



Level 1, 46-48 York Street
Sydney 2000
Australia
DX 643 Sydney
Tel: (612) 9299 7833
Fax: (612) 9299 7855
Email: piac@piac.asn.au
A.C.N. 002 773 524
A.B.N. 77 002 773 524

Our Ref:

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

2 June 2005

Dear Dr Keating

Investigation into water and wastewater service providers in the greater Sydney region

The Public Interest Advocacy Centre is pleased to provide the attached submission to the Tribunal's investigation into water and wastewater services.

We are happy to receive any requests for clarification or further information.

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 the Independent Pricing and Regulatory Tribunal (IPART)

Investigation into water and wastewater service provision in the greater Sydney region

May 2005

Elissa Freeman
Policy Officer

Jim Wellsmore
Senior Policy Officer

Introduction

The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (“PIAC”) is an independent, non-profit legal and policy centre located in Sydney. Its charter is:

To undertake strategic legal and policy interventions in public interest matters in order to foster a fair, just and democratic society and empower citizens, consumers and communities.

Established in July 1982 as an initiative of the Law Foundation of New South Wales, PIAC was the first, and remains the only, broadly-based public interest legal centre in Australia. Although located in New South Wales, the work PIAC does is often of national interest or importance or has consequences beyond state boundaries.

PIAC’s work extends beyond the interests and rights of individuals; it specialises in working on issues that have systemic impact. PIAC’s clients and constituencies are primarily those with least access to economic, social and legal resources and opportunities. PIAC provides its services for free or at minimal cost.

Utility Consumers’ Advocacy Program

The Utility Consumers’ Advocacy Program (“UCAP”) was funded in 1998 by the NSW Government to develop policy and advocate in the interests of residential consumers, particularly low-income consumers, in the NSW energy and water industries. The project is based at the Public Interest Advocacy Centre. UCAP staff receive 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)
- Tenants Union
- Combined Pensioners and Superannuants Association of NSW (CPSA)
- Australian Consumers’ Association (ACA)
- Park and Village Service based at the CPSA
- Rural and remote consumers
- Institute of Sustainable Futures, University of Technology.

This submission to the Independent Pricing and Regulatory Tribunal (the Tribunal) is supported by these organisations.

Community perspectives on private sector involvement in water and wastewater services

The processes that are influencing the reform of water and wastewater services in the greater Sydney region are outlined in the *Investigation into water and wastewater service provision in the greater Sydney region Issues Paper* (the Issues Paper). These include the implementation of the Metropolitan Water Plan; the appointment of the Growth Centres Commission; and the National Competition Council recommendation to grant access to the wastewater network for Services Sydney. These policy drivers are looking towards engaging the private sector to provide solutions to the more pressing context of the review, Sydney’s water supply and demand imbalance. The Issues

Paper is therefore concerned primarily with recommending an operational solution to include greater decentralised planning and private sector involvement in water and wastewater service provision.

However, private sector involvement in the water industry has been consistently unpopular in the community. Research undertaken in 2002 by the Swinburne Institute for Social Research investigated popular support for private sector ownership and participation in the delivery of a variety of public services in Australia. As the tables below indicate, water services were consistently regarded as most appropriately placed in public hands, and were the least popular candidate for public/private partnerships. 71% of respondents agreed that governments should be wholly or mainly responsible for water services with the corresponding ministerial accountability.

respondents agreeing that the private sector should wholly or mainly own selected services		respondents agreeing that governments should wholly or mainly own selected services		respondents in favour of public/private partnerships in selected services	
Service	Should be wholly or mainly privately owned	Service	Should be wholly or mainly government owned	Service	In favour of public/private partnerships
Prisons	2%	Prisons	76%	Prisons	19%
Public transport	12%	Public transport	50%	Public transport	34%
Water	9%	Water	71%	Water	17%
Electricity	14%	Electricity	59%	Electricity	25%
Gas	19%	Gas	50%	Gas	27%
Telephones	22%	Telephones	36%	Telephones	38%
Hospitals	7%	Hospitals	60%	Hospitals	35%

Hayward, D, "The public good and the public services: what role for the Private sector?" *Dissent*, Autumn/Winter 2002 p8-12

