



HUNTER WATER RESPONSE TO IPART

**DRAFT DETERMINATION AND DRAFT REPORT
ON PRICES FOR WHOLESALE WATER AND
SEWERAGE SERVICES**

7 December 2016



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Response to IPART's Draft Determination and Draft Report on prices for wholesale water and sewerage services

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EXECUTIVE SUMMARY

Hunter Water is eager to assist IPART in the task of designing and implementing a set of pricing decisions that send efficient signals for new investment, provide a degree of certainty for all parties, and establish the right regulatory precedents from the commencement of the first wholesale price determination.

IPART's work over the past 18 months has highlighted the complexity of regulating prices for water utility services that are on-sold to end-use customers. The *Water Industry Competition Act 2006 (NSW)* established a regulatory framework for the licensing of private retail suppliers and private operators of water industry infrastructure. It established an access pricing framework as the basis for negotiating and/or arbitrating the terms and conditions for the use of network infrastructure owned by public water utilities.

Competition in the NSW urban water sector has evolved in a way that does not fit neatly with an access pricing model. IPART has taken the responsible step of conducting a public review process to consider broad conceptual issues and practical pricing matters, including: the role of wholesale price regulation, the right form of price regulation, how to calculate regulated prices, and how to implement regulated prices.

As a starting point, IPART committed to the correct overarching objective for this price review:¹

...to establish an approach for regulating wholesale prices that allows new entry to the market for end-use water and sewerage services to occur where this is efficient, to promote competition for the benefit of consumers.

IPART's decisions on the regulation of wholesale prices will have lasting consequences in terms of the timing and extent of private investment in the NSW water industry. It is important to remember that competition in the water sector happens only once – when the property developer makes a decision to lock in the service provider and the technology to deliver those utility services. There is no ongoing competition that allows end-use customers to change utility providers in search of a better service or a lower price.

The decisions that IPART makes in the final determination will establish important precedents for future determinations. A decision that provides an artificial advantage for private operators, or enables private investors to exploit differences in the way that pricing determinations are applied for public water utilities, could result in an expansion of the number and scale of new water recycling schemes – without them necessarily being efficient. It would be difficult for IPART to depart from such decisions in a future determination if it undermined the financial viability of private schemes.

IPART has produced a great deal of good work in the draft report. Hunter Water supports the decision to make a separate and binding determination of wholesale prices for water and sewerage services provided to wholesale customers. IPART's draft report provide a robust definition of the market for wholesale services and adopts the right framework for setting prices. IPART has designed a sensible and pragmatic implementation model by setting system-wide wholesale prices for the on-selling of water and wastewater services, while allowing scheme-specific determinations in instances where facilitation costs may be material.

¹ IPART, 2016 (b), page 19.

HUNTER WATER'S RESPONSE TO DRAFT DETERMINATION

While supportive of much of the draft report, Hunter Water does not agree with IPART's judgment calls on two fundamental issues:

1. The decision to apply non-residential prices to waste discharged from a recycled water plant. This decision goes to the central issue in this entire review – the pricing of sewerage services provided to end-use customers.
2. The decision to set retail-minus prices using reasonably efficient competitor costs. IPART's determination provides a form of industry assistance to less efficient, private sector competitors.

IPART's draft report establishes a different set of pricing rules for private operators by setting non-residential prices for waste disposal from a recycled water plant. Hunter Water may never be able to compete with private operators to offer a recycled water service to new developments under this model.

- Hunter Water must ring-fence all of the costs and revenues associated with providing a water recycling service, as required by IPART's pricing arrangements for recycled water. Any recycled water scheme that Hunter Water builds and operates must be financially viable as a standalone investment.
- The draft wholesale determination allows wholesale customers to cross-subsidise water recycling schemes from the retail sewerage charges they collect from residential and non-residential customers within the development.
- While IPART's draft decisions may subsidise and promote investment in water recycling facilities by private players, the pricing approach does nothing to ensure those operators maximise recycled water output in a way that reduces demand from the drinking water supply system. Waste and surplus product can be discharged inexpensively into the public water utility's sewerage system.

Hunter Water calls on IPART to revisit its draft decisions on the pricing of recycled water waste, even if this means a further round of public consultation and a delay in the start of the final determination. Hunter Water considers that water recycling is an essential and integrated part of providing a sewerage service in all WIC utility developments.² IPART's retail-minus prices for the on-selling of sewerage services should apply to all discharges to Hunter Water's or Sydney Water's sewerage system.

Throughout the course of this price review, Hunter Water has supported a determination of wholesale prices using retail-minus prices where the discount reflects the avoidable costs of the public water utility. Using Hunter Water's actual costs of providing retail services and the actual costs of maintaining local reticulation assets provides a proxy for these minus components, noting that actual costs for contestable services will be higher than Hunter Water's avoidable costs.

IPART's decision to base the minus components on estimates of the reasonably efficient costs for a smaller water utility results in much higher minus components – in the order of two to three times higher than Hunter Water's efficient costs. IPART is using its price setting powers to require public water utilities to under recover the costs of providing wholesale water and sewerage services. Any revenue shortfall can only be funded by Hunter Water's existing customer base or Hunter Water.

Hunter Water can accept IPART's decision to base the minus component on a reasonably efficient competitor cost benchmark as an interim or transitional measure. Hunter Water invites the Tribunal to provide some guidance on the types of factors or indicators that would suggest that the wholesale market had matured to the point where assistance for new private entrants was no longer necessary.

² The term 'WIC utility' refers to the holder of a network operator and/or retail supplier licence under the *Water Industry Competition Act 2006 (NSW)*. The term has been used interchangeably with the terms wholesale customer, new entrant and alternative service provider.

HUNTER WATER'S RESPONSE TO DRAFT DETERMINATION

Hunter Water endorses IPART's package of draft decisions on the implementation of wholesale pricing and the treatment of facilitation costs. Hunter Water agrees that the determination should apply to wholesale supply agreements commencing after the final determination, supports the setting of system-wide wholesale prices every four years, and agrees with the proposal to allow scheme-specific determinations in circumstances where facilitation costs may be material. Hunter Water's response outlines a number of refinements and minor improvements to IPART's draft implementation decisions, focusing on the processes for triggering a scheme-specific determination.

1 INTRODUCTION

Hunter Water welcomes the opportunity to respond to the *Independent Pricing and Regulatory Tribunal's (IPART) Prices for wholesale water and sewerage services – Sydney Water Corporation and Hunter Water Corporation - Draft Determination and Draft Report* (the draft report) as published on 1 November 2016.

Hunter Water's response to the draft report focuses on three key issues:

1. The retail-minus approach to pricing wholesale services purchased for the purpose of on-selling
2. The approach to setting the minus component of the retail-minus price, including the quantum of the minus discount
3. The non-residential approach to pricing recycled water waste disposal

Hunter Water's position on each of IPART's 17 draft decisions is provided in Appendix A.

The following conventions have been adopted throughout the document:

- All dollar amounts presented in this response are in \$2016-17 terms, unless otherwise stated.
- The Draft Determination and Report are both referred to as the 'draft report'.

