

3 June 2016

Dr Peter Boxall AO
Chairman
Independent Pricing and Regulatory Tribunal of NSW
Level 15
2-24 Rawson Place
Sydney NSW 2000

By Email: Anita_Payne@ipart.nsw.gov.au

Re: Prices for wholesale water and sewerage services Sydney Water Corporation and Hunter Water Corporation

Dear Peter,

The Urban Development Institute of Australia (UDIA) NSW is the leading property industry group promoting the responsible growth of this State. We have around 500 company members and more than 3,000 of their employees attend our events, sit on our committees, undertake training or are involved in the activities of the organisation on an annual basis. Our organisation is the oldest property development advocacy group in the country, having been established in 1962.

UDIA NSW is governed by a 13-person Council that is elected annually by the membership. We have 8 policy committees that meet monthly and they actively advise the council on policy positions. UDIA NSW aims to secure the viability and sustainability of urban development for our members and therefore the communities that they create. Our policy agenda has three key themes, namely the delivery of more new homes for NSW, the provision of quality, affordable infrastructure to support development and the creation of more jobs closer to where people live.

Background

Until the commencement of the *WICA 2006 (NSW)* and its companion regulation *WICR 2008*, the public water utilities (Sydney Water Corporation and Hunter Water Corporation) effectively had a monopoly on the provision of potable water and sewerage services in the Sydney and Hunter regions. There was no capacity for a private participant to lay a reticulation network or to transport potable or non-potable water without the assistance of the water utility; nor was there a legislative framework for the retail supply of water by private competitors.

The New South Wales Parliament passed the Act in November 2006 to encourage competition and promote innovation in the water industry, following IPART's inquiry into water and water pricing. The IPART inquiry concluded that an increase of competition in the water industry would also increase efficiency of delivery, encourage innovation and allow for private entry into the industry. WICA was welcomed by the development industry as it provided choice, encouraged efficiency from water service providers and has led to innovative water solutions in One Central Park and Barangaroo, to name a few, that would not have otherwise been possible under the previous structure.

Retail-Minus Pricing Approach

IPART has reached a preliminary view that retail-minus (plus net facilitation costs) aka Efficient Component Pricing Rule (ECPR) is the right approach for wholesale services whilst the postage stamp pricing policy remains.

UDIA NSW has serious reservations about this approach due to its negative impact on affordability, liveability and connectivity.

ECPR has been tested and examined in a number of international jurisdictions. The UK's Competition Appeal Tribunal (CAT) looked at a landmark case in 2006, *Albion Water Ltd v Water Services Regulation Authority and Dwr Cymru*.

In the *Albion* case, a water utility monopoly, Dwr Cymru, had supplied, for many years, non-potable water to Shotton Paper. Shotton is a newsprint manufacturer and one of the largest Welsh water customers. Dwr Cymru obtained water, to be supplied to Shotton, from a nearby water utility (United). It transported the water to Shotton over a 16km pipe owned and operated by Dwr Cymru.

Legislation designed to increase competition in the water was introduced. Relying on that legislation, Albion sought to supply water to Shotton instead of Dwr Cymru. It entered into an agreement with Shotton to provide their water. It also purchased a water supply from United. It sought to use Dwr Cymru's 16km pipe to transport the water to Shotton, making Dwr Cymru a common carrier of the water over that pipe.

The regulator then determined that ECPR would apply to the provision of the common carriage over the 16km pipe but did not regulate the retail price. Instead a notional price was imputed. The regulator also decided that the minus part of the retail-minus formula would be based on marginal costs. It was said that no costs were avoided because the single customer (Shotton) was supplied by Albion instead of the incumbent, therefore the minus component was zero. Consequently, Albion would not be able to supply water as it would be financially unviable, they would be forced to remove themselves from the market and Dwr Cymru would be left as the monopoly supplier.

The decision noted that any decision to implement ECPR should be considered very cautiously, in light of its adverse features. The Tribunal recommended that if there was not a move to a different methodology, the approach to retail-minus should be modified to minimise the problems inherent in ECPR and supplemented by regulation of the retail price. The Tribunal stated that a retail-minus regime should be:

“complemented by additional safeguards, including imputational requirements, to ensure compliance with the control on an ex ante basis to prevent gaming by the incumbent”

The Tribunal concluded that ECPR (which sets the price payable to the incumbent by the competitor at the incumbent's price on retail market less avoidable costs) would not work in isolation where the incumbent has significant market power (SMP). To make it work, regulation of the price itself is essential. Troublingly, the Tribunal came to the conclusion that even if the retail price were to be regulated, it was unlikely ECPR would succeed in engendering competition and in achieving the relatively limited positive outcomes put forward by ECPR proponents.

IPART has sought to bring about efficiency gains notably productive efficiency, allocative efficiency and dynamic efficiency. The CAT found that under an ECPR none of these efficiencies would be achieved. The following is an extract from the decision:

“Professor Armstrong (for the incumbent) saw ‘efficient entry’ in terms of the assumption that lay behind this model, and indeed the Authority’s whole approach, which was that under ECPR market entry was only ‘efficient’ if it could take place without increasing the water industry’s total costs in the short run. In other words, ECPR aimed for ‘productive efficiency’ in the short run, but neither ‘allocative’ nor ‘dynamic efficiency’, even if entry might reduce costs over the longer run. Dr Marshall (for the competitor), on the other hand, saw ECPR as likely in practice to preclude entry by firms who would, by any normal standards, be regarded as ‘efficient’. In her view, ECPR was unlikely to achieve even the theoretical ‘productive efficiency’ relied on by the Authority. More importantly, according to Dr Marshall, ECPR was unlikely in practice to foster the competitive process, or lead to gains in terms of lower costs, lower prices, better service or more innovation. In other words, in technical terms, as Dr Marshall saw it, ECPR would not achieve ‘allocative’ or ‘dynamic’ efficiency either. Professor Armstrong, for his part, emphasised that ECPR was solely concerned to achieve ‘productive efficiency’, emphasising the role of the regulatory process in controlling prices and thus achieving ‘allocative efficiency’ by that route.”

A main drawback of the ECPR model is that it has the competitor underwrite the incumbent’s risk as the competitor is forced to bankroll the incumbent’s costs and thus insulates the latter. A one-sided market results, whereby any new entrant carries all the risk burden whilst the incumbent is not required to compete.

The retail-minus approach is at cross purposes to the original objectives of WICA, being the creation of a contestable market in the provision of water and sewerage services, encouragement of innovation in the sector and increased efficiencies and reduction in retail prices.

Recommendation

UDIA NSW makes the following recommendations:

- 1. The Premier redirect IPART to undertake a broader review, under either Section 9 or 12A of the IPART Act, to look at the future provision of water infrastructure in a more holistic light with an emphasis on the broader benefits of the WICA market to the economy.**
- 2. Until such time as a broader review is announced, the status quo should be maintained with a moratorium placed on the review of pricing model for wholesale water and sewerage services.**

Fostering competition in the water sector is crucial in building affordable, liveable and connected cities. With major city shaping development occurring throughout Sydney and the Hunter, it is now more important than ever to create a sustainable pricing approach where contestability, productivity and innovation are at the forefront.

Should you wish to further discuss any of the above please contact Justin Drew, General Manager, Policy & Strategy on [REDACTED] or at [REDACTED]

Yours sincerely

[REDACTED]

Stephen Albin
Chief Executive