

EMBRACING COMPETITION: 'THE SYDNEY EXPERIENCE'

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INTRODUCTION

For those of you that may not be familiar with IPART, we are the New South Wales economic regulator for a number of industries, including the water industry. Many of our functions are similar to those of the ESC here in Victoria.

We are also called upon to do special investigations for the NSW Government under section 9 of our Act, in a role similar to that performed by the Victorian Competition and Efficiency Commission here in Victoria or the Productivity Commission for the Commonwealth Government.

Since its inception 21 years ago, IPART has been involved in some dramatic changes to the water industry in New South Wales. Many of these have been targeted at the theme of today's conference: "Enhancing Water Sector Productivity".

Related to this, the title of my talk today is "Embracing Competition: the Sydney Experience". IPART has always viewed competition as an important means of enhancing efficiency, innovation and productivity in the water sector. Therefore, where possible, we've sought to facilitate and promote competition – in its various forms – in the provision of water services.

Economic regulation as a proxy for competition

First and foremost, in our role as regulator of a monopoly water utility, we've sought to impose some form of competitive pressure or market discipline on Sydney Water when regulating its prices.

When IPART was first established 21 years ago, Sydney Water was not yet a corporation and many of its charges were based on property values. IPART has worked with Sydney Water to develop more cost reflective water and wastewater prices. For instance, we have set the water usage charge with reference to estimates of the Long Run Marginal Cost of water supply.

Through our function as a price regulator, we have carefully considered Sydney Water's actual and forecast expenses and encouraged Sydney Water to act more like a business facing competition.

Over many determinations, we have worked with Sydney Water to enhance the efficiency of its operations and make its prices more efficient and cost-reflective.

Our price review processes – particularly our scrutiny of the efficiency and prudence of Sydney Water’s expenditure – has encouraged development and expansion of the first form of competition to emerge in the Sydney water market: competitive procurement. In an industry that is a natural monopoly, with significant gains to be made from scale, competitive tendering for designing, constructing, operating and/or maintaining monopoly assets is often the most viable and efficient form of competition. While it is not competition in its purest or most expansive form, competitive procurement can still enhance efficiency and innovation in the provision of otherwise monopoly assets and services.

An important early example of competitive procurement was the Prospect Water Filtration Plant completed in 1996. The Prospect Water Filtration Plant was built under a 25-year build, own, operate, and transfer contract with Degrémont. It is capable of treating 3,000ML of drinking water every day. At present, 90% of Sydney Water’s drinking water is treated in privately owned water filtration plants.

Competitive procurement has been implemented in a wide range of areas. In January of this year, Sydney Water and Thiess announced a 5-year contract worth \$175 million for Thiess to provide mechanical and electrical services for Sydney Water’s operations and provide facilities management services. Sydney Water’s decision to subject these functions to competitive procurement will add to the efficiency of the business.

In addition to imposing competitive rigour on Sydney Water’s expenditure, we have also sought to design our determinations to create further incentives for the utility to act in a competitive manner. For instance, in our 2011 determination of the Sydney Desalination Plant’s prices, we included an efficiency carryover mechanism.

The efficiency carryover mechanism allows the Desalination Plant to keep the savings from efficiency gains for 5 years after realising them, rather than only until the end of the determination period. This replicates the market, where businesses are able to develop and maintain competitive advantages through efficiency gains, until the competitors catch up. Under this mechanism, the Desalination Plant has the same incentive to make efficiency gains at all times in its price path, just as an unregulated competitive business would. This should help enhance the Desalination Plant’s efficiency gains and therefore also benefit water customers overtime.

THE EMERGENCE OF COMPETITION

So far I have discussed how we have promoted competition and competitive pressure in the Sydney Water market through our price regulation function – particularly through competitive procurement. However, we have also been active in developing an environment where businesses can compete with the incumbent water utility, Sydney Water.

Before I discuss IPART's role, I'll just briefly outline an earlier, major development in relation to competition in the Sydney Water market.

In 2004, Services Sydney, a private company, sought to become a competitor with Sydney Water as a provider of sewage collection and treatment services. Services Sydney planned to use Sydney Water's wastewater reticulation network as well as its own private pipeline.

In 2005, under the Trade Practices Act, Services Sydney successfully applied to have the North Head, Bondi and Malabar sewerage networks declared. This meant that Sydney Water was compelled to allow Services Sydney and others to seek access its reticulation networks.

Sydney Water and Service Sydney could not reach an agreement on the access-pricing methodology and it was referred to the ACCC for arbitration in 2006. The ACCC determined largely in favour of Sydney Water's proposed retail-minus avoidable cost approach to determining access prices. This access pricing approach was consistent with the retention of postage stamp pricing. Services Sydney has since not carried out its plans to compete with Sydney Water.

IPART's role in the Service Sydney process was limited. Under the legislation at the time, Services Sydney made its applications to Federal bodies: the National Competition Council, the Australian Competition Tribunal and the ACCC.

However, in 2005, IPART was directed by the New South Wales Government to review and provide advice on pricing principles and alternative arrangements for the delivery of water and wastewater services in the greater Sydney region, including possible private sector involvement.