2 PRICING APPROACH FOR ON-SELLING SERVICES

2.1 IPART regulation of wholesale prices

Hunter Water has consistently supported an IPART determination of wholesale prices for water and sewerage services that are on-sold to residential and non-residential customers in Hunter Water's area of operation. A four-yearly IPART wholesale price determination process should:

- Provide an opportunity for all parties to contribute to the public policy debate and provide evidence as to the appropriate form and level of wholesale prices.
- Remove any doubt as to the legal basis for charging wholesale customers who may not be property owners in the Lower Hunter.
- Eliminate any perception that Hunter Water may unfairly or improperly use its incumbency position to limit competition in the provision of services to developers.
- Reduce the time and cost of transacting future utility services agreements by setting out an exact pricing schedule for each agreement.

At this point in time, Hunter Water envisages that it would adopt IPART's regulated system-wide wholesale prices for future utility service agreements. Hunter Water also recognises that there may be circumstances that are unique to a particular wholesale supply arrangement where it is in the best interest of both parties to negotiate a non-standard pricing agreement. Hunter Water agrees with IPART's draft decision to allow unregulated prices in these situations.

2.2 Retail-minus approach

Hunter Water endorses IPART's draft decision to adopt the retail-minus pricing approach for the on-selling of water and sewerage services. As detailed in earlier submissions, Hunter Water considers that retail-minus pricing can best achieve IPART's objectives for this review of wholesale prices by promoting competition where it results in a reduction in the cost of supplying end-users through time.

As noted by IPART, the retail-minus approach is closely related to the 'efficient component pricing rule', which holds that policies for efficient entry should allow for the integrated monopolist to continue to recover existing contributions to fixed and common costs in its regulated price.³ This pricing approach is particularly relevant where:

- The public utility does not earn monopoly rents on the initial end-to-end supply of services.
- The monopoly provider's retail tariffs are not allowed to reflect the costs of serving particular groups of users.
- The costs of distorted retail prices are not captured via other regulatory instruments, such as a universal service fund.
- Downstream competitors are in position to offer and deliver substitute services.

Hunter Water's retail prices are regulated on a postage stamp basis using a cost of service approach for setting regulated revenues and prices. IPART's price review process should ensure that retail prices, on average, do not include any monopoly rent component. This means that the retail-minus approach should encourage entry only where it will reduce the total cost of service provision to society. If potential competitors can perform the contestable functions of Hunter Water at lower cost, then efficient entry is promoted.

The retail-minus approach is particularly suitable for situations where a new entrant displaces the incumbent. To date, the only type of entry has been where a WIC utility is seeking services from Hunter Water – that is, competition 'for the market' to supply greenfields infrastructure and retail services.

³ IPART, 2016 (b), pages 53, 56 and Appendix C.

HUNTER WATER'S RESPONSE TO DRAFT DETERMINATION

The displacement that occurs is notional, as otherwise Hunter Water would be obligated to provide water and sewerage services to these end users at its postage stamp prices.

IPART's draft report provides a good description of the advantages and disadvantages of different pricing approaches.⁴ IPART recognises that a 'cost of service' approach that was location or scheme specific would result in inefficient price signals given that Hunter Water is bound to postage stamp retail prices. Entry would be driven by the structure of Hunter Water's regulated retail prices, not as a consequence of a better service offering or productivity improvements by the alternative service provider.

IPART's draft report explains how cost of service pricing would result in higher prices for Hunter Water's existing customer base.⁵

This would lead to cherry-picking, where entry occurs only in low cost areas, potentially by inefficient utilities. Cherry-picking increases Sydney Water's and Hunter Water's average cost by reducing the low cost customer base while leaving the high cost customer base unchanged. This would push up the postage stamp price as higher than average costs need to be recovered over a smaller number of customers. In turn, this could lead to further cherry-picking.

IPART also explores how the setting of non-residential prices creates an arbitrage opportunity for on-selling. This effect is most evident in the setting of fixed sewerage service charges. IPART's residential sewerage charges produce a relatively large share of Hunter Water's allowed sewerage service revenues. By way of example, IPART's draft report provides three worked case studies showing indicative revenue impacts of different private scheme types and different pricing structures. In each case, charging using non-residential retail prices compared with expected revenues from each end user within a development results in about one-tenth of the revenue, as shown in Table 2.1.

Table 2.1 On-selling sewerage services, Hunter Water indicative revenue over 2016-17 to 2019-20 (\$'000s, \$2016-17)

	Inner city high density	Small greenfield low density	Large greenfield low density
Expected revenues end-users	\$3,591	\$4,392	\$22,184
Non-residential retail prices	\$350	\$502	\$2,001
Non-residential prices as a % of expected end-user revenues	9.7%	11.4%	9%

Source: IPART, 2016 (b), Table 5.6, Table 5.7, Table 5.8, pages 64 to 65.

IPART's analysis highlights the potential for non-residential pricing structures to drive inefficient entry:⁶

Such an arbitrage opportunity could make it profitable for wholesale customers to enter the market without providing any additional services or improving overall system efficiency. That is, wholesale customers could enter the market through an arbitrage opportunity rather than by being as or more efficient than the wholesale service provider. Overtime, this could increase the revenue Sydney Water and Hunter Water would need to recover from their remaining retail customers, without any offsetting system-wide efficiency gains from the new entry.

Hunter Water considers that a retail-minus pricing approach is the only practical and workable way of regulating wholesale prices given current regulatory settings. To that end, IPART has made the right decision in adopting such an approach for the on-selling of water and sewerage services.

⁴ IPART, 2016 (b), Appendix C.

⁵ IPART, 2016 (b), page 49.

⁶ IPART, 2016 (b), page 49.

2.3 Reasonably efficient competitor costs

IPART's draft decision applies the reasonably efficient competitor standard as the benchmark for calculating retail-minus components.⁷

Hunter Water observes that IPART could have applied one of three methods in determining a retail-minus approach.

1. IPART seeks to set Hunter Water's prices across a four-year determination period based on the efficient costs of the hypothetical best performing, or 'frontier', water utility. IPART engages expenditure consultants to scrutinise Hunter Water's operating and capital expenditure proposals. The consultants apply prudence and efficiency tests to assess the merits of proposed spending programs, which includes 'catch-up' and 'continuing' efficiency cuts designed to encourage ongoing productivity improvements and cost reductions.
2. Hunter Water has consistently argued for retail-minus avoidable cost pricing of wholesale services. Using Hunter Water's actual costs at a point in time would hold the alternative service provider to a standard that closely approximates this benchmark.
3. IPART's reasonably efficient competitor standard does not make any reference to Hunter Water's actual costs of providing the equivalent contestable service. IPART engaged consultants to estimate retailing and reticulation costs for a much smaller scale, private utility using various published data sources. The reasonably efficient competitor standard provides the largest discount for wholesale customers of the options considered.

IPART sets out the following case in support of a larger minus margin for wholesale customers using reasonably efficient competitor costs:⁸

In industries with increasing returns to scale, scale is a major impediment to entry. It would not be feasible for a wholesale customer to replicate the scale economies available to Sydney Water or Hunter Water immediately upon entry, particularly as they are largely restricted to new growth areas. As such, an entrant could not reasonably be expected to match the retailing costs of Sydney Water and Hunter Water in the short-term.

IPART recognises that the use of reasonably efficient competitor costs is designed to encourage entry by utilities that have higher costs than the public water utility. In effect, IPART has made a judgement call to provide a form of subsidy on the basis of an 'infant industry' argument where a greater margin is provided to less efficient, private-sector competitors.

