on capital, reduce service levels and maximise their use of wholesale services. There is a negative incentive to spend any capital on water saving, waste reduction or recycling infrastructure. Moving from non-residential to retail-minus is not qualitatively different in terms of arbitrage.

Also, there is nothing anti-competitive or out of line with the IPART Act considerations with using an available margin to fund an improved level of service/different service (which is what IWCM offers). Talking about arbitrage is only talking about half the story. IPART is not taking the approach that it is required to take under the IPART Act – that is, it is considering the revenue foregone by SWC/HWC, but it has expressly declined to consider the benefit provided by IWCM providers.

8.12 The Supplementary Draft Report is not underpinned by facts

Both SWC and HWC recognise that there is not sufficient data to properly understand the impact of the activities of wholesale customers.

As discussed in detail below under Section 9, the concepts of facilitation costs and scheme specific determinations cannot "cure" the problems inherent in the retail minus pricing model proposed by IPART.

IPART's own experts have advised that there is not sufficient information to formulate a methodology to even calculate systemwide cost impacts (whether or not they are considered in a scheme specific determination):

"Based on our analysis, there were some elements of the upstream and downstream services whereby a system-wide approach to estimating the cost impacts was not considered feasible:

- *Water supply network augmentation;*
- *WWTP operational costs;*
- *Wastewater network augmentation; and*
- *WWTP augmentation.*

The key reason for the inability to estimate system-wide cost impacts for these elements is the significant variations that can arise. The primary driver for these variations is the location of the wholesale customer's RWP. Given this, one potential option in the future is to develop catchment-wide estimates of the cost impacts from the introduction of RWPs. In order to develop these estimates, it would require detailed augmentation requirements and forecast demand based on location."

IWCM needs to be charged like any other non-residential user of water services (the definition of the wholesale services should also exclude IWCM providers). Otherwise, IPART are forcing IWCM providers into a pricing regime that does not reflect the impact and benefits of IWCM on the broader water system. In addition, IPART is setting up an unclear pricing system that will be open to dispute (and possibly litigation) and which fails to deliver against IPART's statutory responsibilities.

How can IPART set system-wide retail minus prices for wholesale water services, when it can't determine a key aspect of that pricing, which is the impact and benefit IWCM has on both drinking water and sewerage, with sewerage being the most critical element (given that it has most at stake).

The inability to understand an appropriate minus or adjustment to apply where an IWCM scheme is in place is a fundamental failure to implement a pricing regime that meets the required outcomes of the IPART Act. The admission by IPART that there is not sufficiently reliable information to incorporate an additional minus for IWCM schemes demonstrates that retail minus is not the right pricing mechanism for IWCM schemes, because it sends the wrong pricing signals. Scheme specific determination will be too slow and uncertain to underpin an IWCM industry and cannot solve the information gap.

That means implementing retail minus will, potentially totally and irreparably, damage the fledgling IWCM industry, despite the numerous broader benefits that industry brings.

8.13 Conclusion

In summary, for the reasons set out above in this section 8, the proposed pricing set out in the Supplementary Draft Report is inappropriate, reduces competition and will result in adverse outcomes both for the water industry and for end-use customers. In reaching the position set out in the Supplementary Draft Report, Flow believes that it would be open to suggest that IPART has failed to consider relevant considerations and has taken into account irrelevant considerations.

9 Facilitation costs do not fix the problem

Facilitation costs are defined too narrowly and involve a negotiation between a large monopoly service provider and a relatively small potentially competing wholesale customer. Any scheme specific determination to resolve the inevitable impasse will be too slow and uncertain to underpin an IWCM industry. That means implementing retail minus is necessarily going to (potentially totally and irreparably) damage the fledgling IWCM industry, despite the benefits that industry brings (which are recognised by the IPART Act).

IPART's proposed scheme by scheme determination, including facilitation costs, has no real-world application. WIC Act proponents competing with public utilities for water servicing projects in the competitive private and public development market would be significantly disadvantaged if a lengthy negotiation of facilitation costs followed by a scheme specific review was required to determine pricing.

The proposed scheme specific reviews do not provide any prospect of relief from IPART's errors in setting system wide prices, on the principle that the equivalent services provided by SWC/HWC are not contestable. This is because it has limited the scope of negative facilitation costs for the most part to avoided augmentation costs. Where there is no avoided augmentation cost, there would be no negative facilitation cost. As explained under section 7 above, this is based on the erroneous view that competition is restricted to augmentation, rather than partial by-pass of wholesale supplier services.

