IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Wholesale pricing for Sydney Water and Hunter Water

Public Hearing

8 December 2015

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Regulating wholesale pricing

This is the first time we are looking at how to regulate wholesale services from Sydney Water and Hunter Water.

There are two regulatory instruments that can regulate these transactions:

1. The WIC Act's access regime
2. IPART's price determination

The WIC Act's access regime

The WIC Act's access regime works in three ways:

1. **Private negotiations** – negotiations enhanced by the threat of coverage declarations
2. **Coverage declarations** – a Ministerial requirement to provide access to a network
3. **Voluntary access undertakings** – IPART approves standard terms, conditions and price methodology for access.

Some stakeholders noted concerns about regulating under the WIC Act:

- negotiating with a vertically integrated competitor
- the WIC Act's definition of infrastructure services excludes wholesale services
- wholesalers are not access seekers but non-residential customers

‘Infrastructure services’

The WIC Act’s access regime applies to the storage, conveyance or reticulation of water or sewage. In general, it excludes:

- the supply of water
- water filtration
- the treatment and disposal of wastewater.

These exclusions may prevent regulation of wholesale supply of water or wastewater services through the WIC Act.

- However, prices and conditions for these services can be negotiated separately from access.
- Alternatively, in future price reviews, IPART could determine separate prices for bulk water, water filtration, wastewater treatment and disposal. This would allow price certainty for these excluded services.

Price determination

To determine prices for WIC utilities we could either:

1. Add WIC utilities to an existing customer category, or
2. Create new customer categories for WIC utilities.

Under a determination we could set a **price cap** or a **price methodology**.

A methodology can vary in complexity, generally there are trade offs between **price certainty**, **flexibility** and **cost reflectivity**.

Sydney Water and Hunter Water, is not required, under its current licence, to supply water and wastewater services to WIC utilities, except in very limited circumstances.

Stakeholder positions

IPART's Issues Paper

We proposed an interim determined price cap or methodology until voluntary access undertakings have been approved.

Sydney Water

Proposed an interim determined price methodology until a voluntary access undertaking has been approved.

Hunter Water

Proposed a price methodology under the determination.

Other stakeholders

Most stakeholders preferred wholesale prices to be regulated under a determination. Some supported the price certainty of a price cap, while others preferred the flexibility of a methodology.

Discussion topics

1. Should wholesale prices be regulated under the WIC Act, IPART's price determination or a transition from a determination to the WIC Act?
2. What conditions or changes would WIC utilities require to use the WIC Act's access regime?
3. Sydney Water has proposed a voluntary access undertaking. How would or should this undertaking accommodate wholesale services?
   - Would it include the supply of drinking water, disposal of sewage, and/or treatment across the network?
4. Under determined prices, should Sydney Water and Hunter Water be required to always provide wholesale water and wastewater services within their areas of operations?
   - If so, how can this be assured (eg, is it necessary to include requirements in their respective operating licences)?

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Efficient competition

Sydney Water, Hunter Water and most **stakeholders** argued that wholesale pricing is important for market efficiency.

Competition can create efficiency gains in two ways:

- **Productive efficiency** – where output is produced at lowest cost. This form of efficiency was the focus of **Sydney Water's** and **Hunter Water's proposals.**
- **Dynamic efficiency** – where competition promotes innovation. This form of efficiency was the focus of most other **stakeholders**' submissions.

Wholesale pricing is important, an inefficient price may lead to too much or too little market entry.

Pricing wholesale services

There are a number of possible approaches:

1. **Retail price minus avoided or avoidable costs –** the retail charges less the costs the incumbent no longer incurs.
2. **Non-residential charge –** the non-residential customer charge based on the connection size, as set under our prevailing price determination.
3. **Cost of service –** the actual cost of supplying the particular wholesale customer.
4. **Retail price minus efficient entrant costs –** the retail charges with a sufficient discount applied to allow an efficient entrant to be price competitive for the same services.

