



Economic Regulation Authority

*Promoting fair prices, quality services and choice*

Our Ref: D67471

26 May 2011

Inquiry into Australia's Urban Water Sector  
Productivity Commission  
Locked Bag 2, Collins Street East  
MELBOURNE VICTORIA 8003

## **SUBMISSION FROM THE ECONOMIC REGULATION AUTHORITY IN RESPONSE TO THE PRODUCTIVITY COMMISSION DRAFT REPORT ON AUSTRALIA'S URBAN WATER SECTOR**

Thank you for the opportunity to provide a submission in response to the Productivity Commission's (**Commission**) Draft Report on Australia's Urban Water Sector. The Economic Regulation Authority (**ERA**) in Western Australia has undertaken a number of inquiries into Western Australia's urban water sector that are relevant to your inquiry.

### **BACKGROUND**

The ERA in Western Australia has two main functions:

- Western Australia's economic regulator; and
- an independent and transparent advisory body to the State Government.

The ERA's functions in the water sector involve issuing licences to providers of water, wastewater, drainage and irrigation services, monitoring compliance with the conditions of these licences and taking enforcement action when needed.

The ERA does not formally regulate the prices of Western Australia's main water service providers, but instead provides recommendations to Government on water and wastewater prices through its advisory role. In its advisory role, the ERA inquires into and reports on matters referred to it by the State Government. Inquiries, and the reports which follow, generally involve extensive public consultation carried out in an independent and transparent way. When the ERA undertakes inquiries or prepares reports, it makes recommendations to the State Government, not regulatory decisions.

The ERA's submission in response to the Commission's issues paper provided a brief description of and links to past inquiries by the ERA on water sector issues.

## COMMENTS ON DRAFT REPORT

### *Responsibility for procurement and investment*

The Commission recommends the structural separation of the bulk water component of integrated water service providers from the retail-distribution component. The retail-distribution utilities would be assigned responsibility for meeting security of supply standards and procuring water supply services (Draft Recommendation 11.1).

There are likely to be significant gains to be made by providing a level playing field for all source procurement options, including the source option preferred by the main water service provider (the Water Corporation) as well as innovative solutions by private sector proponents. The ERA agrees that an independent purchaser is needed to ensure effective competition in the provision of new water supplies.

However, the ERA sees some risks in a 'big-bang' approach to restructuring the sector in Western Australia. In Western Australia, there are technical and operational linkages between bulk water supply and network/retail operations which can help to manage the supply/demand balance. This is particularly important given the considerable uncertainty about future climate, water supply and demand in the south of the State. There is also the potential for increases in synergies between water and wastewater in the future due to technological advances, such as in desalination and wastewater recycling. In addition, a study undertaken by ACIL Tasman as part of the ERA's 2008 Inquiry into Competition in the Water and Wastewater Services Sector (**Competition Inquiry**) indicated the existence of economies from vertical integration.<sup>1</sup>

The separation of bulk water supply might be an option for the Western Australian water sector in the future. However, the ERA recommends a phased approach to structural reform (if this is assessed as being economically efficient at a later date). For this reason, the ERA's preferred model for the initial reform of the Western Australian urban water sector is that of an Independent Procurement Entity (**IPE**), which would have responsibility for ensuring that supply and demand are balanced at least expected cost. The roles and functions of an IPE were outlined in the ERA's final report for the Competition Inquiry and are reproduced in **Attachment 1**. The IPE model can be seen as a way of introducing independence and competition into the provision of bulk water without increasing supply risk or losing the benefits of vertical integration. It would give market participants confidence in bulk water supply procurement processes, which could in the future lead to full bulk water supply separation.

The Water Corporation's preferred model, as proposed to the ERA in the Competition Inquiry, is that of an independent panel to undertake procurement decisions. However, the IPE would have its own secretariat rather than relying on advice from the Water Corporation, so it would allow for greater capacity and independence in the identification and analysis of alternative options. The ERA considers it more likely that alternative providers will submit options to a totally independent body, rather than a panel that depends on information and analysis by the Water Corporation.

---

<sup>1</sup> ACIL Tasman (2007), *Size and Scope Economies in Water and Wastewater Services*, available on the Authority's website, [www.erawa.com.au](http://www.erawa.com.au), at the following link:  
[http://www.erawa.com.au/2/692/46/inquiry\\_into\\_competition\\_in\\_the\\_water\\_and\\_wastewat.pm](http://www.erawa.com.au/2/692/46/inquiry_into_competition_in_the_water_and_wastewat.pm)

There would be coordination benefits in locating responsibility for water supply and demand management within a single agency, rather than having these functions dispersed, as they currently are, between the Water Corporation, the Department of Water and Government Ministers. The introduction of an IPE would not add any risk to supply security, as the “fall-back” option for any supply augmentation would always be the preferred option of the Water Corporation.