Broad support for transparent and accountable public ownership of water resources remains strong, and the processes that are now driving greater private sector engagement have had little, if any, community consultation. In two consecutive elections, the NSW electorate has signaled clearly their rejection of privatisation of the electricity industry. The Auditor-General's findings on the water industry, released last month, confirmed there was inadequate public consultation and transparency in the governmental processes.¹

Given the historical rejection of privatisation of public water and wastewater services, any recommended options for reform will need to balance efficiency gains with risk minimisation in the form of retaining public ownership and responsibility for services. Privatisation does not remove a democratic government's ultimate responsibility for the risks to citizens associated with the commercial production of water and wastewater services. In other words, it is not sufficient to allow for a centralised "back-stop" process. Instead, the community needs to be confident that the government of the day continues to be publicly accountable for water and wastewater services.

The message is that accountability for key decisions in the industry needs to remain with the Government, and that Government policy-making will continue to drive water management. Centralised decision-making encourages uniform and consistent practices and economies of scale and scope. It is however notable that Sydney Water has managed to attain a high level of private involvement in infrastructure and service delivery without raising public concern, suggesting that a mix of centralised and decentralised decision-making is already taking place within the existing framework. These activities take place within the objectives of the *Sydney Water Act 1994*, which requires consideration of social, ecological and competitive factors. This still allows for situations where local knowledge and a flexibility to respond to localised conditions and communities is

¹ Auditor-General's Report Performance Audit, "Planning for Sydney's Water Needs" May 2005, NSW State Library

important, such as in the development of new growth areas of Sydney. The Issues Paper identifies some of these opportunities and they are discussed below.

Options for industry reform

The Issues Paper presents alternative arrangements for water & wastewater services, along with a framework for evaluating the options. It is not possible to provide any detailed comments until more information is available. At this stage, our comments will be limited to raising some broad issues and community concerns around each of the options. The issues raised highlight the gravity of large-scale micro-economic reforms and reinforce that the pace of these reforms should be carefully timed, so that the true costs and benefits of each model can be determined in advance of the reforms.

Extending Competitive Procurement

Private sector involvement in Sydney Water's business is reported at 35% of total operating expenditure and 90% of total capital expenditure. The 'Extending Competitive Procurement' model suggests that it is possible and realistic to extend private sector involvement beyond these levels. This option creates a situation whereby private stakes in the business are built up over time and without a high degree of public scrutiny, raising a concern that this is a form of privatisation by stealth.

Should the Government extend the 'competitive procurement' model it would need to clarify which areas of the business would be subject to competitive procurement beyond the current framework. This information would assure the community that objectives for health, the environment, water conservation and social equity are being met. The Sydney water crisis of 1998 highlighted some of the issues that can arise when water management issues are managed through contracts with private firms. While the evaluation process will provide the bulk of the information needed to judge the option, the Government should be clear about what type of efficiencies are expected to be achieved from each activity.

Competitive Sourcing

A similar degree of transparency is required for a competitive sourcing model. The benefit of this model is that it retains the existing industry structure, therefore minimising the transaction costs and risks associated with reforms of this scale. We are interested again to see details of the types of activities that could be subject to competitive sourcing. Some activities would lend themselves more easily to this type of structure, for example sourcing sustainable infrastructure and technology for Greenfield developments.

This model could draw on the principles of the Electricity Distribution Demand Management Code of Practice, in which businesses identify constraints or demand and supply imbalances and seek tenders for solutions.

Yardstick competition

This 'Yardstick competition' model involves splitting Sydney Water into a number of smaller trading entities. The arguments put forward for yardstick (or comparative) competition are weak when we consider the degree to which current arrangements are already subject to competitive scrutiny. The recent review of the Sydney Water Operating Licence sought to establish new customer service performance indicators and in making the recommendations, the appointed consultant undertook a comparison of Sydney Water with comparative businesses in Victoria. The measures were designed in such a way as to maximise comparability between Sydney Water and other water businesses. The Yardstick competition model would split Sydney Water into smaller divisions but would result in no greater measure of comparability than currently exists.

Single buyer model

The main benefit of a single buyer model would be enforceable and tradable bulk water rights. Even if the Tribunal were able to determine accurate allocations to separate water businesses, the ability to enforce these is questionable. To date, neither Sydney water nor the Tribunal has indicated that licence demand management targets will be achieved or non-compliance penalised.

