

31 May 2005

Dr Michael Keating  
Chairman  
Independent Pricing and Regulatory Tribunal  
Level 2, 44 Market Street  
SYDNEY NSW 2000

Dear Dr Keating

*Investigation into Water and Wastewater  
Service Provision in the Greater Sydney Region*

We appreciate the opportunity to provide the Tribunal with comments in relation to the above investigation.

We note that IPART recognises the Government faces challenges associated with reform of the water and wastewater industry. IPART has been charged with the responsibility of reporting back to the Government on possible private sector involvement in the delivery of water and wastewater services, with a view to making recommendations for providing these services in the most efficient, effective and sustainable way.

The Tribunal's investigation is taking place at the same time as Services Sydney is conducting its application to the Australian Competition Tribunal for third party access to Sydney Water's sewerage system. Due to the work required in connection with that application, this submission is not as detailed as it would otherwise be. Nevertheless, Services Sydney's position in relation to many of the matters raised in the Issues Paper has been set out publicly on previous occasions, including in the material publicly available from the National Competition Council in relation to Services Sydney's application for a recommendation that access to Sydney Water's sewerage system be declared.

Our response follows the format of the Issues Paper with comments on extracts from selected paragraphs (see below).

The critical point is for the NSW Government to put in place a structure that allows private sector participants such as Services Sydney to compete for customers at a retail level, because this will drive greater innovation and efficiencies and allow consumers choice between competing water and wastewater products.

Sydney Water's WaterPlan 21 and the Metropolitan Water Plan deliver a wastewater and water system or product (WP21/MWP) that Consumers under the monopoly structure must procure. They have no choice.

On the other hand, Services Sydney's product (Waterworks) delivers:

- sewerage services with enhanced outcomes (less ocean pollution and improved wet weather sewage overflow performance); and

- in future, a significant new non-rainfall dependant source of bulk water for industry, environmental flows, agriculture and for indirect potable use when the consumer chooses.

Waterworks has the potential to avoid the economic harm of water restrictions and the negative aspects of the bulk water supply options of the WP21/MWP product. Amongst others, these are the impact on the Shoalhaven River, the high (fossil fuel) energy use of desalination and the associated environmental impacts of the brine (the waste stream discharged from desalination plants).

Accordingly, WP21/MWP and Waterworks are distinctly different products.

The key issue for Services Sydney is a structure that allows competition so that consumers can make decisions based on best 'value for money' in their choice between the respective products.

The preferred structure (in the Issues Paper) for Services Sydney is the Third Party access model. Access would allow common carriage across the water and sewerage transportation networks, where Services Sydney would use Sydney Water's sewerage system to be able to deliver its product as an alternative to Sydney Water's product.

Waterworks meets all the broad objectives in managing Sydney's water supplies, as outlined by IPART's Issues Paper. We are committed to delivering a world class, practical and value for money system to meet Sydney's long-term water and wastewater needs.


We are particularly pleased that the principles underpinning the management of Sydney's water supplies include innovation and making decisions adaptively.

There is scope to add value to the measures committed to in WP21/MWP. The Government has the capacity to implement specific aspects of its Metropolitan Water Plan and also those contained in Waterworks.

Finally, if there are any particular matters on which the Tribunal considers that it would value Services Sydney's further input and which are not addressed in this submission or in Services Sydney's other publicly available material, please let me know.

We thank you for the opportunity to submit our comments that allow us to progress our business.

Yours faithfully  
Services Sydney Pty Ltd

  
John van der Merwe  
Director

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Comments on extracts of selected paragraphs from the Issues Paper**3 THE TRIBUNAL'S APPROACH TO THIS REVIEW (Pages 12 to 20)****3.1 Interpreting the task (Pages 12 and 13)**

*The Government's Metropolitan Water Plan is a shift away from this central planning paradigm, as one of its key elements is to encourage the private sector to developing innovative solutions to Sydney's water problems.... It will therefore be important to establish a robust framework for making choices between the alternative options.*

Services Sydney is a private sector company seeking to supply wastewater services in competition with Sydney Water, the current monopoly supplier (with very minor exceptions) of each of the following services in the greater Sydney metropolitan area:

- the transmission and distribution of water;
- the retail supply of water;
- the retail collection of sewage;
- the reticulation and transmission of sewage; and
- the treatment and disposal of sewage.