The Commission’s main concern with the IPE is that it would be difficult to hold an IPE accountable for its decisions. The ERA does not agree with the Commission that an IPE would be any less accountable for its decisions than a government-owned utility, such as a Government Trading Enterprise. The IPE’s allowable revenue would be determined by the ERA and its budget approved by Government.<sup>2</sup> In addition, the IPE could be held accountable through a similar charter to what the Commission has proposed for an independent retail/distribution provider, or through requirements under relevant legislation. For example, the Reserve Bank is held accountable through the *Reserve Bank Act 1959*, which sets out the objectives for monetary policy. In addition, the Reserve Bank’s Statement of the Conduct of Monetary Policy records the common understanding of the Reserve Bank and the Government on key aspects of Australia’s monetary and central banking policy framework, including an agreement between the Reserve Bank and the Government on an appropriate target for inflation.

### ***Charters, price monitoring and price regulation***

The Commission recommends a move away from price regulation in the urban water sector, towards a framework based on charters between governments and urban water utilities. The Commission notes that economic regulators could provide advice to government on the contents of the charter and oversee reporting against the charter (Draft Recommendation 11.2). The Commission also recommends moving away from price regulation and towards price monitoring (Draft Recommendation 11.4). The Commission’s case against price regulation is that the two major reasons used to justify regulation in the water sector are not valid. The Commission notes that the major reasons for regulation of the sector are affordability or distributional concerns (p98) or ensuring that water is priced on a full cost recovery basis (p99). Additionally, the Commission notes that there can be considerable costs to regulation.

The ERA agrees that affordability issues should be dealt with directly by Government and notes that this occurs in Western Australia through government-mandated concessions and government-funded community service obligations.

However, the ERA has some concerns about the Commission’s recommendations regarding price monitoring rather than regulation. Price monitoring can be a weak instrument for ensuring competitive consumer prices are provided by a monopoly supplier. The ERA’s understanding is that the form of price monitoring envisaged by the Commission would depend on the contents of the charter, so that monitoring would indicate when particular charter conditions are not being met. However, for price monitoring to be effective, a method of enforcing compliance with charter conditions would also be required.

The Commission notes that “the role of price regulation has traditionally been to deal with concern about excessive pricing by infrastructure providers with market power”, implying that it sees no concern about this type of behaviour in water services providers. Effectively, the Commission’s view is based on the assumption that there are little gains to be had from improving allocative efficiency. The ERA notes (as does the Commission) that there are

---

<sup>2</sup> This reflects the governance arrangements for Western Australia’s Independent Market Operator, the independent body responsible for administering and operating the wholesale electricity market in the south-west of the State, including ensuring that there is adequate capacity to meet customer demand.

three aspects to economic efficiency – allocative, productive and dynamic (Box 3.5 in the draft report). Allocative efficiency is a problem when a good or service is provided by a non-regulated profit-maximising private monopoly, as it has an incentive to restrict production below the socially optimal level, with consequent welfare losses. A non-regulated private monopoly does, however, have an incentive to improve productive and dynamic efficiency, as it can retain the proceeds of improvements in these forms of efficiency.

The ERA would agree that allocative efficiency is not a significant problem in the publicly-owned Western Australian urban water sector for the reasons outlined by the Commission. However, the consequence of a lack of a profit focus is that there may be problems in terms of productive efficiency and dynamic efficiency. In the absence of regulation, the productivity of the sector over time will be less than under a regulated sector, due to a reduced incentive to achieve efficiency gains.

Hence, if charters are to be used to set the requirements of water service providers, they would need to incorporate provisions to require that the prices paid by customers are based on efficient costs. The monitoring of prices against such charter conditions would need to be independent, and would need to identify (and be supported by mechanisms to ensure) that prices reflect:

- efficient operating costs;
- capital investment decisions that have been made by considering all viable alternatives; and
- a rate of return commensurate with the level of risk of the business.

Such reviews would necessarily involve examination of the service providers' costs and rate of return and the setting of productivity targets. For example, in 2005, following advice from the ERA, the Government imposed as a target for the Water Corporation a 1.88 per cent per annum reduction in real per connection operational costs, which resulted in charges to consumers in 2009/10 being \$59.7 million lower than if this target had not been imposed.