This is a fundamental error on the part of IPART. It results in the imposition of prices on IWCM providers for wholesale services that are not defined in a way that takes account of the matters to which IPART is required to have regard when making a pricing determination. IPART is seeking to include IWCM providers within the pricing framework, but then declines to make a pricing determination that considers matters relevant to IWCM. This is like charging IWCM providers for a service they do not receive and is an abrogation of IPART's responsibility to make a decision that takes into account the factors it is required to consider under Section 15 of the IPART Act.

9.1 The concept of "facilitation costs" is misconceived and too narrow

The facilitation cost approach that IPART has suggested is not a viable solution to the issue of the level playing field. For example, Ms Muras, speaking for SWCat the IPART Public hearing said, in respect of negotiating unregulated agreements:

"For Sydney Water, our in-principle view is that it probably is unlikely that the unregulated agreement option would be used. It was the same sort of response that we had in the retail price determination. We think that the lack of incentives is actually on both sides. Why would either party choose to opt out of a regulated price that would, for one of the parties mean that they would be paying more or receiving less? I think that lack of incentives is certainly a two-way street"

It is clear SWC and HWC will be reluctant to negotiate an approach by Flow for negative facilitation costs. Flow and other wholesale customers will be at a significant disadvantage in any negotiation on facilitation costs with a monopoly service provider.

The incumbent monopoly has no incentive to agree negative facilitation costs and every incentive to charge positive facilitation costs, knowing that the time and process involved in scheme specific determination will be prohibitive for the counterparty (but make no difference for SWC/HWC, particularly in the absence of true up costs).

Furthermore, IPART's definition of negative facilitation costs also does not "solve" the problem of inefficiently installed infrastructure already put in place by SWC/HWC. On IPART's formulation, it also does not allow a negative facilitation cost where Flow has extended the network beyond what was planned (giving SWC/HWC a windfall gain as previously discussed).

In addition, throughout the IPART materials, there is an assumption from IPART that facilitation costs would always be in addition to the retail minus wholesale prices. While IPART also acknowledges that facilitation costs can be negative, this is stated as an afterthought. This indicates:

- fundamental misunderstanding of the benefits of IWCM; and
- too great an emphasis being placed on protecting the interests of incumbents rather than overall market effectiveness.

While IPART explains that facilitation costs can be negative in the Supplementary Draft Report, its formal statement of what a facilitation cost is (contained in each Supplementary Draft Determination) only describes facilitation costs as positive. This is confusing. Facilitation costs as a concept has much more work to do under the Supplementary Draft Determination than under the earlier draft determinations, because of IPART's decision to ignore IWCM schemes in the calculation and operation of retail minus pricing.

Facilitation costs as defined in the Supplementary Draft Report suffer from a number of failings:

- The facilitation costs regime suggested by IPART is inconsistent with the remainder of its retail minus decision:
 - It cannot be that facilitation costs should be equal to the cost of augmentation if the augmentation would never have been triggered under the SWC/HWC growth plans – that should only be the case if only non-residential pricing applied to the wholesale customer. Otherwise, SW/HW are getting windfall gains above and beyond their allowed revenue.
 - Similarly, if the augmentation was planned, and happened at the same time, IWCM providers should be entitled to a negative facilitation cost to represent the saving and deferral of capital as only partial augmentation should be necessary. Otherwise, retail minus pricing will simply incentivise inefficient augmentation works, or reward inefficient existing infrastructure.
- A “zero facilitation costs” outcome is not appropriate for in-sequence development. A negative facilitation cost should always apply. IPART cannot simply avoid the question of IWCM impacts in the minus, shift it to the facilitation cost regime and then in that regime say that no negative facilitation cost should be allowed to account for the benefit of those schemes. There should not be an inherent assumption that ‘in-sequence’ or any other development by SWC or HWC is efficient. That efficiency should be measured according to the impacts of IWCM schemes. But this should only be reduced to the extent that the early revenue does not offset the wholesale service provider growth plans.

In addition to these inconsistencies with retail minus pricing, the concept of deferring IWCM benefits into the concept of “facilitation costs” (and subsequently, on failure to agree to scheme-specific determinations) suffers from a more fundamental problem. IPART states:

“For the two onselling services that retail-minus prices would apply, to the extent the minus component of retail minus prices is greater than the costs that Sydney Water or Hunter Water actually avoid as a result of the wholesale customer supplying end-use customers, this may reduce the actual rate of return relative to those outlined in the 2016 Sydney Water and Hunter Water retail price determinations. However, we would not

expect any such reductions to be material over the upcoming determination period, given the relatively small scale of entry currently in the market.”⁵³

This statement illustrates a key problem with the facilitation costs concept. Flow considers that when determining the facilitation costs (including negative costs) that should apply to a particular scheme, all of the matters listed in Section 15 of the IPART Act should be considered. That concept does not take into account the matters that must, under section 15 of the IPART Act, be taken into account by IPART in making a determination. Instead it refers to ‘actual avoidance’ of costs by SWC and HWC, but that is not the test. For example, if costs have been incurred in an inefficient manner or otherwise without regard to the matters in section 15, they should not have to be paid for by the wholesale customer (and, in turn, their end user customers).

