



Level 9, 299 Elizabeth Street
Sydney NSW 2000
Australia
DX 643 Sydney
Tel: +61 2 8898 6500
Fax: +61 2 8898 6555
E-mail: piac@piac.asn.au
ABN 77 002 773 524

Our Ref:P06-45

Dr Michael Keating
Chairman
Recycled Water Price Review
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

7 August, 2006

Dear Dr Keating

Pricing arrangements for recycled water and sewer mining

Please find attached the Public Interest Advocacy Centre's submission to IPART's Draft Determination for recycled water and sewer mining in the metropolitan water agencies. For further information please contact Elissa Freeman on 8898 6518 or at efreeman@piac.asn.au.

Yours sincerely
Public Interest Advocacy Centre Ltd

A handwritten signature in black ink, appearing to read 'Elissa Freeman', with a long horizontal flourish extending to the right.

Elissa Freeman
Policy Officer

Submission to IPART's Draft Determination on Recycled Water Prices

August 2006

Elissa Freeman
Policy Officer

Jim Wellsmore
Senior Policy Officer

1. Introduction

The Public Interest Advocacy Centre (PIAC) seeks to promote a just and democratic society by making strategic interventions on public interest issues.

PIAC is an independent, non-profit law and policy organisation that identifies public interest issues and works co-operatively with other organisations to advocate for individuals and groups affected.

PIAC established the Utility Consumers' Advocacy Program (UCAP) in 1998 with a grant of funding from the NSW Government. UCAP aims to advocate for the interests of residential consumers of electricity, gas and water utilities, with a particular focus on the needs of low-income and disadvantaged groups. The project receives broad policy direction from a community based reference group. This includes representatives from the following organisations/population groups:

- Council of Social Service of NSW (NCOSS)
- Combined Pensioners and Superannuants Association of NSW (CPSA)
- Tenants Union of NSW
- Park and Village Service (PAVS)
- Rural and remote consumers
- Indigenous consumers
- Institute of Sustainable Futures, University of Technology, Sydney.

2. Public Interest in Recycled Water Price Regulation

Monopoly Power

Essential services like energy and water are generally supplied to residential customers on a monopoly basis. That is, customers have little choice about whether to enter the market, what price they will pay and who will be their supplier. It is the role of the economic regulator (IPART in this case) to ensure that monopoly suppliers do not use their market power to make excessive profits by charging unreasonable prices. Regulation acts as a proxy for a competitive market – it determines what a reasonable profit will be and how that will be recovered through the fees charged to captive customers.

Where recycled water is supplied to customers on a mandatory basis, the water agency will be a monopoly supplier. Therefore customers are reliant on the regulator to ensure that the supplier does not abuse its position in terms of prices charged and service provided.

Equity in essential services

As a policy objective, the community prioritises the equitable supply of essential services. This is delivered by the pricing structure, access to external dispute resolution and Community Service Obligations (CSOs).

Equity in pricing has traditionally been delivered in the water industry through postage stamp pricing. This means that all customers within each customer class are charged the same price for a service even though there are variations in the cost of service delivery across the supply network.

Pricing equity is also achieved in water services by ensuring a fair allocation between fixed and usage charges. This is because, under NSW legislation, landlords are liable for the fixed costs of supply while tenants may be liable for the usage components.

Changing community attitudes and industry structure are driving the greater consideration and implementation of recycled water schemes in metropolitan water agencies across New South Wales. As more customers have their essential water needs met through recycling schemes, PIAC is seeking to ensure that customers receive adequate price protection for the service provision. To achieve this, PIAC is of the view that IPART's price determination needs to address the following:

- Simple and transparent pricing of recycled water
- Price protections for all customers obligated to connect to a recycling scheme
- Continued price regulation until adequate information about costs are known to enable the transition to a lighter form of regulation
- Postage stamp prices for recycled water schemes
- A transparent and robust compliance framework to identify and seek redress for abuse of monopoly power by water agencies.

3. The issues under review

3.1 Objectives for recycled water pricing

A major concern for consumer groups is the growing complexity of household bills. Research commissioned by IPART for the 2005 Metropolitan Water Price Review has also demonstrated the limited grasp of billing data across the customer base. In the survey conducted by Taverner Research over half of the respondents were unable to name any separate, itemised charges that appear on a water bill.¹ For large segments of the community the tariff and consumption data contained in utility bills already are above their level of financial literacy. The anticipated changes to the industry associated with the proposed water access regime stand to create an even greater level of uncertainty among consumers.