The ERA acknowledges that there are costs to regulation and looks to minimise these costs where possible – although a price monitoring approach, to be effective, may not be any less intrusive or costly than regulation. The ERA does not consider that the costs of efficiency reviews would outweigh the benefits. Rather, the information required for such reviews is information that any well-run service provider should have readily available. Some service providers in other industries have commented to the ERA that the process of regulation has helped them to understand their businesses. The cost imposition on service providers can be reduced through clear communication between regulators (or price review bodies) and service providers and the establishment of appropriate information management systems.

It should be noted that the ERA has recommended that under an IPE model, water tariff structures would be determined by the IPE, with the ERA setting the revenue requirement for the Water Corporation and other major water service providers (and possibly also approving the allowable revenue for the IPE).

### ***Tariff options for customers***

The Commission recommends that customers be given more choice on their prices and security of supply, by providing different tariff options, including flexible tariffs that provide a guaranteed supply at a volumetric charge that reflects the scarcity value of water, as well as tariff options where charges are stable for an extended period. The Commission also recommends a move away from inclining block tariffs in retail prices (which the Commission considers result in efficiency losses) towards a flat volumetric tariff (Draft Finding 7.3).

The ERA considers that there is merit in investigating the idea of flexible tariff options, as such an approach would provide customers with more choice, depending on the value they place on water use. The ERA has supported such flexible tariff options in previous inquiries. In its most recent inquiry into water tariffs in 2009, the ERA noted that reflecting the short term value in usage charges could have benefits, as it would provide some scope for using price to defer large source developments if there is uncertainty about their utilisation. Further, it would allow for price, rather than restrictions, to be used to deal with short-term water shortages, which in turn would more effectively allocate water to those who value it most.

There would also be merit in moving towards a flat volumetric tariff if there was certainty regarding the marginal cost of water (both long and short run). However, in Western Australia these costs are highly uncertain. Rainfall in Perth has decreased over the past 40 years, and average inflows into Perth dams over the past five years are around 17 per cent of average streamflows before 1970. It is not clear whether this trend will continue, and therefore what water sources and capacity will be required to meet future demand. This uncertainty makes it difficult to determine a single volumetric charge. Rather, there is likely to be a range of equally valid estimates of long run marginal cost (and short run costs), depending on underlying assumptions about future inflows, other water sources and costs. The uncertainties about future costs are so substantial that any efficiency gains of moving from an inclining block tariff to a single volumetric charge may not be realised.

### ***Real options approach***

The Commission recommends the application of a real options approach in the consideration of source options (Draft Recommendation 6.1). The Commission considers that regulation can be an impediment to a real options approach, as water service providers can find it difficult to obtain regulatory approval for decisions where a real options approach has been applied. The decision by the Western Australian government not to use water from the south-west Yarragadee is cited as an example where a real options approach would have resulted in substantial savings.

The ERA does not consider that economic regulation should hinder a real options approach by service providers. Rather, an options approach would sit comfortably within the sorts of assessments that service providers should be carrying out as part of any decision-making ahead of large capital investments. As long as the assumptions, uncertainties, impacts and costs of each decision are clearly set out, a regulator should have no problem in approving an options approach, particularly when it could lead to considerable cost savings with little impact on down-side risks.

### ***Structural reform***

The Commission recommended the aggregation of smaller regional water service businesses, and that consideration be given in Western Australia of the establishment of a regional water corporation (Draft Recommendations 13.1 and 13.3). The Commission also asked for further information on the potential for gains in efficiencies of scale and scope of different industry structures.

In its inquiry into competition in the water sector in 2008, the ERA considered the transfer of regional and remote water services, currently provided by the Water Corporation, to the regional electricity provider, Horizon Power, to create a regional power and water service provider. The ERA concluded that there could be benefits to this arrangement and recommended that a business case be developed.

In the same inquiry, the ERA also considered there were potential benefits from improved economies of scale in combining Busselton Water and Aqwest (two small adjacent regional water service providers in the south west of Western Australia) or amalgamating them with the Water Corporation.

The ERA's recommendations in the competition inquiry drew upon a consultant paper by ACIL Tasman on the economies of scale and scope in the water service industry (cited earlier). This paper, along with all of the reports on the competition inquiry, can be found on the ERA's website [www.erawa.com.au](http://www.erawa.com.au).

The ERA looks forward to the Commission's further reports on this inquiry.

Yours sincerely



LYNDON ROWE  
**CHAIRMAN**