By reducing the equation applicable to IWCM schemes to cost, IPART is failing to consider the other 11 relevant mandatory considerations set out for it in the IPART Act.

9.2 Scheme specific reviews provide no prospect of relief from IPART errors

A scheme-specific review is risky and undesirable from an IWCM and overall water system perspective. It would involve first entering into negotiations with a monopoly service provider who has no interest in progressing those negotiations, followed by significant costs in relation to preparing and lodging a scheme-specific review request with IPART and a lengthy review process of up to 12 months. All the while creating risk for the market. Any net benefits from such a process would be highly uncertain.

Aside from the procedural and timing challenges, the proposed scheme specific reviews do not provide any prospect of relief from IPART’s errors in setting system wide prices. This is because it has limited the scope of negative facilitation costs for the most part to avoided augmentation costs. As explained above, this is based on the erroneous view that competition is restricted to augmentation, rather than partial by-pass of wholesale supplier services.

9.3 The scheme specific determinations do not work

As outlined above, existing sewage recycling projects such as the iconic Central Park scheme are under threat from the retail-minus pricing methodology proposed in IPART’s Supplementary Draft Report. The Utility Services Agreements governing the wholesale services arrangements for those projects allow for SWC and HWC to reset prices, which we expect they will do if IPART makes a final determination in the terms of the Supplementary Draft Report.

Flow and other wholesale customers are left with no effective protection from the monopoly power of incumbent public water authorities. Instead, IPART has indicated that Flow would be required to ‘negotiate’ with its key competitors in order to enter the market.

Scheme specific reviews proposed by IPART are not a practicable solution to setting appropriate wholesale prices. Industry participants have rigorously maintained that scheme-specific reviews are not suitable.⁵⁴ Such reviews will be costly for both provider and customer⁵⁵, and will:

⁵³ Supplementary Draft Report page 100

⁵⁴ Refer Box 9.2 on page 92 of the Supplementary Draft Report

⁵⁵ Indeed SWC and HWC say at Box 9.2 that IPART should take into account all the administration and resourcing costs for all parties before deciding whether to proceed with a review

- take a minimum of 12 months to complete;⁵⁶ and
- erode certainty for developers of new urban growth areas, which will lead to the developer defaulting to wholesale providers for water and sewerage services, thereby presenting a barrier to entry of competitors offering sustainable alternative solutions for these services.

For new schemes, the Supplementary Draft Report notes⁵⁷ that if scheme-specific regulated prices are to be determined before any wholesale services are provided, the wholesale provider or supplier will need to request a scheme-specific review well before the scheme becomes operational. This is not a realistic proposition due to the commercial exigencies involved in providing services to new urban developments. Flow could not compete for any proposed new recycled water schemes because it would not know the true costs. Any participation in a tender process would require significant caveats on price and be “subject to” IPART determinations. This would represent a significant barrier to competition and would deny new urban communities and retail water customers the opportunity to realise the benefits that competition brings.

Scheme specific determinations have no real-world application. Flow or any other IWCM provider cannot compete in the market without certainty around pricing.

IPART faces a fundamental problem. On the one hand, IPART professes that:

“We maintain our view that, in principle, negative facilitation costs should be reflected in wholesale prices.”

On the other hand, their only way forward is:

“However, as outlined further below, we consider that, at this stage, these cost savings or benefits of wholesale customer’s schemes to wholesale service providers, such as those associated with recycled water plants, can only be determined with a reasonable degree of accuracy on a scheme by scheme basis. Hence, as with other facilitation costs, they are not included in our system-wide determination. Rather, they are best included in wholesale prices via a scheme-specific review. Over time, if more information is revealed and tested through conducting scheme-specific reviews, we may be in a position to establish estimates of benchmark or ‘typical’ facilitation costs.”⁵⁸

As set out above:

- IPART’s formulation of facilitation costs would not allow what IPART is suggesting should occur;
- There is no basis on which parties could come to an agreement on facilitation costs and the incumbent has all of the monopoly bargaining power; and
- The scheme-specific determination regime will not work and therefore cannot be the ‘release valve’

⁵⁶ Refer Section 9.1 of the Supplementary Draft Report. In addition, as IPART will not commence a review until the parties have demonstrated a period of negotiation, the IPART timetable will be in addition to the time taken to attempt negotiations.