IPART accepts that its proposed approach of setting the minus amount would create a deficit in funding for the public water utility. In a departure from past practice, IPART has proposed a form of industry assistance that is not funded directly or explicitly by government. This subsidy can only be provided by one of two parties – either by Hunter Water through lower earnings and a lower dividend, or alternatively by Hunter Water's existing customer base through an uplift or cost recovery margin added to retail prices.

IPART has indicated that it will consider the size of any deficit and whether Hunter Water or its customers should fund any under recovery of costs when it next determines retail prices. Hunter Water does not have a view at this stage on which of the two funding options it would pursue if there was an actual or likely revenue shortfall at the next price review. Neither approach holds any appeal.

⁷ IPART, 2016 (b), section 5.3.

⁸ IPART, 2016 (b), page 51.

2.4 Realising dynamic efficiency gains

Hunter Water accepts that IPART is attempting to balance a number of competing objectives in designing and implementing a determination of wholesale prices for the first time. IPART has applied a degree of regulatory discretion to set the minus component at a level that should provide a margin for wholesale customers to out-compete the public water utility when offering water and sewerage services for new developments. However, IPART does place some important conditions on its support for the reasonably efficient competitor cost approach by flagging that the minus component should move closer to the efficient costs of the public water utility through time.

First, when commenting on the rationale for reasonably efficient competitor costs, IPART notes:⁹

Over time, as the market develops and wholesale customers have had an opportunity to grow and experience economies of scale, there would be a case to transition away from the reasonably efficient competitor cost approach.

Second, when commenting on the level of new entry, IPART observes:¹⁰

It could lead to some inefficient entry, particularly where the wholesale customer does not become more efficient over time. However, IPART can manage this risk by periodically reviewing the use of the reasonably efficient competitor cost approach including considering the transition to the use of the as efficient cost standard over time.

Hunter Water supports IPART's stated intent to review the rationale for and the setting of the retail-minus allowances at the next review of wholesale prices in 2020-21. Hunter Water accepts that a future Tribunal is not bound by the decisions made in the upcoming final determination. Nonetheless, there is a reasonable case to say that the current Tribunal could provide some form of guidance on the factors and indicators it considers important in judging the success or otherwise of the reasonably efficient competitor cost approach.

Hunter Water is subject to a high level of regulatory scrutiny by IPART in the setting of monopoly prices. This includes the preparation of annual information returns, special information returns for price reviews, periodic expenditure reviews, and ongoing monitoring of prices and expenditure levels. IPART has also indicated that it will look to use performance benchmarking in future price reviews.

IPART's draft decisions on wholesale pricing do not impose any similar reporting obligation on alternative service providers. Hunter Water questions how IPART could make assessments of the relative efficiency of wholesale customers through time when it does not have access to actual costs of any private water utility. Relying on published industry data from other government agencies or other secondary sources will not provide information that is timely or specific to the task of establishing cost trends for contestable water and sewerage services. The four-yearly wholesale pricing period does allow sufficient time for IPART to establish better ways of gathering accurate and reliable cost data.

Hunter Water notes that each wholesale customer is a licensed retail supplier holding monopoly rights to supply water utility services to residential and non-residential customers in a local area. To date, IPART has not sought to regulate the retail prices that wholesale customers are able to charge end-users within a new development. WIC utility applicants have indicated that they will match the retail prices of the incumbent public water utility. Whether the private utility shares all, some or none of the benefits of the reasonably efficient competitor cost approach is a matter for that utility to decide. As the number of licensed WIC schemes increases, and the number of connected lots within each development grows, it will become increasingly difficult for IPART to monitor or examine retail pricing outcomes across the private water utility sector.

⁹ IPART, 2016 (b), page 51.

¹⁰ IPART, 2016 (b), page 53.

2.5 Quantifying reasonably efficient competitor costs

IPART's draft decision applies system-wide wholesale prices based on the sum of regulated end-use customer retail charges less an allowance for retailing costs (per property) and an allowance for maintaining and renewing local reticulation assets (per kilometre of reticulation main within a development).

Hunter Water accepts IPART's approach to applying the minus components. Hunter Water will need to know details on the number and type of customers within each development in order to calculate the retail component of wholesale prices. Hunter Water will also need regular updates on the reticulation assets within each scheme in order to calculate the minus component. While there is a degree of complexity in working out exact billing amounts, this was always going to be the case for any regulated or unregulated pricing agreement.

2.5.1 IPART's estimates of retail-minus allowances

NERA's report to IPART on approaches to calculating average wholesale prices describes the difficulties of applying an engineering approach when estimating cost of providing contestable services.¹¹

Adopting an engineering based approach would require a large number of reasonably subjective assumptions relating to the scale of the services being provided, the technologies employed to deliver these services and the costs associated with those technologies.

IPART has relied upon Oakley Greenwood's report, 'Calculation of reasonably efficient competitor costs', to derive assumptions about typical network configurations, benchmark rates, and retailing costs. IPART calculates actual minus components based on a weighted average of costs from three different wholesale supply scenarios.

Hunter Water questions how any retail-minus methodology that only excludes retailing costs and operating and renewal costs for reticulation assets could result in a substantial revenue reduction for the public water utility. The table below shows IPART's indicative revenues for Hunter Water under different pricing approaches for the on-selling of a water service in each of the three worked examples. Applying IPART's minus allowances for both greenfield schemes results in a 25 per cent discount from the sum of regulated customer end-use charges.

Hunter Water has re-calculated the minus components after reducing the volume of drinking water sold in each of three worked examples assuming that a recycled water scheme would replace 40 per cent of residential drinking water use.¹² Hunter Water estimates that IPART's minus allowances would result in a nearly 40 per cent reduction in Hunter Water's revenues in the greenfield examples.

¹¹ NERA, 2016, page 47.

¹² The 40 per cent reduction is based on an analysis of typical residential consumption by end-use and permissible end-uses of recycled water. It has been confirmed by monitoring at sites with dual reticulation (Gillieston Heights and Chisholm).

Table 2.2 On-selling water services, Hunter Water indicative revenue over 2016-17 to 2019-20 (\$'000s, \$2016-17)

	Inner city high density	Small greenfield low density	Large greenfield low density
Expected revenue from end users	\$2,911	\$3,662	\$18,547
IPART's system-wide wholesale prices	\$2,427	\$2,738	\$13,927
Minus allowance as a % of revenue from end users	16.6%	25.2%	24.9%
Minus allowance as a % of revenue from end users (including 40% recycled water use)	25.4%	38%	37.6%

Source: IPART, 2016 (b), Tables 5.3, 5.4 and 5.5. Hunter Water analysis.

Hunter Water has identified a number of areas where it considers that IPART has overstated costs in its derivation of the retail-minus components.

Retail operating costs

Hunter Water provided IPART with internal cost estimates for retail activities (customer contact, billing and collections) of around \$30 per customer per annum for water, sewerage and stormwater services. Oakley Greenwood's benchmark operating cost estimates for retail activities are \$84 per customer per annum – nearly three times higher Hunter Water's actual retail costs.

Retail metering costs

IPART has used a benchmark cost for the purchase and installation of a 20mm water meter of \$500 per meter using the Oakley Greenwood numbers. IPART's 2016 retail determination set Hunter Water's 2016-17 miscellaneous charge for water service connection at \$128.00 (up to and including 25mm water meters). Hunter Water considers that halving the \$500 benchmark estimate would give a more realistic assessment of reasonably efficient costs.

