



30 October 2020

Dr Paul Paterson
Chair
Independent Pricing and Regulatory Tribunal
PO Box K35
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Dear Chair,

Water Pricing and Licensing Special Review – Regulating Water Businesses

Flow Systems Pty Ltd (**Flow**) welcomes the special review (the **Review**) being undertaken by the Independent Pricing and Regulatory Tribunal (**IPART**) into the way in which it regulates Sydney Water, Hunter Water, Water NSW and the Sydney Desalination Plant (**Incumbents**). Flow is grateful for the opportunity to provide feedback in respect of the Review.

About Flow Systems

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

Regulation in context

Flow agrees that the communities of New South Wales rely on resilient water services for their continued liveability and prosperity. Customers are rightly asking governments and regulators to remove constraints on the creation of liveable urban environments. Innovation and consideration of all water supply options within an IWM framework will be critical to the future wellbeing of the people of New South Wales. Consumers want affordable, liveable and sustainable places in which to live and work.

New South Wales faces immediate and long-term challenges in ensuring a resilient drinking water supply to its urban communities. Wastewater collection and treatment is a large and growing challenge, especially away from the coastal deep ocean outfall catchment areas. In all areas discharge of treated and untreated wastewater into waterways and oceans will increasingly compromise already fragile or damaged ecosystems. The urban heat effect means that many suburbs will be "too hot to live in", with days exceeding 50 degrees Celsius expected to become common in Sydney's key growth corridors.

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At the same time, new approaches to IWM and the circular economy are presenting opportunities for communities to:

- access wastewater as a resource - precious water that offsets fragile drinking water supplies;
- reduce load on sensitive waterways within urban growth areas;
- own a new home, where public sector service models would continue to be a constraint on release of housing stock; and
- enjoy year-round greening of public and private gardens, support tree canopy and a healthier community micro-climate.

As IPART has recognised, recent reviews at the State¹ and Federal² levels have highlighted the need for a more coordinated and directed approach to improving water resilience outcomes.

A competitive water sector will deliver better outcomes

The WICA has been in the tool kit for over a decade as a starting point to build a vibrant and competitive water sector. The private water industry has built up expertise in integration, knowledge and innovation about maximising benefits to customers and a ready and willing investor base. Over the last 10 years, the private WICA industry has demonstrated that private water services can work and deliver tangible liveability and environmental outcomes to their communities while contributing to acceleration of Sydney's housing stock at a time when housing supply remains under stress.

In its recently released "All Options on the Table" report, the Water Services Association of Australia states:

"The Australian urban water industry needs to continue moving towards a diversified portfolio of water supply options to meet the water security needs for Australia's rapidly growing cities and regional centres in the face of climate change and drought."³

A diverse portfolio can only be achieved through a viable competitive marketplace for water service delivery.

The WICA industry is a largely untapped resource for solving some of the key problems identified in recent reviews, including:

- **Integration** The WICA industry is about unlocking value for households, developers and communities (and, if given presented with the right regulatory and pricing settings, at the bulk water level as well). Private businesses are incentivised to bring together different participants, including local government, regulators, local water authorities, landowners, residents and visitors. The private sector has immediate value to add in coordination and integration.
- **Innovation** Flow Systems has been providing water services for over 10 years and has had to innovate (and continues to innovate) by bringing together proven technologies and working them into a whole of system approach. That system includes water, wastewater, stormwater, community amenity, energy efficiency and emissions, telecommunications, research and development, employment and waste. Our approach is at a local community level, which compliments the approach, infrastructure and expertise demonstrated by public water authorities. The private sector can bring these benefits with the cooperation and facilitation of governments and government owned water services, extending their ability to provide the best possible customer outcomes.

¹ For example, the NSW Audit Office's performance audit in respect of "Water conservation in Greater Sydney", 23 June 2020: <https://www.audit.nsw.gov.au/sites/default/files/documents/Water%20conservation%20in%20Greater%20Sydney.pdf>

² For example, the Productivity Commission's report entitled "Integrated Urban Water Management - Why a good idea seems hard to implement", March 2020: <https://www.pc.gov.au/research/completed/water-cycle/integrated-urban-water.pdf>

³ Water Services Association of Australia (2020) "All Options on the Table: Urban water supply options for Australia" 3 September 2020 p.2

- **Investment** As IPART has identified, the combination of a very large and growing regulated asset base with an extremely low WACC in the latest retail price reviews presents a potentially massive risk for retail prices into the future. Yes, retail prices were held low in this pricing period due to the very low WACC, but that also gives rise to the question: what happens if (when) that WACC creeps (or jumps) up again? With the right regulatory settings, which allow the private sector to create and access value through integration and innovation, IPART will also find that there is willing private capital ready to invest. The private sector is a way of reducing risk for the regulated incumbents: by spreading the asset base, and allowing the private sector to take on, manage and generate a return from that risk.

What does this mean for IPART's review?

Optimising customer outcomes depends on achieving a more agile and innovative water sector. IPART has an important role to play.