The Issues Paper claims that, “the retailers’ incentive would be to plan and provide for new water and wastewater assets in the most cost-effective and efficient way” and yet Sydney Water has the exact same incentives placed on it under its regulatory framework. Under the single buyer model, it would need to be demonstrated that localised planning would exceed the benefits of economies of scale and scope that exist within Sydney Water. It is difficult to see how such a restructure could make a positive contribution to the supply/demand imbalance.

Third party access

The Issues Paper concedes “Third-party arrangements require a high-level of administrative and regulatory capacity... reform is only justified if the efficiency gains from competition outweigh these costs”. Third party access arrangements carry much higher risks than other reforms, in large part because of the regulatory and political risks as well as the much higher degree of transaction costs. Retail costs account for a small proportion of the final price paid by consumers for water and wastewater services. The experience in energy retail competition suggests that the scope for economic efficiency is fairly small given the small margins involved. It is difficult to see how a retail competition model could improve upon the economies of scale and scope enjoyed by an integrated monopoly.

The system of incentive regulation has now been working effectively for over 10 years. It is fair to say that over this period of time, most of the efficiencies that were promised under corporatisation have been delivered. In light of the current strain on resources we would expect that the Tribunal consider how the current framework could be extended to produce the sustainability outcomes that are being sought before looking to a more costly and risky industry restructure. For example, specific recycling targets for new developments could be introduced to the Operating Licence and the demand management and reducing discharge targets could be more rigorously enforced under an enhanced incentive framework.

Evaluating the options for industry reform

The evaluation criteria (as outlined in the Issues Paper) will add scope and depth to the mooted models and will enable stakeholders to make more detailed contributions to the reform process. It is important that this information is put into the public domain before the Tribunal delivers its recommendations.

In addition to the evaluation criteria suggested in the Issues Paper, the Government needs to be clear about what contribution the industry reforms will make to the supply/demand imbalance. We recommend that additional ‘sustainability’ criteria be included in the evaluation, providing information about the how the reform will contribute to inter-generational equity, in terms of water conservation and the expected costs relative to this contribution. There is a subtle difference between this and environmental outcomes, which aim primarily to ensure that the way that the service is undertaken is not detrimental to the environment. For example, a model may produce positive environmental outcomes (e.g. a reduction in pollution levels) but fail to contribute to the water demand/supply imbalance.

Lastly, in addressing the social outcomes of each model, the use of targeted subsidies should not be relied on to address equity problems. Subsidies to households are a crude policy tool in essential

services such as water and wastewater. Price increases in essential water and wastewater services impact on entire communities. For example, unbundling of prices would see parts of Western Sydney become much more expensive for households to live, businesses to operate and community services to be offered. Localised increases in prices of this nature cannot be easily offset by direct subsidies.

Pricing Implications

Postage Stamp Pricing

The importance that the community places on affordability of essential services is reflected in the current pricing of water and wastewater services. Postage stamp pricing ensures horizontal and geographic equity across the greater Sydney catchment area, without requiring targeted subsidies. It is unlikely that the community would be willing to accept any deviation from these core principles.

In the case that prices are unbundled, the Issues Paper has identified one scenario in which lowest cost/highest return customers are cherry-picked by a competitive retailer. As well as disadvantaging Sydney Water, this scenario would create an additional price burden for those households who remain commercially unattractive. The experience within the competitive energy retail business is that the bulk of households which remain unable to secure a competitive retail contract are those households deemed commercially unattractive i.e. low usage, outside metropolitan areas, poor debtors and tenants. It is easy to see how unbundling prices in the wastewater industry would create the same outcome.

Postage stamp pricing delivers social benefits at both retail and a network level. There is a social benefit in having everyone entitled to the same level of access and affordability in water and wastewater services. The equity outcomes, in terms of pricing, of any proposed reform must maintain this standard.

Access Pricing

In the event that the retail market for wastewater is opened to competition, access pricing should reflect that same respect for social equity. Specifically, access to networks should not be based on localised costs, but rather the average cost of network provision. Average cost access to the network fulfils a similar role to postage stamp pricing, in that the public benefit of an efficient sewerage system is spread across all consumers.