Local reticulation costs - inclusion of lead-in mains

Oakley Greenwood's network configuration for greenfield projects includes DN450 and DN250 lead-in mains to the new development site. Oakley Greenwood assumes that the services provided by the reasonably efficient competitor would include those upstream from the wholesale connection to the physical connection of individual customers.¹³

Oakley Greenwood's proposed network configuration does not align with Hunter Water's funding practices. Hunter Water maintains and operates lead-in infrastructure within its current wholesale supply agreements. Hunter Water does not see any reason why a wholesale customers would seek to own or operate this type of infrastructure in any future wholesale supply agreement. These assets should be excluded from IPART's estimates of reasonably efficient reticulation costs.

¹³ Oakley Greenwood, 2016, page 2.

Local reticulation costs - life cycle operating costs

IPART's draft report describes its proposed approach to estimating operating expenditure for network asset:¹⁴

We consider that operating expenditure should match the age of the assets being operated. As our approach uses an initial MEERA valuation of retail and reticulation assets and annual estimates of building block costs, we therefore decided that the operating expenditures should reflect the assets' life cycle operating costs.

In general, as assets age they become more expensive to operate. Our approach (ie, matching asset age to its operating expenditure) is broadly consistent with our approach in retail price reviews.

IPART has not reflected the age profile of new assets in the actual minus allowance for local reticulation. This could overstate the costs of be affecting the minus by around \$1,000per kilometre for water.

IPART's building block model for local reticulation costs assumes:

- Operating and maintenance costs are stable over the life of the asset.
- Operating and maintenance costs have been based on benchmark cost data published by the Department of Primary Industries.¹⁵ This cost data reflects average costs incurred by Local Water Utilities with 3,000 to 10,000 properties. Cost data from this sample would relate to infrastructure of various ages.

The building block costs should include an expected profile of these average costs over the life of the asset. These costs would be lower when an asset is new, and higher as the asset approaches its design life.

¹⁴ IPART, 2016 (b), page 141.

¹⁵ Department of Primary Industries, 2015, page 187.

3 PRICING APPROACH FOR TRANSFORMED SERVICES

3.1 Setting of separate prices for transformed services

IPART's 2016 Discussion Paper detailed a preliminary view that retail-minus was the most appropriate approach to pricing wholesale services.¹⁶ The inclusion of service transformation as wholesale service was to be further considered (e.g. drinking water used to top-up a recycling scheme), but there was no discussion or indication that it would be priced separately to on-selling.¹⁷

Within this context, Hunter Water's expressed the following position in response to the Discussion Paper:¹⁸

- Wholesale services provided for use by a new entrant in recycled water schemes should be priced consistently with other wholesale services (i.e. on-selling).
- Wholesale pricing arrangements for drinking water top-up and recycled water waste disposal should be consistent with IPART's pricing arrangements for recycled water that apply to public water utilities.¹⁹ This would result in level playing field for competition in recycled water services between wholesale service providers (public water utilities) and wholesale customers (private utilities).

Hunter Water reiterates this view and elaborates on the rationale in the following sections.

3.2 Drinking water top-up to recycled water schemes

All recycled water schemes require top-up from another water source (e.g. drinking water, stormwater or groundwater) to ensure continuity of the water supply to end-use customers:

- during initial stages of development in the period prior to full commissioning of the recycled water plant;
- to match seasonal variation in demand and supply;
- when the recycled water plant is offline for maintenance (if sufficient product to meet end user demand cannot be stored); and
- when recycled water does not meet quality requirements (referred to as 'off-specification' water).

IPART's draft decision adopts the non-residential retail price for wholesale customer purchases of drinking water services for the purpose of topping-up recycled water schemes. It does so on the basis that drinking water is an input to the production of a separate product (i.e. recycled water) and therefore akin to a factory.

Recycled water schemes are typically designed such that drinking water top-up occurs after recycled water is produced.²⁰ The drinking water is likely to be used to top-up the recycled water storage tank, as shown in Figure 3.1. The drinking water is not transformed by the recycled water plant. It is a factor post-production rather than a factor of production.

¹⁶ IPART, 2016 (a), pages 3.

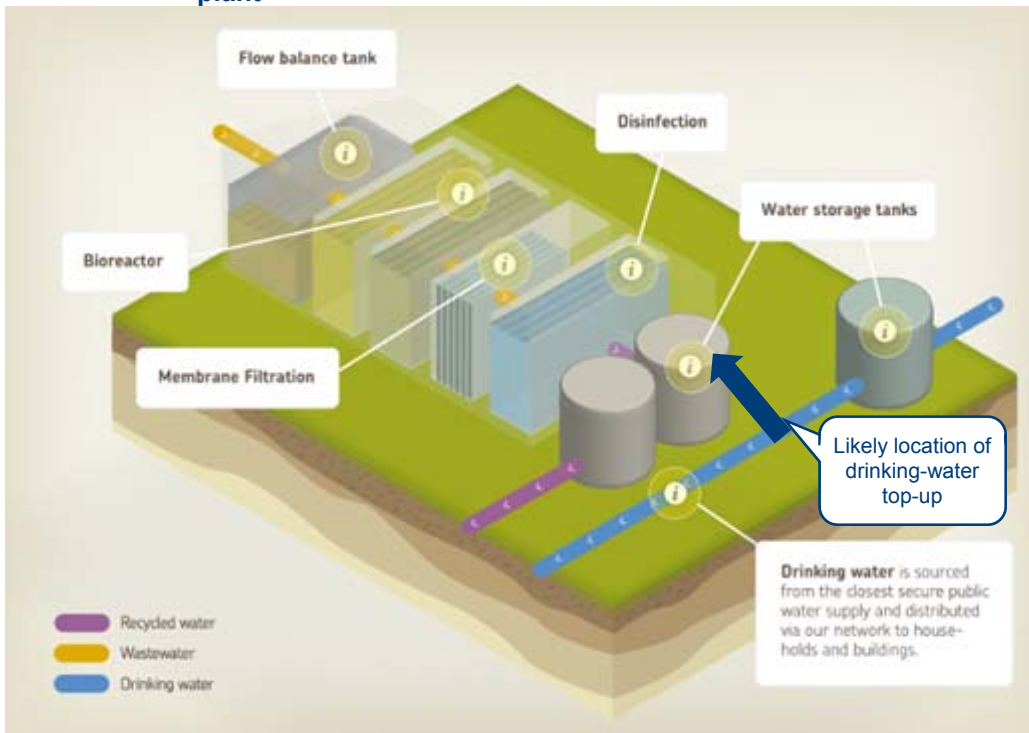
¹⁷ IPART, 2016 (a), page15.

¹⁸ Hunter Water, 2016, pages 8 and 9.

¹⁹ IPART, 2006.

²⁰ The suitability of the recycled water quality for provision to customers is assessed at the point of (or after) disinfection. Off-specification recycled water will generally be returned to the start of the recycled water plant for reprocessing or discharged to sewer. Any drinking water top-up occurring prior to this decision point would be inefficient.

Figure 3.1 Conceptual drawing of potable top-up to a wholesale customer's recycled water plant



Source: Based on <http://cooranbongwater.com.au/how-it-works/local-water-centre/>

Hunter Water recognises that the non-residential price is very similar to the retail-minus price for this service. Water usage charges comprise most of the water bill for both residential and non-residential customers (close to 90 per cent for households) and the water usage price is common for both customer categories. Furthermore, the application of the full water usage price is consistent with IPART's pricing arrangements for recycled water, which requires NSW metropolitan water utilities to treat potable top-up to recycled water schemes as water sales to itself, costed at the retail drinking water usage price.²¹ On this basis, Hunter Water would accept a final decision consistent with the draft decision on the pricing of recycled water top-up.