⁵⁷ Refer Section 9.1.4 of the Supplementary Draft Report

⁵⁸ Supplementary Draft Report page 84

IPART states that it is not able at this stage to apply a pricing regime that properly takes into account all of the matters in Section 15 of the IPART Act. The solution for IPART should be not to make this determination at all, but to wait until it is able to do so. IPART cannot make “half a decision” – it is required to consider all of the matters specified in Section 15 of the IPART Act.

IPART should not decide to implement retail-minus pricing for IWCM providers when a critical element of that pricing methodology is left up to scheme-specific determinations.

Failure of IPART to include a minus tariff to apply where an IWCM scheme is in place, is a fundamental failure to implement a pricing regime that meets the required outcomes of the IPART Act. Simply saying that there is not sufficiently reliable information to incorporate an additional minus for IWCM schemes demonstrates that retail-minus is not the right pricing mechanism for IWCM schemes.

10 What pricing for wholesale water services should look like

Wholesale water services should be charged on a non-residential pricing basis. This will allow SWC and HWC a return on the cost of providing the types of service that wholesale customers need, which are the same types of services as needed by other non-residential customers.

A pricing methodology of the type set out in the Supplementary Draft Report locks non-SWC/HWC customers into capital decisions made by SWC/HWC, instead of being able to choose the solution that they wish to support (ie, giving customers the option to choose IWCM). In the meantime, those customers have to continue to subsidise capital decisions in which they had no say and which result in lower levels of service, poor sustainability and inefficient, old style infrastructure decisions.

The very fact that IWCM operators have been able to successfully penetrate the market is because IWCM does offer whole of system benefits. While water services are not contestable, the only path to market for an IWCM operator is through the property development process. A property developer will only select an IWCM option if it can be demonstrated that the IWCM option offers something more than the ‘business as usual’. That is, in water (due to its non-contestability), market entry is the test rather than incremental price increases.

In addition, in the absence of retail contestability, the “customer” is the property developer and the subsequent lot purchaser in IWCM-serviced precincts. Developers and serviced lot/apartment buyers are willing to pay for recycled water schemes and do pay for those schemes. What customers are not prepared to do (and which they shouldn’t be required to do), is to pay for their own recycled water infrastructure and redundant additional infrastructure installed by the incumbent wholesale services provider.

As set out in Flow’s submission in December 2016, the scarcity offset would take into account both water security and downstream sewerage infrastructure and environmental benefits. IPART cannot ignore ecological sustainability and the patent benefits that IWCM brings over traditional sewerage systems, particularly where sewerage treatment involves ocean outfalls and other forms of environmental discharge. The fact that IPART’s consultant Oakley Greenwood has not been able to come to a conclusion at this stage of the emergent IWCM market development means that it is not the right time to change pricing – non-residential pricing remains the right approach at this stage of market development. In another four or five years when the market has

developed, IPART and market participants will have the data needed to make a properly informed decision.

So, at that time, what would an appropriate pricing regime look like?

- **Wholesale customers would pay for what they use:** Wholesale customers would be charged for a service they actually use, not on the basis of a notional/deemed service
- **The wholesale tariff would reflect the cost of the service:** The actual cost impact of the wholesale customer's use of the service on the wholesale service provider
- **Wholesale customers would not be overcharged:** Wholesale service charges would not double charge amounts already recovered (eg. through the industrial trade waste charge).
- **Efficient redundancy would be rewarded:** Where an IWCM wholesale customer has installed redundancy upstream (for sewerage) or downstream (for drinking water) either because they are required to do so under legislation, or it is efficient, they should be allowed to make a return on that infrastructure (whether by a pricing differential or by a minus factor).
- **Innovation would be fostered and protected:** Water industry participants should be permitted to retain revenue originated through the deployment of innovative water generation and savings technology and improved wastewater solutions.
- **Wholesale customers would be paid for the benefits they bring to the wider water system:** As previously submitted by Flow, a water scarcity tariff and a sewer augmentation avoidance tariff would be built into the wholesale pricing equation.
- **Ecological sustainability would be considered for the retail customers, wholesale customers and wholesale service providers, not just the wholesale service providers:** Industry, incumbents and regulators would work together to ensure the most ecologically sustainable outcomes are available for customers and their communities.

