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Dr Michael Keating, AC
Chairman
The Independent Pricing and Regulatory Tribunal of NSW
Level 2, 44 Market Street
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Dear Dr Keating

Pricing arrangements for recycled water and sewer mining

This submission by AGL is made in response to the Tribunal's Draft Determinations and Draft Report on pricing arrangements for recycled water and sewer mining. AGL generally supports the key elements of proposals in the Draft Report. The pricing principles proposed for voluntary and mandated recycling schemes and for sewer mining provide clear bases for establishing appropriate prices, and avoid a level of prescription that could have the unintended consequence of deterring investment in otherwise worthwhile recycling schemes. The Draft Report's approach to difficult-to-quantify issues, such as avoided and deferred costs and sewer mining access charges, will provide the opportunity for commercial processes to work in the knowledge that arbitration is available should negotiations fail.

In addition to these overarching comments, AGL has some comments on specific issues raised by the Draft Report.

Importance of Potable Water Pricing:

The Draft Report highlights the central role that potable water pricing will play in determining the price of recycled water and hence the viability of recycling projects. In its most recent potable water pricing decision, the Tribunal set usage charges by reference to the Long Run Marginal Cost (LRMC) of water supply which it assessed to be in the range $1.20 to $1.50/kL. AGL has previously expressed the view that this estimate of LRMC is likely to be understated on the basis of known/published costs of recycling and desalination which are expected to be the next large scale and sustainable sources of supply. AGL has also commented on the current low marginal price of raw water from Sydney Catchment Authority which has potential to distort Sydney Water's sourcing decisions for so long as dam water is available. Given the importance of LRMC in potable water pricing decisions, AGL recommends that the estimate of LRMC be refined before the next pricing review.

Competitive neutrality and private sector recycling:

AGL supports the objectives for recycled water pricing identified by the Tribunal in section 3.1 of the Draft Report. However, AGL notes that if the principle of competitive neutrality (section 3.1.5) is to be realised for private sector participants in the industry it will be necessary to develop mechanisms to enable private sector infrastructure providers to access:

- amounts equivalent to the Developer Charges that would be paid to the incumbent provider, and

- revenue from parties other than direct users of a recycling scheme where the scheme gives rise to avoided or deferred costs beyond the scheme itself.

If the private sector provider cannot access those amounts directly, a possible option could be to require the incumbent provider to contribute equivalent amounts to the private sector scheme.

Another matter that has a bearing on competitive neutrality is the cost of make-up/supplemental potable water supplied to a recycling scheme. Sydney Water should not be permitted to charge any more for make-up/supplemental potable water it supplies to a private sector recycling scheme than it would charge itself if it operated the scheme. In that regard, AGL supports the Tribunal's proposal that make-up/supplemental potable water be costed at the retail price of potable water (Box 7.1, item 4).

AGL acknowledges that it is beyond the scope of the Tribunal's current review to deal directly with matters affecting private sector participation in the water industry. Having said that, it would be helpful if the Tribunal could include a discussion of matters such as those affecting competitive neutrality, for example, in section 10 of its report.

Guidelines:

The Tribunal proposes "guidelines" to be used in the development of prices for recycled water. This raises an important question about the nature of regulatory instruments and in particular "guidelines". In AGL's view there is a material difference between a "guideline" on the one hand and a "rule" or "regulation" on the other. A "rule" or "regulation" is a requirement or direction whereas the purpose of a "guideline" is to provide interpretation, advice or guidance. A "guideline" should not impose substantive regulatory obligations and should not be mandatory. It is important that this distinction be recognised and preserved when using the terms in a regulatory context.

The *Draft Pricing Guidelines for Mandated Schemes* in Box 7.1 are cast as requirements or directions – the word "must" is used a number of times – and as such they are more correctly characterised as rules. The Tribunal also indicates in section 7.4 that it will be seeking the power to establish enforceable pricing guidelines [of the type proposed in Box 7.1]. Once again, "rules", "directions" or "mandatory pricing principles" are more appropriate terms than "guidelines" – if a "guideline" is made mandatory, then it is indistinguishable in substance from a rule.

The proposals in Box 7.1 can be contrasted with the proposed *Guideline for Calculation and Treatment of Avoided and Deferred Costs* in Appendix C which AGL interprets as non-mandatory guidance or advice as to how the calculation should be performed. AGL submits that, for the term "guideline" to be appropriate and meaningful, the *Guideline for Calculation and Treatment of Avoided and Deferred Costs* should provide guidance to relevant parties on how the Tribunal will exercise its statutory powers: it should not be mandatory. Alternatively, if it is to be mandatory, "guideline" should be replaced with a more appropriate term.

Other observations:

AGL has several observations to make on the detail of the Draft Report:

1. The Tribunal's proposal in relation to recovery of avoided costs (section 4.4) envisages an *ex post* evaluation where the business will be permitted to recover the costs from its broader customer base only if relevant criteria are met. This leaves the business exposed to the risk that the pass-through of the negotiated avoided costs to the wider customer base will be disallowed. This situation is likely

(notwithstanding the Tribunal's proposed guideline) to create an unacceptable level of risk and as a consequence lead to some projects not proceeding, or unnecessary arbitrations. This could be avoided if there were a mechanism for prior approval of the recovery amount. Section 8.21 of the Gas Code provides a possible model.

2. Item 11 of the *Draft Guidelines for Mandated Recycled Water Schemes* (Box 7.1) should permit recycled water prices to escalate at the greater of inflation and movements in the potable water price between reviews. There should also be provision for escalation at greater than the rate for potable water (subject to the cap specified in item 6) where the recycled water price is substantially less than the potable price – Rouse Hill is a case in point. A uniform higher rate of escalation should be preferable to the alternative of sharp increases at reviews with moderate escalation between.

3. While AGL supports access to arbitration by the Tribunal in the event of a dispute in negotiation of access for sewer mining, it suggests that such arbitration be modelled on the provisions in the Gas Code. That is, arbitration occurs when the parties have, after undertaking good faith negotiation, not been able to resolve a dispute and one of them lodges an application.

Should you wish to discuss this submission, please contact Chris Harvey on 9921 2601.

Yours sincerely

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