²¹ IPART, 2006, pages 30 and 47.

3.3 Recycled water scheme waste disposal

3.3.1 Principles

Hunter Water agrees there are complex issues to consider in setting the pricing approach for recycled water scheme waste disposal services e.g. whether recycled water waste disposal may be a contestable service, the potential for pricing to incentivise an inefficient servicing solution (e.g. tankering) and the limited number of operating examples of this type of service provision.

Hunter Water is of the view that the pricing approach should be guided by the following principles:

- Reflect the extent of transformation. Is the recycled water plant designed and operated to produce a new product or service (recycled water) or is the recycled water plant a means of providing a sewerage service to end-users?
- Encourage recycled water plants to be built as a means of providing a sewerage service only where it is efficient to do so.
- Incentivise efficient operation of the recycled water plant.
- Reflect the quality and quantity of actual and potential discharges.
- Be practical to implement.

Hunter Water does not currently have any agreements to provide this service as none of its wholesale customers currently has an operational recycled water plant. However, it is important to get the pricing right as it is expected that wholesale customers will seek this service in the future. IPART's pricing approach for this price review will set a precedent upon which new entrants will base investment decisions.

3.3.2 The nature of recycled water waste discharges

Liquid waste streams are produced at various process steps within the recycled water plant, including:

- Backwash or flush water used to clean inlet screens at the start of the plant (prior to flow balance tank).
- Reject from membranes or other main processing steps.²²
- Off-specification water that is not of high enough quality to supply to end users.
- Excess recycled water that is surplus to end user demands and exceeds storage capacity.

The public versions of WIC licence applications provide little detail of the intended approach to managing recycled water waste streams.²³ The operational intent of the recycled water plant is relevant to characterising the level of transformation occurring prior to discharge to the public water utility's sewerage system and therefore the volume and quality of discharges. Potential steps in the process of generating wastewater from the recycling process are shown in Figure 3.2.

²² This may be waste activated sludge or the filtrate from mechanical sludge dewatering. See Lake Macquarie City Council, 2015, Sewerage and Recycled Water Process Flow Diagram, Cooranbong Local Water Centre.

²³ Cooranbong Water's network operator licence application states that it "is in negotiation with Hunter Water for a permanent connection to its sewerage network for the discharge of excess wastewater" (Cooranbong Water, 2015, page 35). The environmental impact statement accompanying the development application states that excess recycled water will be discharged to the existing Hunter Water sewerage network; and Dewatered Waste Activated Sludge (WAS), including membrane screenings, will be disposed offsite in a licensed solid waste facility or via HWC's existing sewerage network under a trade waste agreement (RPS Australia East, 2014, pages 1 and 50).

HUNTER WATER'S RESPONSE TO DRAFT DETERMINATION

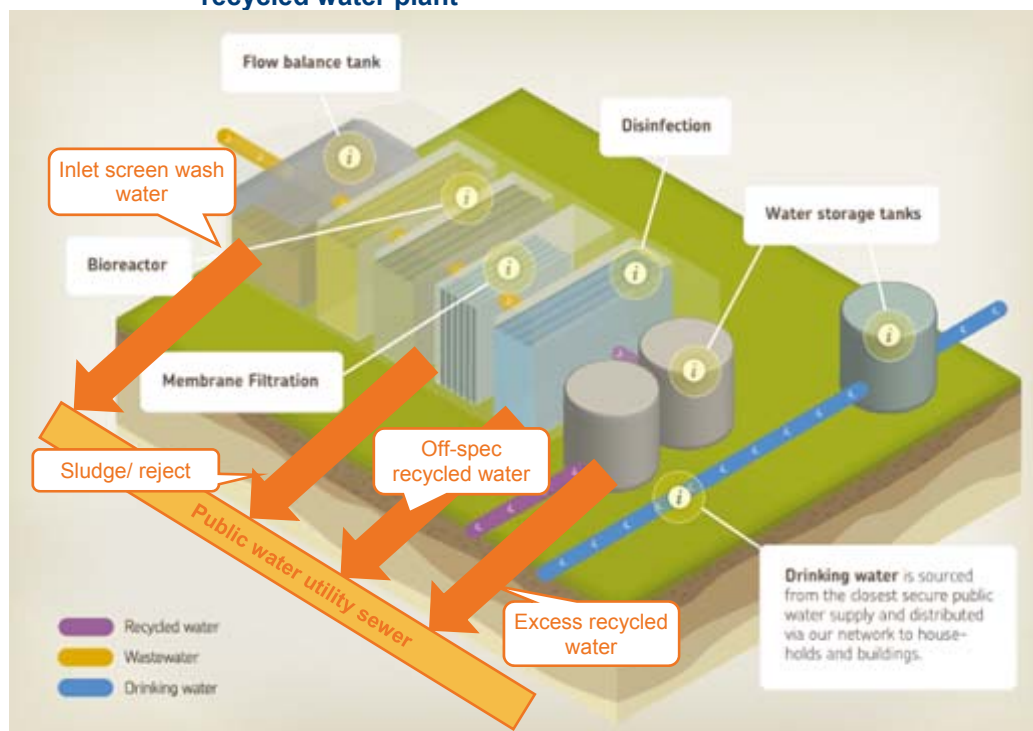
IPART's draft decision treats the sewerage collected by the new entrant as a factor of production and appears to only consider the discharge to sewer of reject from the membranes at the recycled water plant. Hunter Water encourages IPART to further consider the likely volumes and frequency of discharge to the wholesale provider's sewerage system to confirm whether the non-residential prices are likely to be cost reflective.

IPART's draft decision does recognise the potential for bypass of the recycled water plant by nominating the 'retail-minus' price for on-selling sewerage services to apply when the recycled water plant is bypassed, or only treats wastewater from some end-use customers. Conceptually, this appears to create a pricing approach that better reflects the quality and quantity of potential discharges. However, it is unnecessarily complex to the point where it may not be possible to calculate accurate billable amounts

Hunter Water has a number of practical questions about applying the Draft Determination and Report in situations when the recycled water plant is bypassed, or only treats wastewater from some end-use customers.

- For the retail component, would a pro rata of end user sewer service charges apply based on the proportion of the time in bypass mode? If so, based on what time increments?
- If the recycled water plant only treats the wastewater from some end-use customers, which ones are 'deemed' to have been subject to on-selling? This is particularly relevant if the wholesale customer services both residential and non-residential end-users with a mix of meter sizes, discharge factors and discharge allowances.
- How should Hunter Water calculate billing amounts when there is partial bypass of the recycled water plant (e.g. sludge/ reject or off-specification recycled water)?

Figure 3.2 Conceptual drawing of liquid waste disposal from a wholesale customer's recycled water plant



Source: Based on <http://cooranbongwater.com.au/how-it-works/local-water-centre/>

3.3.3 Retail-minus pricing is appropriate

Hunter Water is of the firm view that 'retail-minus' is the most appropriate pricing approach for this service. IPART acknowledges the arguments in support of this approach in the draft report.²⁴ That is, the recycled water plant is the means by which the new entrant provides a sewerage service to its end-use customers. Moreover, the recycled water service provides "end-use customers with the same service or a close substitute to one provided by Sydney Water or Hunter Water" (i.e. sewerage service).²⁵ In effect, the recycled water scheme can be considered a form of on-selling sewerage services to end users. There is no need for a separate wholesale price for recycled water waste disposal.