All of these characteristics will be met by requiring non-residential prices to be the maximum prices that SWC and HWC may charge for IWCM proponents who use wholesale services in order to provide the IWCM service.

11 What Sydney and the Hunter will miss out on if this pricing determination proceeds

11.1 Competition

Flow supports a dynamic NSW water industry underpinned by the objectives of the WIC Act. The WIC Act promotes dynamic efficiencies through innovation including IWCM approaches such as water recycling. This market has been founded on innovation and new approaches to water services and infrastructure, which are essential to making the transition to a more competitive water industry that will place downward pressure on pricing. This competitive market will also help to deliver more affordable and timely housing stock in NSW's urban growth areas.

Without private sector competition, consumers will be locked into antiquated and increasingly inefficient water management solutions.

11.2 Ecological sustainability

With the right settings, Flow and other IWCM providers can significantly transform the way new communities use water, and hence drive key efficiencies to the water network, meeting key NSW Government objectives for productivity, livability, resilience and sustainability. IWCM has a positive impact on existing communities, reducing ocean outfall and waterway contamination, and generating new sources of more affordable water that can improve amenity all-year-around as well as contribute to environmental flows, making more livable and resilient neighbourhoods.

IWCM is an approach to managing water which is completely different to centralised solutions. It is essential that IPART does not apply tariff approaches to this new market which promote centralised water infrastructure solutions. This market needs to be fostered and understood within a new paradigm. Applying incentives that promote centralised water infrastructure solutions will prohibit innovation and much needed change.

Flow maintains its concern that current centralised infrastructure approaches to water management continue to present a material risk to the environment and water scarcity. The 'flush and forget mentality' – where wastewater is simply pumped over long distances through multiple communities then out to sea with minimal (or in some cases, zero) treatment, is an outdated approach to water management that fails to reflect the aspirations of customers and the community, and fails to incorporate innovations over past decades years that allow the reuse of a waste at source.

11.3 Customer choice

The best outcome for customers is to have a competitive market where there are innovative options for water supply, management and reuse. The currently proposed retail-minus approach rewards business as usual (BAU) centralised thinking and outcomes, resulting in upward pressure on pricing.

11.4 Land release

Flow maintains that IPART's arguments for a retail-minus tariff are not about cost of efficiency but instead about protecting an income stream which subsidises inefficient outdated infrastructure approaches that cannot meet the needs of a growing resilient city such as Sydney. Centralised water infrastructure approaches are ageing and reaching the end of their lifespan. They have resulted in slow land release, poor housing supply solutions, vastly unequal property value distribution, continuation of poor environmental outcomes, and antiquated service standards. IWCM is revolutionising the way land is serviced and released through sustainable water utility solutions. IWCM can bring forward land release by five years or more and finally ends a last century approach to building communities along the sewer.

11.5 IWCM projects

Flow's modelling, which has been independently reviewed by EY, shows that future IWCM projects in urban growth areas will not be financially viable if IPART's proposed pricing regime is introduced. This will deny the Sydney and Hunter areas the opportunity to have sustainable urban communities.

In addition, projects on the urban fringe will only return positive operating revenues if sewage is tankered, even if existing SWC/HWC sewerage infrastructure exists and has spare capacity.

12 Conclusion

Flow's NSW water business will be rendered uneconomic by IPART's proposed wholesale pricing determination.

As the majority holder of WIC Act licences in NSW, Flow has made numerous public submissions to IPART, held meetings with IPART, and attended public hearings on the matter over the past two years. All of Flow's arguments and concerns spelt out to IPART over this time appear to have been ignored by IPART in the latest draft pricing determination.

The feedback of Flow, and other IWCM providers should be taken on board by IPART and reflected in its pricing determinations. By failing to take into account the concerns of Flow and other water industry innovators, IPART is effectively killing competition in the NSW water sector and promoting inefficient antiquated water infrastructure and service solutions.

Accordingly, IPART should:

- Suspend its current review of wholesale water and sewerage prices until an overall industry review is completed;
- Participate in an independent industry review led by an expert taskforce to develop a holistic strategy for the water recycling market in order to unlock both public and private investment. The review must consider wholesale pricing in concert with other policy, pricing and regulatory issues; and
- Ensure Sydney Water and Hunter Water continue to apply the current cost based non-residential prices based on the actual service, not a deemed service, and prevent the application of any type of retail-minus tariff to IWCM WIC Act licensees.

Yours sincerely,



Terry Leckie
Founder & Executive Director
Flow System