Retail minus avoidable cost

A retail minus avoidable cost charge is the *sum of end users retail charges less avoidable costs.*

Avoidable costs could include:

- costs avoided today
- costs that could be avoided in the future, and
- costs of assets that could potentially be stranded.

Retail minus charges are **consistent with postage stamp pricing.** Charges would be lower in higher cost areas, reflecting avoidable costs.

A retail-minus methodology would require **Sydney Water** and **Hunter Water** to either:

- Estimate a WIC utility's number of customers and activities that produce avoidable costs, or
- Require information from WIC utilities on customers and operations.

Non-residential retail prices

Wholesale customers could be charged the non-residential meter based price as set under our determinations.

The non-residential price is **simple to apply** in a determination.

However, non-residential prices are designed for end users not wholesale customers.

Margins under a non-residential price would vary with usage charges and price structure changes

- In particular, differences in Sydney Water's and Hunter Water's price structures lead to very different outcomes from applying a non-residential charge: in some cases in the Hunter it may be more expensive than the residential retail charges.

Residential and non residential prices

Five 200mm connections to service 1,000 residential end users

Sydney Water	Residential retail charge	Non-residential retail charge	*Margin*
Water bill	$448,195	$398,933	*$49,262*
Wastewater bill	$582,340	$410,731	*$171,609*
Total	**$1,030,535**	**$809,664**	***$220,871***

Hunter Water	Residential retail charge	Non-residential retail charge	*Margin*
Water bill	$414,740	$407,534	*$7,216*
Wastewater bill	$515,565	$618,599	*-$103,034*
Total	**$930,305**	**$1,026,122**	***-$95,817***

Cost of service/building block

The cost of service method sets prices for wholesale customers at the cost of providing that service. This method would not be consistent with postage-stamp pricing.

Consequently, it could lead to inefficient outcomes:

- **high cost entrants could profitably enter** in low cost areas
- **low cost entrants could not profitably enter** in high cost areas.

Under a determination, a cost of service approach would require a methodology.

Efficient entrant costs

Some jurisdictions require that wholesale prices allow an efficient competitor to enter and compete on price.

This could be used to set prices where there is a margin (between the incumbent's retail price and its wholesale price) that is sufficient to allow an efficient entrant to compete on price.

We are considering this form of retail minus pricing.

Efficient entrant costs formula

Wholesale charge = retail charge *minus* efficient entrant (EE) costs of relevant supply chain elements.

That is:

Wholesale charge **=** Retail water and wastewater revenue **minus**:

- EE retail cost **X** customer numbers
- EE distribution cost **X** km of distribution network
- EE water filtration cost **X** ML of water filtered
- EE wastewater treatment cost **X** ML of wastewater treated
- Costs of other services to be subtracted from the retail price?

Stakeholder positions

IPART's preliminary view

In our Issues Paper we proposed using retail minus avoidable cost.

We are now also considering retail-minus efficient entrant costs.

Sydney Water

Proposed using a retail minus avoidable cost approach, with a three percent minus for an interim price determination.

Hunter Water

Proposed a retail minus avoidable cost approach where the avoidable cost is between two and three percent.

Other stakeholders

Most other stakeholders stated a preference for the non-residential price.

Price caps and price methodologies

In the next slides we present different models of WIC utilities. Each scheme generates **different avoidable costs.**

A price cap, such as the non-residential price or retail-minus three per cent, would not reflect these differences.

A **price methodology**, such as the efficient competitor margin or retail-minus avoidable costs, or **negotiation through the WIC Act**, would allow more individualised prices.