At the public hearing for this price review, Lend Lease conceded this point for the Bingara Gorge development:²⁶

We built a recycled water plant there that deals with the volume of wastewater produced rather than the volume of recycled water that they are likely to consume. So we have a water balance challenge ahead...

...In that particular example, we have built a scheme that really is about taking wastewater and turning it into something that we could dispose of one way or another. If we were just building a recycled water plant to produce recycled water for consumption, it would be about one-third the size of that.

The criticality of the public water utility's wastewater system to the new entrant's provision of a similar service is exemplified by the following hypothetical, yet plausible, situation. The wholesale customer discharges inlet screen wash water and membrane reject to the public water utility's sewer. It then detects off-specification (below quality) recycled water which it discharges to sewer. The volume and quality of the new entrant's discharge is essentially the same as it would be without the recycled water plant – there would be no service transformation. The same problem applies for discharges of excess recycled water

IPART asserts that "the non-residential retail price...is broadly cost reflective..." however it does not take into account the capacity required in the public water utility's receiving sewerage system and the required ability to treat the pollutant load to an appropriate standard at a public water utility's wastewater treatment plant.²⁷

IPART's draft decision to adopt a non-residential retail pricing approach for recycled water waste disposal has taken into account the risk that setting the price too high may result in inefficient bypass, such as using tanker trucks to transport the waste to an intermediate receival facility.²⁸ Hunter Water considers a greater risk is created by the draft pricing decision in that it incentivises inefficient operation of the recycled water plant by providing a method of cheaply disposing of partially treated wastewater. A profit-maximising business would not maximise recycled water production, particularly given that any shortfall can be made up with drinking water. The draft report does not consider or discuss such outcomes.

²⁴ IPART, 2016 (b), Box 7.1, page 81.

²⁵ IPART, 2016 (b), page 29, definition of a wholesale service.

²⁶ IPART, 2016 (c), page 57, lines 40-43 and page 58, lines 4 to 9.

²⁷ IPART, 2016 (b), page 82.

²⁸ The intermediate facility may partially treat the wastewater prior to discharge into the public water utility's sewerage system under a trade waste permit. Arguably, the WICA licensing process already provides a mechanism to assess the acceptability of tankering as a permanent recycled water waste disposal solution.

3.3.4 Recycled water cost recovery differences between public and private providers

IPART's 2006 recycled water pricing guidelines sets out the methods by which the costs of recycled water schemes can be recovered. Whilst the guidelines only apply to New South Wales price-regulated metropolitan water utilities, IPART acknowledged that the likely role of WIC utilities in the recycled water market:²⁹

The Tribunal appreciates that the private sector is likely to play an increasingly important role in the provision of water related services in the future. The Tribunal has sought to develop approaches to charging for recycled water services that are not only applicable to the existing industry structure, but can also be applied to a market in which private sector participants are playing a greater role.

At that time IPART's objectives for recycled water pricing were economic efficiency; revenue adequacy; transparency and administrative simplicity; equity; competitive neutrality; and compliance with national reforms.³⁰ Three of these objectives are particularly relevant to this wholesale pricing review:

- Revenue adequacy³¹

In general, the prices of water services provided by a water agency should enable the agency to recover the full costs associated with providing those services where these costs reflect the efficient long-term means of balancing supply and demand...

...recycled water schemes interact with potable water and sewerage services and investments in a way that means they may enable lower costs elsewhere in the system – such as by enabling the agency to avoid or defer investing in additional sewage treatment capacity to meet environmental discharge requirements. Recycled water schemes may also provide broader external benefits, such as better environmental outcomes. Where this is the case, it may be appropriate for the agency to recover at least some of the costs of delivering recycled water services from its whole customer base.

- Competitive neutrality³²

The pricing of recycled water services should ensure consistent treatment of all potential suppliers in the market, whether they are private companies or government-owned water agencies.

- Compliance with national reforms³³

The National Water Initiative (NWI), which has been endorsed by the Council of Australian Governments, requires pricing policies to “encourage the re-use and recycling of wastewater where cost effective.”

IPART's draft decision establishes two sets of pricing rules for recycled water schemes – one for public water utilities and another that allows private utilities to earn large margins from retail sewerage customers.

²⁹ IPART, 2006, page 4.

³⁰ IPART, 2006, page 15.

³¹ IPART, 2006, page 16.

³² IPART, 2006, page 17.

³³ IPART, 2006, page 17.

Public water utilities are not allowed to cross-subsidise recycled water schemes using sewerage revenues, except in very limited circumstances:³⁴

...economic principles suggest that where a firm supplies a number of services, the prices for each service should be set in a way that enables the total costs of delivering all services to be recovered while also ensuring that no individual service is subsidised by the others.

Conceptually, IPART's recycled water pricing guidelines allow for some of the costs for recycled water schemes to be recovered from the broader customer base where there are deferred or avoided costs in the water or sewerage systems as a result of the recycled water scheme.³⁵ Cross-subsidies from water and/or sewerage customers to recycled water schemes are calculated as the expected change in the present value of an agency's operating and capital expenditure with and without the recycled water scheme (i.e. the recycled water scheme must be the least cost water supply or sewerage solution).

In practical terms, IPART has put in place significant barriers for a public water utility to justifying a cross-subsidy where none of these barriers exist for WIC utilities. For example, cross-subsidies between products:³⁶

- can only be assessed as part of a four-yearly retail price review,
- need to be re-justified at each subsequent price review, and
- are subject to a post-adjustment mechanism when the actual avoided costs are materially different from forecast.

IPART's draft decision creates an uneven playing field in the provision of recycled water services and is contrary to the 2006 recycled water pricing objectives. This inconsistency should be corrected as part of this wholesale pricing review or through a review of the recycled water pricing guidelines for public water utilities.

3.3.5 Practical alternative approaches

Hunter Water understands that the pricing approach for recycled water waste disposal services is a complex and contentious issue. A retail-minus approach could be implemented in a manner that balances various considerations while maintaining flexibility for further refinement during future wholesale pricing reviews. Two possible modifications to the retail-minus approach are suggested:

Option 1: A retail-minus approach where the minus component reflects the competitor costs in partially treating sewage from within a development area prior to discharge into the public water utility's sewerage system. The additional minus amount would reflect the quality and quantity of discharges expected in practice or given various levels of transformation.

Option 2: IPART could set a 'notional negative facilitation amount' that approximates deferred or avoided costs in the water or sewerage systems as a result of the recycled water scheme. The size of adjustment factor could be refined through time. At the next wholesale price review, IPART should have more reliable information on the actual avoided costs or deferral benefits associated with recycled water schemes that are fully commissioned and servicing new developments.

Hunter Water emphasises the importance of establishing the right regulatory precedents that do not 'lock-in' unintended consequences. Hunter Water requests that IPART reconsider a retail-minus approach to pricing recycled water waste disposal service. It may be necessary for IPART to undertake further stakeholder consultation on possible pricing models for waste discharge from recycled water schemes. There is no imperative to commence the final determination from 1 March 2017.