The effective participation of consumers in the marketplace, including demand responsiveness and switching behaviour, requires that bills be easily understood. Simplicity in billing data can be delivered in a myriad of ways, however simple pricing structures will make an important contribution to the maturing water market.

Simple and transparent pricing of recycled water should therefore be a core pricing principle of recycled water prices. This approach is more likely to enable consumers to exercise a greater level of control over their consumption profile and therefore deliver the important sustainability goals that underpin recycled water schemes.

3.2 Overview of Tribunal's draft decisions in relation to mandated schemes

The *Draft Determination* observes that the delivery of water services in Australia is undergoing a significant shift. It is laudable that the regulation of water services has kept pace with this change by acknowledging that recycled water constitutes an essential service in the lives of some Australian households and businesses.

¹ Taverner Research, 2005, *Research Report: Survey Of Household Water Attitudes* Prepared For: Independent Pricing And Regulatory Tribunal February 2005

The separate treatment of mandated water-recycling schemes is appropriate to protect consumers from abuses of monopoly power in terms of prices, pricing policies and standard of services. Users who are required to enter into a contractual arrangement for the supply of recycled water are captive customers of the water agency in the same way as customers of potable water and sewerage monopolies.

IPART's determination will need to ensure that all customers of mandated schemes receive adequate protection. We note that mandated schemes are not limited to those schemes which have been or will be deemed by Government policy. An integrated approach to water management requires that recycling be considered as a matter of course in a least-cost approach to planning. As water conservation becomes more highly valued, more cost-effective recycling schemes are expected to develop as part of the ordinary network planning process. Customers of schemes developed within water agencies should not be treated differently from schemes derived from government policy.

Whether or not a scheme has been mandated by government policy remains a key determinant of which costs will be allocated across the network. It should not, however, be the key determinant of whether users receive price protection in the form of direct regulation by IPART. The key criterion for determining which schemes are 'mandated' recycling schemes should be whether or not there is an obligation on the user to connect to the scheme.

3.3 Tribunal's considerations on the form of regulation

It is concerning that IPART has settled on a light-handed form of regulation when, by its own acknowledgement, the industry is not well established and IPART would have difficulty in calculating efficient prices.

PIAC submits that greater regulatory oversight is required for the costs of recycled water than allowed for in the *Draft Determination*. For the reasons outlined below, the community and customers would be better served in the current determination period by a direct determination on the price of this essential household service.

PIAC maintains that IPART is uniquely and appropriately placed to test the efficient and prudent costs of essential infrastructure services, and balance these with environmental and social considerations as required under the *IPART Act*. IPART's approach to retail gas pricing reflects a balance between regulatory oversight of costs and flexibility in pricing. The Voluntary Transitional Pricing Arrangements grant flexibility to the retailer on the grounds that the cost inputs are known and prudent. It then establishes a bounded path for prices. In the case of the proposed pricing guidelines for recycled water, there is neither a similar examination of the cost input nor the same guidance in pricing.

The recycling industry is in an early stage of development and, as IPART has acknowledged, there is a natural limitation to the capacity to make accurate cost assumptions under such circumstances. This has raised concerns for IPART that inefficiencies may be forthcoming if a maximum price is set on either a network-wide or scheme-specific basis. IPART's approach to this situation in the past (at the Rouse Hill Development Scheme) has been to make a formal price determination and adjust for any inefficient pricing outcomes in subsequent determinations. This approach protected customers and provided regulatory certainty for the water agency, while creating leverage for the scheme to develop. As reflected in the *Draft Determination*, the community has learnt much about the costs and pricing of recycled water at the Rouse Hill scheme but there is still some distance to go to ensure pricing elicits efficient consumer behaviour and costs are equitably shared.