WIC utility: model one

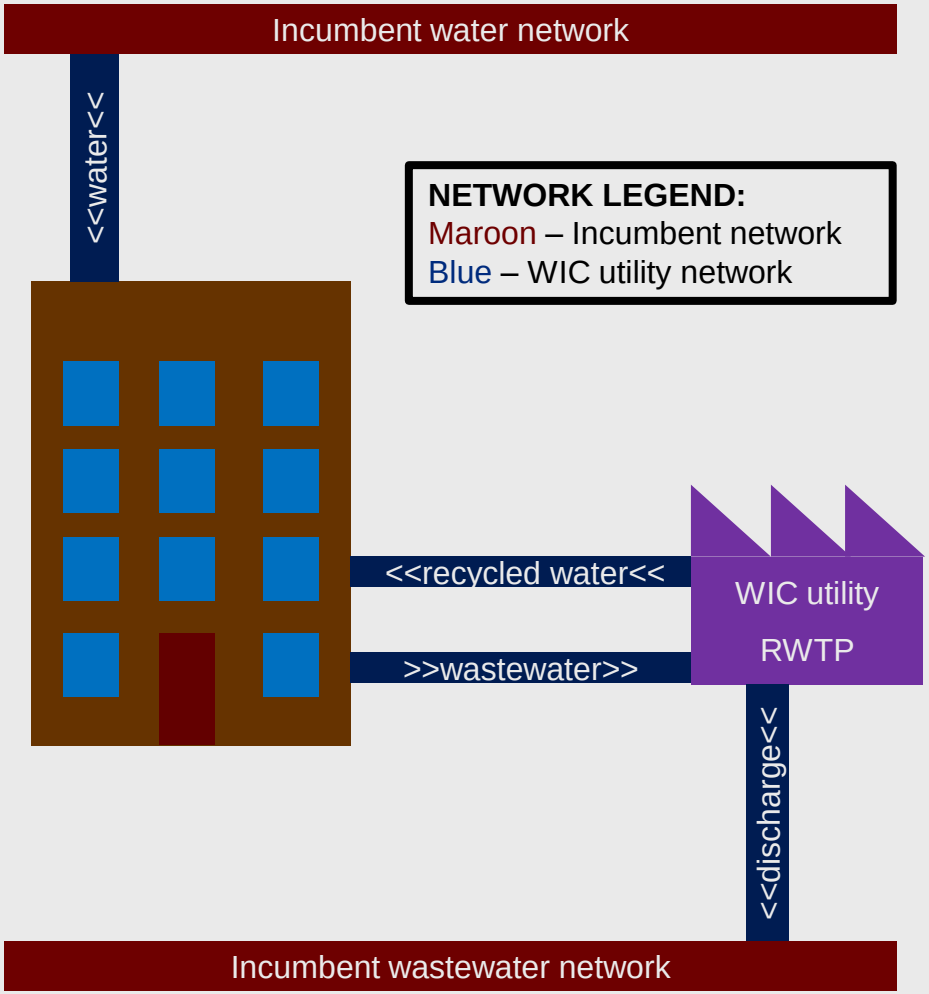
Description

The WIC utility operates:

