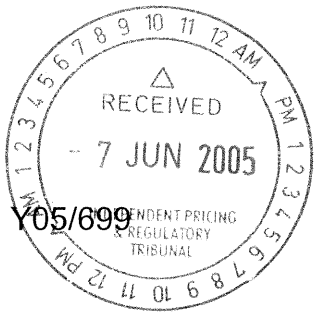
Department of
Infrastructure, Planning and Natural Resources

Office of the Director General



Y05/699

Mr J Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Dear Mr Cox

I write in relation to the Tribunal's current deliberations regarding the level and structure of prices to be charged by Sydney Water Corporation and Sydney Catchment Authority during the next determination period.

As you know, the Department of Infrastructure Planning and Natural Resources (DIPNR) is playing a key role in the development and implementation of Sydney's Metropolitan Water Plan, '*Meeting the challenges – Securing Sydney's water future*'.

Pricing reform has a vital role to play in helping to reduce water demand and to support investment in alternatives. As such it is critical to the effective implementation of the Metropolitan Water Plan. I also wish to emphasise the importance of ensuring that agencies earn sufficient revenue to implement the measures outlined in the Metropolitan Water Plan.

These and other issues are further explored in the attachment to this letter. Please contact Marion Bennett on 9762 8177 should you have any queries.

Yours sincerely

for Jennifer Westacott
Director General
29/5/05

Bridge St Office 23-33 Bridge St Sydney NSW 2000 GPO Box 39 Sydney NSW 2001 DX 22 Sydney
Telephone: (02) 9228 6111 Facsimile: (02) 9228 6191 Website dipnr.nsw.gov.au

Attachment

DIPNR input to the Metropolitan Water Price Review 2005

The importance of pricing as a conservation tool

Through the Intergovernmental Agreement on a National Water Initiative (NWI), Australian governments agreed to implement water pricing and institutional arrangements which (inter alia) promote the economically efficient and sustainable use of water resources. States and Territories also agreed to implement pricing that includes externalities where feasible, and to examine the feasibility of using pricing (and other market mechanisms) to account for positive and negative environmental externalities associated with water use.

Pricing has a key role to play in facilitating the efficient allocation of water resources and managing the external impacts of providing water services. DIPNR supports pricing reform to facilitate the least cost provision of water services (having regard for externalities) and the efficient and equitable allocation of resources between consumptive and non-consumptive uses.

In the course of developing the Metropolitan Water Plan, the NSW Government considered a broad range of supply and demand side options in order to identify the most cost-effective mix of measures to balance Sydney's demand for water with supply. This process considered the costs and benefits of each option within a broad framework of sustainability, taking into account financial costs to the individual, utility and the community, as well as environmental and social considerations.

Based on the analysis in IPART's '*Investigation into Price Structures to Reduce the Demand for Water in the Sydney Basin*', price reforms were included among the suite of options examined during the development of the Metropolitan Water Plan. In particular, it was assumed that price reform (ie the introduction of an inclining block tariff or similar) would result in savings in the order of 15 gigalitres (GL) or 15 billion litres per year, this being the mid-point of the range in IPART's report.

The analysis of options demonstrated that – compared with other possible supply and demand management options – retail pricing reform is one of the most cost-effective measures available. As such, significant water savings from pricing reform (the introduction of an inclining block retail tariff or similar) were incorporated in the projections for the demand/supply balance in the Metropolitan Water Plan.

The analysis undertaken for the Metropolitan Water Plan indicated that – if pricing reform is not implemented – more expensive measures will be required in order to balance demand and supply over time. As such, costs to end users will rise more than necessary, thereby impacting all consumers (including those least able to pay).

In view of the volume of water savings estimated to result from pricing reform, a decision not to adopt pricing reforms would have important implications for managing the gap between supply and demand. It would be difficult to identify alternatives to meet the estimated 15 gigalitres a year shortfall that are not already incorporated within the Metropolitan Water Plan and that are similarly low cost, large scale and able to be delivered in a short timeframe.

Pricing reform is also supported because it is likely to encourage increased take up and interest in other Metropolitan Water Plan actions. For example, following pricing reform, consumer interest in purchasing water efficient appliances could be expected

to increase. Pricing reform could also encourage the adoption of alternatives (eg rainwater harvesting etc, greywater reuse etc).

The above serves to highlight the key role of pricing as a means to

- conserve water resources – both by sending appropriate price signals to water users, and by reinforcing other programs that promote efficiency etc,
- deliver significant water savings compared to a scenario in which pricing reform does not occur, and
- achieve these outcomes cost effectively and with short lead times.

DIPNR therefore strongly supports pricing reform as part of the mix of supply and demand management measures best able to meet Sydney's water needs in a sustainable and cost effective way.

Managing the impacts of pricing reform

It is recognised that changes to price structure have the potential to create inequitable impacts on some consumer groups. For example, the introduction of step prices for consumers using more than 400 kilolitres (kL) of water per year may unfairly penalise low-income large families with high non-discretionary water demand.

DIPNR notes the Government's stated intention to ensure that programs are in place to protect low income and large families and people with special needs from the impacts of price reform (p19, Metropolitan Water Plan). DIPNR considers that such impacts can be addressed adequately through targeted programs, and that such impacts should not act a barrier to the implementation of pricing reform. Even if significant resources are invested to offset impacts on large families etc, pricing reform remains a very efficient tool to support least cost delivery of water services.