This review was conducted in the context of the Services of Sydney access application. It was also carried out at a time of concerns about Sydney's water supply/demand balance.

Our recommendations from this review were aimed at increasing the scope for competition, private sector involvement and innovation in the water industry. We were particularly focused on the potential for competition to promote innovation in the development of new water supply sources.

There were 2 key elements of our recommendations.

- ▼ First, we recommended greater and more effective use of outcomes-based competitive procurement by water authorities – particularly in relation to additional water supplies.
- ▼ Second, we recommended a regime allowing open access to monopoly infrastructure. Under this regime, new entrants could seek access to the incumbent's monopoly water and/or wastewater transportation networks in order to compete in upstream or downstream services (eg, wastewater treatment and retail services).

To support greater and more effective use of outcomes-based competitive procurement, we made several other recommendations. These included:

- ▼ that the Government establish an appropriate regulatory framework for sewer mining – including, at the very least, formal dispute resolution procedures relating to sewer mining and the right to seek arbitration through IPART, and
- ▼ that Sydney Water be required to internally separate its competitive sourcing activity from the rest of its operations.

We recommended a **State-based** access regime, to allow the integration of regulatory issues and State Government policy matters. We also considered this to be appropriate in the context of no national market for urban water.

We also recommended the access regime be, at least initially, based on a **negotiate-arbitrate** model. This reflected uncertainty about the demand for access, and a lack of direct precedents to draw on to develop detailed access arrangements.

Other recommendations of our 2005 review included:

- ▼ Removing statutory impediments to private sector participation and competition in Sydney's water and wastewater markets.
- ▼ Improving arrangements for the collection and dissemination of information about the water and wastewater market to better support private sector participation and innovation.
- ▼ That the Government ensure there are clear and robust guidelines and rules in place for all potential sources and applications of recycled water.

Following our review, the New South Wales Government created the *Water Industry Competition Act in 2006* and an associated regulation in 2008

THE WATER INDUSTRY COMPETITION ACT

I'll now talk about the Water Industry Competition Act – or 'WICA' – in more detail.

'WICA' incorporated many of the recommendations from our 2005 review. WICA has three main parts:

- ▼ A sewer mining arbitration regime
- ▼ A private operator licensing regime, and
- ▼ An infrastructure access regime.

I will talk about each of these parts of WICA separately. However, first I note that the New South Wales Department of Finance and Services is currently conducting a review of WICA. When I talk about each of the parts of WICA, I will talk not only of the strengths and successes, but also some of the challenges we have faced and how we have proposed to overcome these challenges through our submission to the Department of Finance and Service's WICA review or through other means.

The sewer mining arbitration regime gives IPART the role of arbitrator where there is a dispute regarding sewer mining arrangements. It has never been used. However, this does not mean it has not been successful!

There are currently 9 sewer mining arrangements in Sydney, in addition to 7 onsite reuse schemes. Since WICA has been implemented, these agreements have been readily negotiated between private businesses and Sydney Water.

In the current WICA review, we have not recommended any changes to the sewer mining arbitration regime. We consider the current arrangements to be working well.

The private operator licensing scheme has been similarly successful. IPART's role is to recommend to the Minister for Finance whether or not to approve license applications, based on the criteria set out in WICA. We also perform regular reviews of WICA licence holders. The Minister has currently approved 12 network operator licenses and 9 retail operator licenses. We are currently in the process of reviewing another 7 license applications.

The diversity and scope of the WICA applications we have received and have been approved has been encouraging. WICA schemes include:

- ▼ Schemes that provide recycled water within commercial towers in the Sydney CBD.
- ▼ A scheme that operates a recycled water treatment plant and recycled water network in Western Sydney.
- ▼ A scheme that provides a desalinated water supply to Sydney in times of water shortages.
- ▼ A scheme that operates a groundwater treatment plant and supplies an industrial park in Sydney's Eastern Suburbs.
- ▼ Schemes that provide sewerage and recycled water services to greenfield developments on Sydney's fringe and in-fill developments in Sydney's inner west.
- ▼ A newly established scheme that provides water, sewerage and recycled water services to a new infill development in Sydney.

Compared to Sydney Water, the WICA schemes have been relatively small in scale. They have primarily involved wastewater treatment and recycled water for non-potable use. Where potable water has been involved, this has been purchased from Sydney Water.

There has also not been significant direct competition with Sydney Water for its existing customers.

Nevertheless, the variety of schemes shows how creating an environment that allows for private sector participation and competition in the provision of services can promote innovation, and change the way water and sewerage services are delivered. These projects have increased the supply of water in Sydney and provided water and sewerage services to some areas that would have otherwise not received them, at least within the timeframes that they have. It has helped speed up development in greenfield sites and added value to commercial and residential developments in inner Sydney.

Of the 21 active licences, there are over 10 corporations. While some are owned by the same parent company, it has revealed that there is potentially a number of businesses interested and capable of operating in the water industry and competing against a more traditional centralised service provided by Sydney Water.