- Connection infrastructure
- Recycled water plant

Possible avoidable costs

- Retail costs
- Recycled water avoided costs
- Wastewater treatment costs



WIC utility: model two

Description

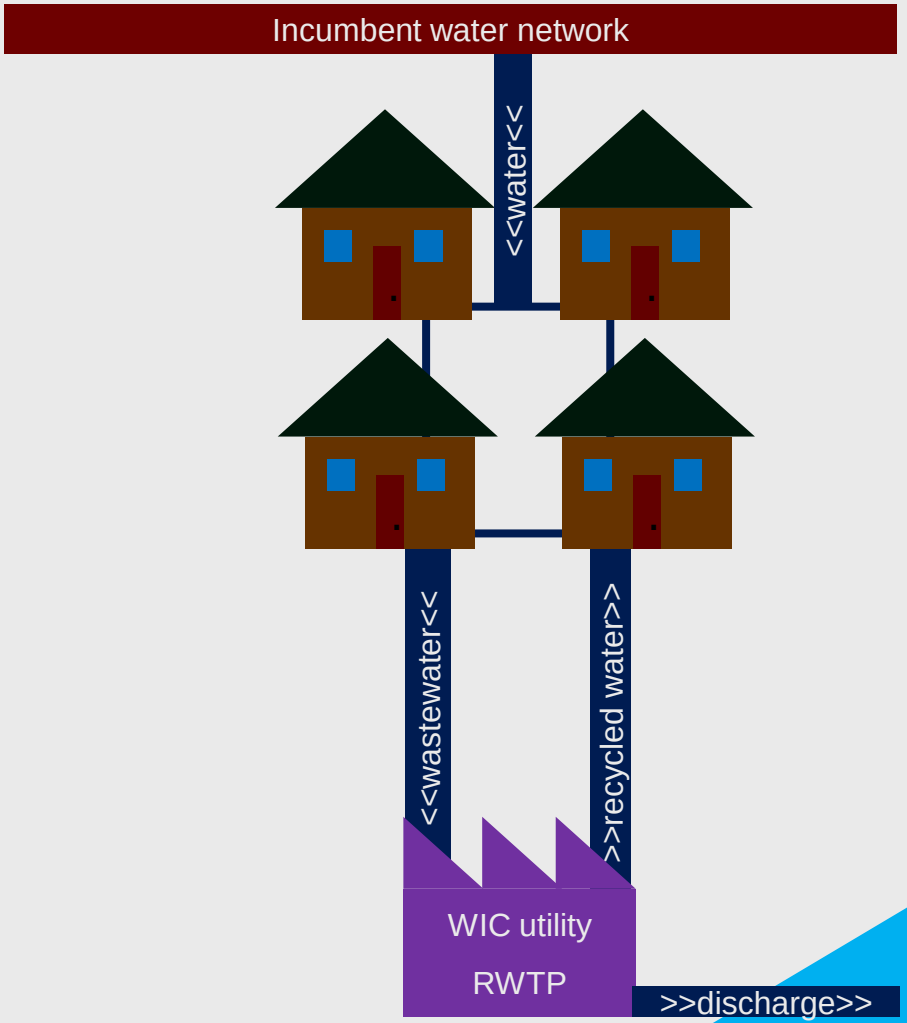
The WIC utility operates:

- A recycled water plant
- Distribution network
- Wastewater disposal

Possible avoidable costs

- Retail costs
- Recycled water avoided costs
- Treatment costs and augmentations

In this scenario there is no wastewater connection but there may be avoidable costs.



Overlapping pricing issues

Recycled water avoided costs

Stakeholders noted existing inconsistency in treatment of recycled water avoided costs:

- Sydney Water and Hunter Water can cross-subsidise their recycled water programs
- WIC utilities have no access to an avoided cost subsidy

Zero developer charges

In 2008, the NSW Government set Sydney Water's and Hunter Water's water and wastewater developer charges to zero, now:

- Sydney Water and Hunter Water can cross-subsidise growth from their existing customer bases

Some stakeholders have called for a wide ranging review to look at all the issues impacting competition in the water industry

Discussion topics

1. For each of the models presented, which pricing approach should apply? Where applicable, what costs are avoidable?
2. Sydney Water and Hunter Water estimated avoidable costs of two to three percent, what costs is this based on?
3. Under a determination, should WIC utilities providing different services face the same or different charges?
4. If IPART set a retail-minus or efficient competitor approach, how would Sydney Water and Hunter Water obtain the information required to calculate charges?
5. Should WIC utilities be compensated for savings created by recycled water deferring or avoiding augmentations?

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Key dates

June 2015	Receive Sydney Water's proposal
September 2015	Release Issues Paper
October 2015	Receive submission on Issues Paper
December 2015	Public hearing/roundtable
March 2016	Release Draft Determination
April 2016	Receive submissions on Draft Determination
June 2016	Release Determination

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