DIPNR considers that a combination of pricing reform and targeted programs best serves the interests of low income families etc and is confident that measures can be implemented in a timely way to address equity concerns. Should the Tribunal decide that an inclining block tariff is not the preferred option, DIPNR encourages the Tribunal to consider alternative pricing reform options so as to ensure that similar (or better) water conservation outcomes are achieved. As noted above, failure to reduce consumption through appropriate price signals will place further pressure on water supplies, leading to higher costs and impacts on all water users.

Cost recovery

As the agency charged with overseeing implementation of the Metropolitan Water Plan, DIPNR is concerned to ensure that Sydney Catchment Authority (SCA) and Sydney Water Corporation (SWC) have sufficient resources to implement their responsibilities under the Plan. As noted earlier, the options included in the Metropolitan Water Plan have been selected on the basis of their cost effectiveness (following detailed analysis), as well as their environmental and social acceptability. As such, they represent the most cost-effective way to achieve a balance between supply and demand for water in Sydney.

Wholesale tariff

In its Final Report into Price Structures to reduce the demand for water in the Sydney Basin, IPART recognises "the potential to rebalance the current price structure so that the usage price paid by Sydney Water for all the water it purchases from SCA better reflects its true scarcity value" (p48).

DIPNR encourages IPART to implement a wholesale price structure that effectively communicates the scarcity value of Sydney's water resources and supports optimal investment in demand management and alternative supplies.

Recycled water

The National Water Initiative (NWI) calls on States and Territories to develop by 2006 "pricing policies for recycled water and stormwater that are congruent with pricing policies for potable water, and stimulate efficient water use no matter what the source" [NWI cl 66(ii)]. States and Territories have also agreed to the "review and development of pricing policies for trade wastes that encourage the most cost effective methods of treating industrial wastes, whether at the source or at downstream plants, by 2006".

Two processes are underway that have implications for the development of recycled water pricing, including IPART's Industry Structure review and DIPNR's coordination of the whole-of-government *Metropolitan Strategy: Recycled Water*. The latter will consider pricing, funding and financing arrangements for recycled water initiatives, particularly in Western Sydney. This Strategy will be developed by July 2005. On advice from an interagency Working Group, including IPART, DIPNR has engaged consultants to assist it in developing the Recycled Water Strategy. DIPNR will continue to work with IPART to discuss the findings from these consultancies as they become available.

Appropriate price signals are critical to stimulate optimal investment in recycled water. It will be important to ensure that the forthcoming price determination facilitates recycled water uptake in line with the objective of least cost water service delivery (including over the longer term). Stimulating efficient investment in recycled water will help to avoid more costly supply augmentation options in future, diversify our supply profile, provide protection against future prolonged droughts (particularly in view of projected climate change impacts) and may also avoid the need to augment water treatment capacity. As noted, however, these issues will be further explored in the course of the two processes outlined above.

Non-residential water users

Non-residential water users account for 30% of Sydney's potable water use. Appropriate pricing signals to non-residential customers will support investments in water efficiency and recycling, contribute to least cost water service provision, and promote equity between all classes of water users. Improving non-residential water efficiency and supporting investment in alternative supplies could be expected to deliver significant benefits to

- end users (through direct benefits – ie reduced charges – and indirectly through improvements to throughput efficiency); and
- the community (ensuring optimal use of potable water resources and avoiding unnecessary augmentation of water capacity through inefficient investment in supply or demand side measures).

IPART's Final Report notes (page 19 and 29) that the Tribunal lacks sufficient information (eg the ratio of discretionary to non-discretionary water use) to make decisions about pricing reforms for non-residential customers. DIPNR considers that further work by the Tribunal is warranted to ensure that pricing reforms apply equitably to *all* customer classes and support least cost outcomes for the benefit of the whole community.

The information required to support decision-making on this issue could be collected through Metropolitan Water Plan actions – notably, Sydney Water's 'Every Drop

Counts' and the Department of Energy, Utilities and Sustainability's Business, Government and Local Council Water Conservation Plan program. DIPNR encourages the Tribunal to work with SWC and DEUS to explore the potential for non-residential pricing reform to support improved efficiency and investment in alternative supply options.

Metering

DIPNR notes that around 40 per cent of households do not pay individual water usage charges, and that not receiving a water usage bill is estimated to increase a household's water use by approximately 19 per cent (IPART, "Residential water use in Sydney, the Blue Mountains and Illawarra", 2004).

IPART's report on residential water use further notes that, "based on the statistical modelling, we estimate that if an average household that currently does not receive a water usage bill could reduce its water consumption to the same level as the average for the rest of the community, then 19 per cent of its total water use contribution could be saved. Applying this estimate to the average consumption of households that do not receive a water usage bill from the survey data suggests that around 18 GL of water could be saved."

This represents a significant potential saving that warrants further investigation. As IPART notes, it will be important to consider the costs and benefits of measures to help realise this potential – for example, programs to instal individual meters in units and encourage the installation of water saving devices in tenanted properties by landlords.

As Sydney's population grows, medium density housing is expected to increase. It is therefore likely that the percentage of individually metered households will fall relative to total housing stock. Should this occur, it will reduce the future capacity of pricing reform to support sustainable water outcomes over time (since a growing number of households will not receive direct price signals via usage charges).

DIPNR welcomes the recently announced trial of meters in individual units and is interested to work with other agencies to progress the issue of individual metering, following the trials.