³⁴ IPART, 2006, page 24.

³⁵ IPART, 2006, page 27.

³⁶ IPART, 2011, page 1.

4 IMPLEMENTATION

IPART has developed a robust and workable set of arrangements to implement its decisions on system-wide wholesale prices for the on-selling of water and sewerage services and the setting of scheme-specific wholesale prices.

Under IPART's draft arrangements for determining scheme-specific prices, the wholesale customer or the wholesale service provider writes to IPART to request a price review and determination for an existing or proposed wholesale water and/or sewerage scheme. IPART indicates that it may issue guidance on the information that must be included in a request for a scheme-specific review, including the parties involved, a description of wholesale service and the reasons why a scheme-specific review is being requested.³⁷

IPART places much of the onus for conducting the early stages of any scheme-specific determination on the wholesale service provider. The public water utility would be required to submit a 'wholesale pricing proposal' within a specified timeframe. The proposal would need to include information on:³⁸

- how the wholesale customer's input has been considered,
- the infrastructure and operating requirements to provide end-users with retail services,
- the net facilitation costs the wholesale provider would incur,
- the wholesale service provider's relevant growth plans, and
- proposed transitional pricing arrangements.

Hunter Water offers a number of suggestions to streamline these processes and better allocate future workloads. First, the party that requests a scheme-specific review should be responsible for describing how the parties have consulted, areas of agreement and disagreement, and providing a rationale for why the IPART-determined wholesale prices are not appropriate. The onus should not default to the wholesale service provider if it is the wholesale customer that has lodged the request.

Second, IPART should take into account all of the administration and resourcing costs for all parties before deciding whether to proceed with a scheme-specific review. In addition, Hunter Water considers that the wholesale service provider should be able to recover legal, administration and regulatory costs associated with reviewing and implementing scheme-specific wholesale prices.

Third, Hunter Water accepts that a wholesale customer may create deferral benefits or result in avoided costs for the public water utility. More work needs to be carried out to calculate such benefits and demonstrate the permanency of such savings.

Hunter Water agrees that a pricing period of up to five years is appropriate for one-off, scheme-specific determinations. This would provide certainty for both parties without locking in wholesale prices that may be too high or low for an extended period. Flexibility is particularly important given competition in the water industry is in its early stages. IPART could consider longer determinations when there is better information on actual operational practices (e.g. drinking water usage and wastewater discharge volumes), and better published data on the costs of contestable services.

Hunter Water notes that a feature of IPART's proposed approach is that it should cap the time taken to complete a scheme-specific review. IPART can ensure that no party is able to 'strategically protract negotiations' by setting a fixed timetable for each step in the public review process. Such an approach should remove the need to set interim scheme prices, given that pricing would default to the system-wide prices. It also reduces the need for some of true-up mechanism.

³⁷ IPART, 2016 (b), page 92.

³⁸ IPART, 2016 (b), pages 93 and 94.

5 CONCLUSION

Hunter Water supports the majority of decision in the draft report. The three key issues are:

1. **The retail-minus approach to pricing wholesale services purchased for the purpose of on-selling**

Hunter Water agrees this is the most appropriate approach within the constraints of the current New South Wales legislative and policy framework.

2. **The approach to setting the minus component of the retail-minus price including the quantum of the minus discount**

In principle, the minus component should be based on an 'as efficient competitor' rather than a 'reasonably efficient competitor' if the pricing is to achieve IPART's stated aim of encouraging competition to occur only where it is efficient. If competition is intended to benefit all customers, the potential for dynamic efficiencies need to be harnessed through a transition to an 'as efficient competitor' minus component over the medium term.

The draft minus component allows the new entrant to be two to three times less efficient than Hunter Water in providing services. This inefficiency is subsidised through higher prices paid by the new entrant's retail customers, higher prices paid by Hunter Water's customers or by the NSW community.

3. **The non-residential approach to pricing recycled water waste disposal**

Hunter Water disagrees with IPART's assertion that "*the non-residential retail price...is broadly cost reflective...*" Hunter Water is of the view that this pricing approach has the potential to incentivise the inefficient operation of recycled water schemes by private water utilities. The draft decision to price this service separately to on-selling fails to recognise the new entrants' primary motivation for building and operating a recycled water plant – to provide a sewerage service to new developments. Hunter Water also questions whether it would ever be possible to correctly calculate billing amounts on the basis of the draft report.

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APPENDIX A

LIST OF DRAFT DECISIONS AND RESPONSES

DEFINITION OF WHOLESALE SERVICES

1. For the purposes of this review, we have decided a wholesale service is: (a) a service purchased from Sydney Water or Hunter Water by a customer; (b) that is used by that customer to potentially compete with the relevant utility (ie, Sydney Water or Hunter Water) for end-use customers; and (c) that has the following characteristics:
 - The service purchased by the wholesale customer is a monopoly service.
 - The service purchased by the wholesale customer is used to provide its end-use customers with the same service or a close substitute to one provided by Sydney Water or Hunter Water (the wholesale service provider). In effect, this means wholesale services:
 - a. are limited to those used to supply end-use customers with services that Sydney Water or Hunter Water could provide within the limits of their operating licences
 - b. can include some transformed services (eg, a wholesale drinking water service to top up a recycled water scheme to provide recycled water).
 - The service purchased by the wholesale customer is used (by the wholesale customer or another party that it supplies) to supply end-use customers under a retail supplier's licence under the WIC Act.

Hunter Water supports IPART's draft decisions on the definition of wholesale services. IPART's definitions address issues raised by Hunter Water in response to the Discussion Paper (e.g. inter-regional transfers outside the public water utility area of operations that do not result in competition).³⁹

Hunter Water does not agree with IPART's proposed pricing approach for recycled water top up or the discharge of waste from a recycled water scheme.

APPROACH TO IMPLEMENTING WHOLESALE PRICES FOR THIS REVIEW

2. We have decided to adopt a determination period of four years and four months, from 1 March 2017 to 30 June 2021 for the system-wide determinations.

Hunter Water supports a four-year determination period, and a one-year lag between retail and wholesale price reviews. IPART's proposed approach:

- strikes a reasonable balance in providing a degree of price certainty for wholesale customers, without locking in IPART's coarse estimates of reasonably efficient competitor costs for too long;
- is long enough period to observe possible trends in the market – for example, changes in the form or mix of services offered by wholesale customers, and the level of new entry by private operators.

The sequencing of retail and wholesale price reviews has the benefit of evening out the resourcing workload for Hunter Water, IPART and stakeholders compared with a parallel review of retail and wholesale prices.

³⁹ Hunter Water, April 2016, page 9.

3. We have decided the system-wide wholesale price determinations would only apply to new wholesale services (or 'schemes').

Hunter Water accepts IPART's draft decision to 'grandfather' existing agreements and notes that the new determination would not apply to:

- Wholesale water services for on-selling and top-up to Huntlee Water (Flow Systems) and Cooranbong Water (Flow Systems) schemes.
- Hunter Water's temporary agreement to provide wholesale sewerage services for on-selling to Cooranbong Water (Flow Systems) scheme.

PRICING APPROACH FOR ON-SELLING DRINKING WATER AND SEWERAGE SERVICES

4. We have decided to use a retail-minus approach to set prices for the wholesale supply of drinking water and sewerage services for the purpose of on-selling to end-use customers.