The Issues Papers explores Long Run Marginal Cost (LRMC), 'building block approach' and Efficient Component Pricing Rule (ECPR) methods for calculating the cost of network services. The difference between the avoidable and the stand-alone cost of service provides a large scope for determining the efficient cost of access. Within these boundaries, each of methods represents a cost approximation and will only ever come close to estimating the cost of the service. Our view is that the factors that differentiate these (proven) methodologies are the transparency, simplicity and ability to respond to specific circumstances of the wastewater network in Sydney. The 'building block approach' to costing a monopoly service has been successfully implemented in other industries and provides a high degree of transparency for stakeholders. While we have had no experience with the ECPR methodology, its ability to account for stranded assets is appealing. LRMC methodology seems inappropriate in the specific case of wastewater because the number of entrants to the market will be naturally limited, restricting the effectiveness of a LRMC pricing methodology aimed at maximising competitive entrants.

Competition and pricing outcomes

In deciding on the pricing principles for any competitive arrangement the Tribunal should make it clear that no “headroom” will be factored into pricing arrangements. The Issues Paper points out that “competition is not an end in itself” and we would expect this to be reflected in the Tribunal’s pricing principles. Our experience with retail pricing in electricity is that, based on small profit margins, there is pressure on the government to allow prices to drift upwards and encourage more firms to enter the market. This is not an appropriate expectation for the types of industry models being considered by the Tribunal.

The “Third party access” option identified above could potentially bring an additional entrant (Services Sydney) to one part of the wastewater industry. However, the natural barriers to entry, including huge sunk-costs, suggest that the market will retain monopolistic or oligopolistic characteristics even after the reforms. Oligopolistic suppliers have a high degree of market power, particularly as firms tend to favour non-price product differentiation. We expect that the role of IPART as both price and market regulator will become greater, not less significant, under this type of market restructure. Perfect competition will never be achieved in this market and the primary policy objective of pricing strategies should be to keep essential services affordable, reliable and secure.

It is also reasonable for consumers to have some expectation of price implications of the recommended reforms over the short, medium and long term. The Issues Paper predicts that under certain options, such as the competitive sourcing model, “competition creates a profit opportunity for those options that are less costly than the least cost options able to be identified by Sydney Water as a central planner.” This statement implies that there are cost savings to be made. The returns for these cost savings should be passed through to consumers through lower prices.

Additional Service Prices

The pricing of supplementary services such as recycled and grey water are touched on in the Issues Paper. We expect that more dynamic, localised projects will be established in the greater metropolitan area and that households will be able to enjoy a greater diversity of water and wastewater products in the future. While the utility derived from these products will vary, there are some fundamental principles that should oversee such services. These services will clearly be subject to the same health and safety provisions as standard potable water sources, and should be subject to the same pricing protections. IPART should retain regulatory price oversight of localised project that deliver water for human use to households.

Non-price implications of reform

The reform options discussed in the Issues Paper generally fall short of the level of competition introduced into the retail energy industry. All the options, however, would entail additional layers of regulation and additional costs. In assessing the benefit of proposed reforms it must be acknowledged that many of these extra costs will be borne by the community and customers of Sydney Water.

Third party access, in particular, would involve significant extra costs. For example, the provision of wastewater services based around competition for customers would require further legislative and regulatory change. It also would need significant spending by Sydney Water in customer information systems. We note that recent experience shows this generally to be an expensive exercise. 'Sewer mining' would avoid competition for upstream customers yet it, too, would require substantial legislative and regulatory reforms to bring into existence a viable level of demand for recycled water.

International trade implications of reform

Lastly, we would point to Australia's membership of the World Trade Organisations' General Agreement of Trade in Services (GATS). Australia has agreed to include sewerage services and wastewater management in the GATS, but 'Water for human use' and 'public services' are both exempt under Australia's GATS commitment (Trade Minister Vaile, media release MVT42/2005). Australia's GATS commitment excludes the provision of water for human use, including water collection, purification and distribution through mains. The reason for this exclusion is that both Federal and State Governments recognise that governments must have full flexibility to regulate water services to ensure both equitable access and environmental sustainability. If water services were included in the GATS, government regulation would be subject to international trade law, and could be challenged by other governments on the grounds that it was burdensome to business or a barrier to trade.

However, the definition of a "public service" under the GATS includes services carried out in exercise of governmental authority and provided neither "on a commercial basis nor in competition with a service provider" (GATS Article 1.3). In other words, wastewater services remain outside the reach of GATS so long as they remain a strict "public" service. If the NSW government permits greater private sector involvement in wastewater treatment, it could be exposed to the limitations of international trade law and reduce its ability to regulate this industry.