In relation to any review of the most efficient, effective and sustainable way to deliver water and wastewater services in Sydney, Services Sydney considers that a well accepted and robust framework already exists for any such review.

This framework is reflected in the Competition Principles Agreement and recognizes that optimal results are achieved through, first, identifying those elements of the supply of the relevant services that are potentially competitive (contestable) and those elements that exhibit natural monopoly characteristics. Once these elements have been identified, competition should be introduced in the provision of the potentially competitive elements, and arrangements introduced to ensure that the access terms (including price) for the natural monopoly elements facilitate competition in the provision of the potentially competitive elements.

Once services provided by a public monopoly have been identified as potentially competitive, it becomes a matter for those seeking to retain monopoly service provision to establish that the introduction of competition in the provision of those services would result in a net public detriment. Services Sydney is concerned that IPART does not seem to have adopted this well recognized approach in developing its Issues Paper.

Instead, IPART seems to be quickly moving to a consideration of a series of possible options for the supply of water and wastewater services that are clearly second best solutions, such as the competition for the market option discussed in section 4.3.1.

Services Sydney strongly believes that the key to achieving optimal results in the supply of water and wastewater services in Sydney is to allow the market to determine the appropriate price/quality features of these services through allowing competition in the provision of those elements that are potentially competitive, being retail collection services and treatment and disposal services for wastewater. Only by allowing retail competition will the market be able to send the correct signals to treatment and disposal providers. Although it may be possible for Sydney Water to arrange a tender for the competitive provision of sewage treatment services, this will only deliver a small part of the potential benefit from retail competition because:

- consumers will not be able to choose to use the services of that particular sewage treatment provider; and
- Sydney Water will continue to have a strong incentive to favour treatment solutions which use its existing (sunk) infrastructure.

*The Tribunal seeks comments on this interpretation of its task.*

Services Sydney submits that the Tribunal has missed the point by focusing on centralised and decentralised decision making. This does not address third party access, or the availability of consumer choice in the acquisition of wastewater services.

### **3.2 Identifying the key strategic issues (Pages 13 to 20)**

*Encouraging decentralised decision making is likely to involve structural reform of the water industry, and increasing competition. Thus, in undertaking the above task, the Tribunal will need to evaluate the various options for the structure of the water and wastewater industry that would allow for increased competition.*

The key issue for Services Sydney is the ability to compete for retail customers on a level playing field.

#### **Box 3.1 (Page 14) The role of industry reform and competition**

*The aim of industry reform is generally to improve the efficiency of service delivery. Competition is a mechanism through which decentralised decision making and efficiency improvements can be encouraged. According to economic theory there are three types of efficiency – technical or productive efficiency, allocative efficiency and dynamic efficiency.*

*The estimated benefits from introducing competition should be compared to the costs of its implementation. These implementation costs fall into two categories – the costs of transition to the new arrangements and the increase in transaction costs associated with an increased number of market participants. The term ‘transaction cost’ refers to the cost of providing for some good or service through a market (ie, a number of firms offering the good or service) rather than having it provided from within one firm. (In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to conduct negotiations leading up to a bargain, to draw up the contract and to undertake the inspection needed to make sure that the terms of the contract are being observed.)*

Services Sydney believes that the benefits from introducing competition through third party access will far outweigh the costs of implementation.

*The Tribunal seeks: (page 16)*

- *Comments on how the private sector can be involved in service provision in the water industry, including the criteria that could be considered in proposals for private sector service provision.*

IPART already has Services Sydney's proposal which addresses one way in which the private sector can have a significant beneficial involvement in the water industry. Under this proposal, Services Sydney would compete for retail customers in the provision of sewerage collection services, obtain sewerage transportation and interconnection services from Sydney Water, and then provide its own sewage treatment services and as a second element, supply bulk water for various purposes.

There are a number of other ways in which the private sector could participate in the water industry, as discussed in the Issues Paper. These include the provision of various outsourced services, including sewage treatment services. For example, Services Sydney originally proposed that Sydney Water engage it to implement the unique sewerage network configurations, sewage treatment and water reclamation elements of its project by commercial arrangement.

The correct approach to evaluating proposals for private sector involvement in the water industry would involve letting consumers (the market) decide through the introduction of competition.