There have been a number of challenges facing IPART in the licensing role. It is often difficult to predict how many applications we will receive or when we will receive them. This creates issues for resourcing and potentially creates delays in processing applications. Another challenge of the regime is the scheme-specific nature of the WICA approval process. It is not simple for a WICA licence holder to expand or start a new project. They are required to submit new WICA applications for each scheme they operate. This has the effect of limiting the growth potential for WICA licence holders, and creates added bureaucracy that the public water utilities do not have to deal with.

In our submission to the Department of Finance and Services' review of WICA, we have proposed a simple way to improve both of these issues. IPART is proposing a licensing scheme where businesses are granted WICA utility licences. A utility licence holder would be pre-approved to operate certain types of WICA schemes without having to seek new licences – based on their technical and financial capacity. This would allow WICA licences to grow more organically, with less bureaucracy.

A key concern with the WICA framework is the lack of an effective mechanism for operator of last resort. This is not necessarily a major issue with the industrial water or in-fill developments, where proximity to the Sydney Water network will allow recycled water to be replaced by potable water and sewage to be redirected into Sydney Water's sewerage network. However, for the greenfield developments, this is an important consideration. They are often relatively isolated communities, operating their own networks with their own procedures. Should one of these operators fail, there are no existing processes or rules designating who (if any one) takes over the operations. This is not a desirable situation for essential services like water and sewerage.

Again, we have submitted to the Department of Finance and Services' review the necessity of incorporating a operator of last resort into legislation. Provisions need to be made for who is the designated network operator – whether it is a public utility or a WICA utility licence holder – and how the operator of last resort is compensated for this service.

The final element of WICA is the access regime. The access regime allows for negotiation and arbitration between parties for access; for the Minister to declare coverage – ie, that access to that infrastructure must be allowed; and for infrastructure owners to voluntarily propose access regimes through access undertakings.

SYDNEY WATER'S ACCESS UNDERTAKING

Since Services Sydney, there have been no new entrants seeking access to Sydney Water's monopoly infrastructure. However, in January 2012, Sydney Water submitted to IPART the first access undertaking for its water network. This undertaking, if approved, would provide WICA licence holders access to Sydney Water's water distribution network. We consider this type of access is important for encouraging increased competition in the retail market.

Under WICA, we need to consider 4 key criteria when deciding whether or not to approve an access undertaking. They are:

- ▼ The legitimate interests of the service provider.
- ▼ The public interest, including its interest in competition.
- ▼ The interests of prospective access seekers.
- ▼ And any other matters we consider relevant.

Sydney Water's access undertaking proposed to provide the three different services to access seekers, they are:

- ▼ Water transport services – that is simply the transport of treated water within Sydney Water's distribution network.
- ▼ Interconnection services – that is charging for the right to connect infrastructure to inject treated water into Sydney Water's distribution network.
- ▼ Off-take services – that is charging to connect to Sydney Water's network for the purpose of extracting treated water for your own network.

Sydney Water proposed a standard charge for water transport services that was consistent with postage stamp pricing, which is New South Wales government policy. We considered Sydney Water's submission to be of a very high standard and to have covered a broad range of issues. Overall, we were pleased with the access undertaking as submitted. However, we decided we could not approve it without some amendments.

We decided elements of the access undertaking proposed by Sydney Water would disadvantage or deter competitors from seeking access, and we were not satisfied that all of WICA's criteria were sufficiently met.

One of our key concerns was that the timeframe and scope were limited. We felt that this would limit who would be able to invest in seeking access. With only a 4-year period for access and not allowing access to local government, we felt the opportunities for entry were insufficient.

We also considered the three services. The pricing, the terms and the conditions for the water transport service were very clearly defined and practical. However, we considered that Sydney Water's access undertaking did not provide sufficient guidance on what basis the interconnection and off-take services would be charged and what conditions would be imposed on access holders requiring these services. Again, we considered this could be a barrier to entry.

Sydney Water's access undertaking included a charge for all access holders using water transport services to contribute to water security projects. In principle, we have no issue with entrants contributing to the water security projects Sydney Water has been required to finance. However, the Minister has the discretion to decide if WICA licence holders must make contributions to New South Wales' water security, when awarding a licence.

Furthermore, there is a clause in WICA that requires private water operators to supply a sufficient quantity of their water from a source other than a public water utility. In satisfying this clause, WICA licence holders are already be contributing to water security. We have recommended in our submission to the Department of Finance and Services that this clause is removed.

In total, we recommended 43 amendments to Sydney Water's access undertaking, the vast bulk of the remaining amendments were relatively minor issues. We continue to work with Sydney Water to resolve these differences.

Conclusion

In conclusion, the Sydney region's water and sewerage supply has changed remarkably over the 21 years that IPART has been involved in it. IPART is committed to improving the efficiency and maintaining the standards of the water and sewerage markets. We have embraced competition and competitive practices to the extent that they can help achieve these goals. We will continue to promote competition and efficiency where we see benefits to the community. I expect in another 21 years there will be even more competitive elements to the Sydney Water market.

Are there any questions?