Hunter Water agrees with IPART's draft decision to apply retail-minus pricing of wholesale services – see section 2 of this response.

5. We have decided to use the reasonably efficient competitor cost as the minus component in retail-minus prices for the wholesale supply of drinking water and sewerage services for the purpose of on-selling to end-users.

Hunter Water does not agree with IPART's decision to apply the reasonably efficient competitor benchmark for calculating retail-minus components – see section 2 of this response.

6. We have decided the retail charges in the retail-minus reasonably efficient competitor cost prices will be the sum of end-use customer retail charges based on the prevailing Sydney Water or Hunter Water determination.

Hunter Water agrees with IPART's decision to implement system-wide wholesale prices using the retail charges for each end-use customer within a WIC utility scheme.

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- 7. We have decided to calculate the reasonably efficient competitor costs based on:**
- an annual building block cost that has an initial valuation of assets at the undepreciated cost to reflect a new entrant's costs, operating expenditure matched to asset age, gifted assets treated as assets free of charge, and a return on assets based on the prevailing Sydney Water and Hunter Water real post-tax WACC of 4.9%
 - an equivalent annuity of the annual building block costs over a 50-year period using a discount rate based on the prevailing Sydney Water and Hunter Water real pre-tax WACC of 5.9%, and
 - the cost drivers of the service (ie, per customer for retail functions and per kilometre of pipeline for reticulation functions).

Hunter Water supports the underlying building block methodology and the use of the prevailing WACC to calculate the reasonably efficient competitor costs.

Hunter Water questions some of IPART's assumptions used to derive the minus allowances – see section 2.2 of this response.

PRICING APPROACH FOR DRINKING WATER TOP-UP TO RECYCLED WATER SCHEMES

- 8. We have decided wholesale customers that purchase drinking water to top up their recycled water schemes should be charged the wholesale supplier's non-residential service and usage retail prices for the drinking water supply.**

Hunter Water accepts the application of non-residential prices of drinking water top-up services. Drinking water prices are dominated by the usage charge and there is little difference between the pricing outcomes under non-residential compared with retail-minus approaches. For further detail refer to section 3.2 of the main body of this response.

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- 9. We have decided that wholesale customers that purchase drinking water for the purpose of on-selling and drinking water top-up should be charged:**
- a retail-minus price for the water supplied for on-selling, and
 - the retail non-residential water service and usage prices for the water supplied for drinking water top-up.

It would be more appropriate and administratively simpler to apply the prices for on-selling services to services used in relation to recycled water production, however this draft decision is supported.

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- 10. We have decided that in cases where the connection to the recycled water system (drinking water top-up) is not separately metered, wholesale customers should be charged a non-residential retail service charge for drinking water top-up based on a deemed meter size of 100mm.**

This draft decision is practical and will make the determination easier to implement.

PRICING APPROACH FOR RECYCLED WATER SCHEME WASTE DISPOSAL

- 11. We have decided that waste from recycled water plants should be subject to non-residential retail prices (including trade waste charges, where applicable) for sewerage services.**

The draft decision to adopt non-residential prices for waste from recycled water production is inconsistent with recycled water pricing arrangements for public water utilities. This creates an artificial advantage for new entrants and rewards inefficient recycling practices as a means of providing a sewerage service.

The pricing approach for recycled water scheme waste disposal services is not conceptually sound and is unnecessarily complicated in its treatment of situations when the recycled water plant is bypassed, or only treats wastewater from some end-use customers. Moreover, it incentivises inefficient operation of the recycled water plant by providing a method of inexpensively disposing of partially treated wastewater.

IPART should reconsider a retail-minus approach to pricing recycled water waste disposal service, even if this delays the final pricing decision so that additional stakeholder consultation can occur.

For further detail refer to section 0 of the main body of this response.

FACILITATION COSTS

12. We have decided that facilitation costs should be included in wholesale prices where they are:

- **additional to what the wholesale service provider would have otherwise incurred in the absence of servicing the wholesale customer, and**
- **not reflected elsewhere in the wholesale price or recovered via another charging or funding mechanism of the wholesale service provider.**

IPART identifies three types of facilitation costs:

- Positive facilitation costs arise if a wholesale service provider needs to upgrade or extend its water or sewerage network to provide services to a wholesale customer.
- Negative facilitation costs may arise if a wholesale customer produces recycled water that allows the public water utility to defer a water supply augmentation.
- Transaction costs – legal costs of establishing a supply agreement and the administration costs of servicing wholesale customers.

Hunter Water agrees it is conceptually correct to include facilitation costs in wholesale prices.

13. We have decided not to include facilitation costs in the draft system-wide wholesale prices and therefore would only consider them in scheme-specific determinations.

Hunter Water supports IPART's decision not to include infrastructure-related facilitation costs in the system-wide wholesale prices. It would be unlikely that any one development involving recycled water would provide sufficient deferral benefits to justify a scheme specific determination, particularly prior to reaching the full uptake of lots.

14. We have decided that facilitation costs should:

- **reflect the status of water and sewerage developer charges**
- **include positive (costs) and negative costs (cost savings), where appropriate**
- **exclude initial transaction costs, and**
- **exclude ongoing administration costs, except where they are material.**

Hunter Water applies the same growth funding policy to all major new developments. If a development is on the fringes of Hunter Water's system and requires a substantial augmentation of lead-in and lead-out infrastructure, we would generally require the developer to fund some or all of the infrastructure costs. This approach applies uniformly to all major developments.

IPART has provided further support to wholesale customers by excluding initial legal and transaction costs, as well as administration costs for on-selling arrangements. Hunter Water has already absorbed substantial legal costs in developing utility service agreements.

SCHEME-SPECIFIC REVIEWS AND UNREGULATED PRICING AGREEMENTS

15. We have decided to use the process in Box 9.1 to review and determine scheme-specific prices for wholesale water and/or sewerage services.

IPART's draft determination and report provide two mechanisms whereby alternative pricing arrangements may be made if IPART's system-wide prices are not considered reflective of a particular wholesale scheme's characteristics:

- The parties may agree together to opt-out of IPART's determined wholesale prices and enter into an unregulated pricing agreement, or
- The wholesale service provider or wholesale customer may request a scheme-specific price review and determination. IPART may also initiate a scheme-specific wholesale price review.

Hunter Water supports IPART's overall approach to setting scheme-specific wholesale prices in limited circumstances. It is appropriate that IPART decides whether to proceed with or defer a review, or to leave existing prices unchanged. Hunter Water's response proposes some improvements to the process for triggering a scheme-specific review.

16. We have decided not to set an interim price to apply while a scheme-specific review is being undertaken, or apply a true-up mechanism to adjust for any differences between the price before and after a scheme-specific determination is made.

Hunter Water agrees that setting interim prices is not necessary, as the IPART-determined system-wide wholesale prices are the default prices for new agreements.

Hunter Water supports IPART's decision not to have a true-up mechanism at this stage, given the maximum 12 month timeframe envisaged for reviews and that scheme-specific reviews can be completed before supply to a scheme has commenced.

17. We have decided to allow wholesale service providers and wholesale customers to opt-out of IPART's determined wholesale water and sewerage prices by voluntarily entering into unregulated pricing agreements.

Hunter Water requests that IPART provide further clarification in the final report of reporting requirements in relation to unregulated price agreements. This should include details of IPART's position on the form and extent of ring-fencing of costs and revenues associated with unregulated agreements.