- *Specific information on the extent to which there may be benefits created through private sector service provision (for example, more efficient use of water resources, lower costs, improved service quality) and the risks that need to be considered.*

Services Sydney's proposal would result in the following benefits and risks:

Benefits:

- Reduced marine pollution from sewage through ocean outfalls;
- Enhanced wet weather sewage overflow performance;
- Improved environmental performance supported by customers and the major environmental groups;
- New source of water that is not rainfall dependent and which can be used to meet environmental flows, industry etc.; and
- Reduced funding by the State Government for sewerage infrastructure.

Risks:

- Failure of private sector management providing these services. At the extreme, management would be replaced by a receiver or liquidator. The infrastructure constructed would still be available for use.

### 3.2.3 Ensuring security of supply (Page 16)

*Notwithstanding any move to more decentralised decision making, the Government can be expected to continue to manage the risks associated with security of supply, by providing for a central back-stop industry planning role.*

Waterworks, integrated into existing water and sewerage systems, provides the Government with a significant net decrease in risk.

### 3.2.7 Need for staged implementation of reform (Page 20)

In order to compete, the private sector will require the same operating conditions and rights as the existing provider. For the purposes of Services Sydney's proposal, any staging of reform that resulted in Services Sydney being delayed in introducing its offer to consumers would merely delay the realization of the benefits from the proposal. Services Sydney is not aware of any compelling reason why these benefits should be so delayed.

A pilot scheme would be an appropriate way to proceed for new or unproven technology; however Services Sydney's proposes to use proven technology.

## 4 OPTIONS FOR INDUSTRY STRUCTURE (Pages 21 to 31)

*Sydney's water and wastewater services industry is dominated by Sydney Water, a large, vertically integrated monopoly that provides:*

- *treatment, transport and retailing services to water customers*
- *collection, transport, treatment, disposal and retailing services to wastewater customers.*

Services Sydney seeks to 'un-bundle' collection, transport, treatment, disposal and retailing services to wastewater customers.

This will allow the company to directly compete for retail customers who will have the choice between Waterworks and WP21/MWP.

### 4.4 Options that involve third-party access (Page 29)

*A further alternative for reform is to introduce third-party access.*

*Under third-party access, a new entrant shares access to those facilities in the supply chain exhibiting natural monopoly characteristics, while competing in the areas that are potentially competitive.*

The introduction of third party access to the monopoly components of sewerage services would allow Services Sydney to commence implementing its proposal and would provide the consumer with a choice of products. This option is preferred by Services Sydney.

*Third-party access arrangements require a high-level of administrative and regulatory capacity. For example, complex metering and payment systems are needed to facilitate relationships between firms that compete while sharing a single network or facility.*

Services Sydney does not consider that particularly high level administrative and regulatory capacity would be required for an effective third party access arrangement, especially when compared with the likely benefits that would flow from third party access. In particular, Services Sydney does not consider that any additional complex metering or payment systems would be necessary. Bulk sewage flows at interconnection points can be measured through the use of relatively uncomplicated meters, and the sewage volume and pollutant contributions of relevant classes of existing users of Sydney Water's sewerage system are either available from existing data provision and metering processes or can be estimated with sufficient accuracy.

*As with other options, reform is only justified if the efficiency gains from competition outweigh these administrative and regulatory costs.*

Services Sydney does not agree with this statement. Reform is justified wherever the services being provided are potentially competitive, unless it can be demonstrated that the potential costs of the introduction of competition would outweigh the benefits that would flow from the introduction of competition.

*The Tribunal seeks views on: (page 31)*

- *Where the opportunities for benefits from implementing options are largest, and where the implementation risks are.*

As noted above, the greatest benefits will flow from the introduction of competition for those services that are potentially competitive, including the provision of retail services. By providing consumers with the ability to choose between different price/quality combinations (including different treatment and disposal options), retail competition will drive efficiency and innovation in many other related services, including treatment services. This in turn will open the door to a wide range of other benefits, including environmental benefits.

- *The next steps in implementing one or more of the models above. (page 31)*

Genuine third party access would be funded by the private sector with no risk or subsidy from Government.

## **5 IMPLICATIONS OF PRICING INDUSTRY REFORM (Page 32 to 40)**

### **5.1.2 Relationship between access prices and retail prices (Page 36)**

*The Tribunal seeks views as to the most appropriate method of calculating access prices, including the level of geographic disaggregation or differentiation, and whether there are alternative methods that should be considered.*

Services Sydney considers that the most appropriate model for setting prices for third party access in the water industry is a negotiate/arbitrate model, such as that contained in Part IIIA of the Trade Practices Act.