Focus on actual not theoretical competition

IPART's current review should focus on ways to build a competitive water sector, instead of ways to try and shore up an ersatz regulatory construct. Regulation cannot ever achieve the same customer focus and innovation as competition. "Financial incentives" are just as constructed as the concept of replicating competition. This is because, at the end of the day, there is no real risk to the capital invested in the public water authorities.

Instead, IPART's focus should be on how best to nurture the emerging water services market and make competition really work.

The starting point should be investigating the value chain of water services (from bulk water,⁴ through "wholesale" water services,⁵ to the customer meter) and the nature of competition at each point.

Both the *Independent Pricing and Regulatory Tribunal Act* and WICA give IPART the necessary legislative basis for conducting a thorough review of how IPART's regulatory framework can be optimised to encourage competition for the benefit of the end customer.

Recognise the importance of price signals and structures at all levels

Facilitating optimal outcomes means ensuring that there are meaningful incentives for efficiency and innovation at all levels of the water value chain. For example:

- **Bulk Water should be priced to value demand management/offsets:** In the last pricing review for WaterNSW, the potential for bulk water pricing to send price signals to alternative water source providers was overlooked in favour of a mechanical matching of fixed costs to fixed revenue. That is, the value that competition could bring to the bulk water market was not considered. Setting a high fixed price for bulk water means that there is no incentive for Sydney Water to find and reward providers or solutions that offset the need for it to draw on WaterNSW's bulk water supply. This flows through the system to the way that pricing structures for community-based local water utilities work.
- **Retail minus wholesale pricing is anti-competitive:** Retail-minus price structures are inherently anticompetitive and are designed to protect the revenue of established incumbent utilities rather than focusing on cost to serve and facilitating innovation.⁶ Integrated water management providers should be charged for the cost of providing them services, just like any other wholesale customer. Retail minus will not lead to the best customer outcomes long term. "Information sharing" is not practical and means that WICA licensees will be relying on their competitor to provide them information about opportunities.

⁴ That is, the water purchased by the public 'monopoly' water businesses.

⁵ That is, services provided to WICA licensees.

⁶ The problems with retail-minus pricing and its impacts on private entry into water markets are extensively discussed in Flow's submissions to IPART, which can be found at: <https://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Metro-Pricing/Wholesale-pricing-for-Sydney-Water-and-Hunter-Water?qDh=3>.

- **Retail pricing places public authorities and innovation at risk:** Water is chronically under-priced by deferral of infrastructure that is needed now to secure supply to metropolitan areas and by the current very cheap cost of capital applicable to State-owned instrumentalities. While retail water prices in Sydney and the Hunter have been kept low for the next four years, the biggest driver of that pricing outcome was not efficiency, but record-low weighted average costs of capital driven by macro-economic factors. As those global drivers change or become more volatile, the importance of distributing the water infrastructure asset base out of the Regulated Asset Base (**RAB**) of Sydney Water and Hunter Water will be increasingly critical. Unless private balance sheets are leveraged, the whole of the burden will rest on those RABs and retail prices will be set to rise rapidly and substantially when WACCs increase. Other water supply solutions and the private sector are artificially frozen out of the market and the risk of large price hikes in the future is increased.

We encourage IPART to take a root and branch approach to reviewing its pricing structures and overall methodology for regulating water businesses. In this regard, we support IPART's proposal to conduct a review of WACC methodologies. Flow Systems encourages that review to have regard to the broader approach considerations referred to in the special review.

Look to incentivise contestability

IPART has referred to the approaches of the UK's Ofwat and the Australian Energy Market Operator. We believe both of those models show a way forward for water in New South Wales by demonstrating the value that a truly independent planning body can bring in brokering real competition between private and partly private actors. For example, Ofwat oversees and facilitates innovation in distributed water service utilities, including by "levelling the playing field" - giving all participants in the market access to growth and innovation dollars paid by water consumers as part of their tariffs.⁷ Long term efficiency gains and downward pressure on customer prices have long been accepted outcomes of UK's privatised water sector.⁸ Infrastructure Australia has repeatedly cited that work in its calls for reforms to water service delivery. There is no good reason why New South Wales could not do a similar thing.

IPART has an opportunity to look to replicate and build on these successful models by stepping back and considering how to incentivise contestability at all parts of the value chain (including water supply, network augmentation, customer service). For example, where private industry could offset the burden on 'monopoly' water business wastewater infrastructure through an "off grid" solution, what pricing structures could be used to ensure that such solutions are considered on a contestable basis against other network augmentation options?⁹

Concluding remarks

Flow Systems welcomes IPART's special review regarding regulating water businesses and congratulates the Tribunal on its Position Paper. Flow Systems looks forward to the consultation process and is pleased to participate.

Regards



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⁷ See <https://www.ofwat.gov.uk/publication/innovation-funding-and-competition-decision-on-design-and-implementation/>

⁸ See Cave, M. (2009) *Independent review of competition and innovation in water markets: Final report*, available at: <https://www.gov.uk/government/publications/competitionand-innovation-in-the-water-markets-cave-review>

⁹ Noting that, of course, existing pricing structures for evaluating "avoided costs" would not help here, because there is no pricing interface between such schemes and the existing wastewater network.