Over the determination period to June 2009 there are just two new schemes under construction (at Hoxton Park and Ropes Crossing at St Mary's) and the large scale Western Sydney Recycled Water Initiative (in Sydney's North West and South West).²

The NSW Government's Metropolitan Water Plan envisages that the new Western Sydney Recycled Water Initiative will eventually serve 160,000 homes. The size of this customer base warrants significant regulatory oversight. For example, IPART currently regulates maximum prices for each of Gosford and Wyong Councils, which combined provide water services to fewer than 125,000 properties. While limited information is known about the costs for the planned development, the scale of the mandated scheme is known and is significantly large. For this reason we submit that IPART should set a high standard now for managing the increased regulatory task into the future.

Recycled water now plays an integral role in the delivery of essential water services and expansions to the network have specifically identified a core role for recycling. It is natural that as the regulated network grows, the regulatory task also grows. The relative burden of price determinations for these schemes is outweighed in PIAC's view by the community-wide benefits of greater regulatory certainty for agencies and investors, minimising the economic risks borne by customers and, most importantly, increasing the regulator's knowledge of costs for future recycled water determinations.

Over the longer term our concern is that a price guideline approach to recycled water prices for these schemes (as outlined in the *Draft Determination*) will not allow cost structures to be sufficiently understood, and therefore will not provide adequate price protection for customers. Direct price regulation, with the flexibility to adapt into a pricing calculation over subsequent determinations, appears a stronger method to protect the interests of customers.

3.4 Tribunal's proposed pricing guidelines for mandated schemes

The structure of water prices has important equity implications beyond basic cost-recovery requirements. For example, under NSW legislation tenants may be liable for water usage charges while the landlord only can pay the fixed charge. Under the proposed methodology water agencies will not be subject to scrutiny about cost allocation between landlord and tenant. An unintended consequence of these reforms could see landlords entering into contractual arrangement with new entrant suppliers that effectively shift costs from the landlord to the tenant. Tenants would be unfairly charged under this arrangement. The guidelines contained in Box 7.1 grant full discretion to the water agency to set the price structure and grant no capacity to address any inequity that may arise from the pricing strategy.

The structure of water prices has a significant impact on the breadth and value of customer assistance and government concession programs. If these measures are to keep pace with water service reforms, there must be a high level of transparency to enable IPART to analyse the customer impact of the price determination in line with its statutory obligations.

While pricing guidelines may provide a clear framework for developing pricing arrangements they fail to provide a simple and transparent mechanism for customers (and customer advocates) to identify pricing incidents that represent an abuse of monopoly power. The information asymmetries that exist between customers and water agencies, as well as the commercial-in-confidence environment of a competitive water market challenge the assumption that abuses of monopoly power will be identifiable. Moreover, there is no scope for consumers to guard against inefficient pricing by switching to a lower priced competitor.

² NSW Metropolitan Water Directorate, 2006, *Metropolitan Water Plan*

In contrast, a regulated maximum price is a far simpler mechanism to assess agency compliance by customers, the Ombudsman and the regulator, by comparison to the proposed pricing calculation. However, only a regulated maximum price provides security and simplicity to customers.

Lastly, we note that it remains the policy of the NSW Government that households have access to postage stamp pricing for essential water and wastewater services. The NSW Government's recent consultation paper *creating a dynamic and competitive metropolitan water industry* states;

It is the Government's view that all consumers within the region services be existing water supply authorities should, on grounds of social equity, continue to be able to obtain essential water and wastewater services at a 'postage stamp' price.³

The proposed pricing arrangement does not preclude the use of postage stamp pricing. However, it does not ensure that water agencies provide customers with an essential service on the basis of postage stamp prices in accordance with Government policy. Given that mandated recycling schemes are considered an essential service, PIAC's view is that there must be provision within the pricing determination to ensure that customers receive the same price for the same service, even though costs may differ across the water agency.

3.5 Compliance with recycled water pricing guidelines for mandated schemes

A significant disadvantage of the proposed pricing calculation is the greater monitoring and compliance task on IPART for the various schemes. This is particularly concerning where changes to the industry structure anticipate new entrants undertaking this supply role.

In the absence of amendments to the *IPART Act* described in the *Draft Determination*, customers have only weak mechanisms to protect them from abuse of monopoly power. The proposed measures would be more appropriately implemented after the industry restructure is in place and new compliance powers have been granted to IPART. Nonetheless, PIAC argues that direct price regulation is preferable to the use of guidelines.

³ NSW Metropolitan Water Directorate (2006), *Creating a dynamic and competitive metropolitan water industry*, p7