In relation to the appropriate method of calculating the appropriate access price, Services Sydney considers that prices for access to Sydney Water's monopoly infrastructure should be set so as to promote the environment for competition in the supply of services in related markets, such as the market for the supply of retail sewage collection services or the market for sewage treatment.

Such access prices should be set to allow Sydney Water to recover the operational and capital costs of the infrastructure on a forward looking basis.

In relation to the discussion in the Issues Paper, Services Sydney notes that there is no relevant economic principle that requires an access provider to be allowed to recover historical sunk costs, and there are strong arguments that the optimal outcome is that there should be no such allowance.

Nor is Services Sydney aware of any principle which would require access prices to be set such that Sydney Water would be compensated for the net losses unavoidably incurred when providing access as compared with continuing to provide the service.

Finally, Services Sydney does not consider that an Efficient Component Pricing Rule (ECPR) approach would be appropriate for the water industry. Pricing based on an ECPR approach allows vertically integrated providers of monopoly infrastructure to continue to earn monopoly profits and would result in sub-optimal entry.

Postage stamp pricing should be maintained.

### **5.2 Retail prices, developer charges and recycled water (Page 40)**

*The Tribunal seeks comments on the sustainability of uniform retail pricing under the structural models discussed above.*

Under Services Sydney proposal there would be price competition at the retail level. Uniform retail pricing under retail competition would raise a number of issues under the *Trade Practices Act*.

However, in relation to access (wholesale) pricing, a postage stamp approach to access pricing has been adopted in a number of other network industries, including the telecommunication industry. Such an approach may also be appropriate for the water industry. A considered approach to access pricing would also eliminate any legitimate concern in relation to 'cherry picking'. These concerns have been satisfactorily resolved in setting access pricing in other



network industries where the variable costs of supplying customers with the regulated services differs.

## 6 NON-PRICE IMPLICATIONS OF REFORM (Pages 41 to 43)

### 6.1 Legal and regulatory framework (Page 41)

*The legal and regulatory framework is likely to require significant amendment to accommodate major change to the structure of the water industry.*

*For example, if a model involving competing suppliers is preferred, it will be necessary to ascertain whether the applicable legislation creates barriers to entry and competition in potentially competitive activities. If models involving third-party access are preferred, they will need to be supported by a legal right to such access.*

If Services Sydney is successful in its application to the Australian Competition Tribunal for third party access under the Trades Practices Act, the company would seek to have any necessary changes to the legal and regulatory framework made in a timely manner to allow it to get on with business and implement its plan to deliver Waterworks to customers on a competitive basis.

The NSW Government has obligations under the Competition Principles Agreement to ensure competitive neutrality.

Further, any legislation would also need to comply with clause 5 of the Competition Principles Agreement. Clause 5(1) states that the guiding principle is that legislation should not restrict competition unless it can be demonstrated that:

- the benefits of the restriction to the community as a whole outweigh the costs; and
- the objectives of legislation can only be achieved by restricting competition.

*The Tribunal seeks views as to whether the options described above are supported by the current institutional and legal arrangements and what key issues would need to be considered.*

Third party access will only work if competitive neutrality is provided.

### 6.3 Retail competition (Page 43)

*Depending on the industry model chosen, a decision will be needed on whether retail competition in water and wastewater services should be introduced and, if so, to what extent.*

*Evidence from the electricity industry in NSW highlights the costs of implementing full retail competition. The Tribunal allowed costs of \$150 million for the implementation of full retail competition across the four distribution network service providers in NSW. This amounted to \$16 to \$35 per customer per annum over a three-year period, depending on the service provider.*

Services Sydney considers that the benefits that will result from the introduction of competition through third party access will justify the costs of implementing any necessary reform.

Services Sydney considers that the Tribunal should be very cautious in drawing conclusions about the costs of reform in the water industry from other industries.

The cost of reform in other industries is likely to be a function of a wide range of different factors, including the number of competitive providers, the need for integration of legacy systems, the need for particular types of metering, and the features of the full competition model that was chosen for that industry.

Waterworks also delivers other positive externalities that need to be weighed in the balance, such as less ocean pollution, no need for further water from the Shoalhaven River, the prevention of 'run of river' water transfers, the use of renewable energy, adequate environmental flows and ultimately the potential to avoid economically harmful water restrictions.