Dear Sir/Madam

Please accept my second submission below.
Carol O'Donnell, NSW 2037.

SECOND SUBMISSION TO THE PRODUCTIVITY COMMISSION INQUIRY INTO MARKET MECHANISMS FOR RECOVERING WATER IN THE MURRAY/DARLING BASIN

This is my second submission to the Productivity Commission (PC) Issues Paper 'Market mechanisms for recovering water in the Murray-Darling Basin' to answer the questions:

What are the advantages and disadvantages of the different market mechanisms that could be used to obtain water for the environment? In particular, how do they compare in terms of compliance and transaction costs and the ability to meet different watering needs of environmental assets? (p. 19)

Are there other market mechanisms, not listed above, that the Commission should be considering?

One assumes that accounting methods and related prices are at the centre of the concept of market mechanisms. Some different market mechanisms (accounting methods) that can be used to obtain water for the environment are addressed in the draft National Water Initiative Pricing Principles and Consultation Regulation Impact Statement which are currently under discussion. The Productivity Commission should definitely be considering them. My response to these draft principles and consultation impact statement is below and I also offer it to your inquiry in response to the questions above.

THE DRAFT NATIONAL WATER INITIATIVE PRICING PRINCIPLES AND CONSULTATION REGULATION IMPACT STATEMENT ARE OPAQUE

This submission refers to the Draft National Water Initiative Pricing Principles and to the related Consultation Regulation Impact Statement (2009) prepared by the Department of the Environment, Water, Heritage and the Arts under the National Water Initiative (NWI) agreed by the Council of Australian Governments in 2004 and which are currently the subject of public consultation. The broader commitments made by government under the NWI are discussed at the conclusion of this discussion of pricing principles.

Draft NWI Pricing Principle 5: Pricing transparency, states that urban water tariffs should be set using a transparent methodology, through a process which seeks and takes into account public comment, or which is subject to public scrutiny.

Draft NWI Pricing Principle 8: Transparency, states that prices should be transparent, understandable to users and published to assist efficient choices.

The main concern is that the pricing principles for existing asset valuation, asset investment and for the related sale or treatment of water are very confused and confusing in both documents under discussion. They are not transparent.

The Draft NWI Pricing Principles wrongly appear to assume that the meaning of 'transparent' is 'statutory based' when it states that:

> The water planning component of water planning and management is concerned with establishing transparent (statutory based) frameworks for ensuring an appropriate balance between economic, environmental and public benefit outcomes (p. 12).

The dictionary gives the meaning of 'transparent' as 'obvious'; that 'can be seen through distinctly'. Australia is awash with opaque legislation which makes the assessment of comparative service outcomes impossible, thus hindering good business and competition. Heaps of stupid legislation often prevent national and regional communities from achieving goals competitively and hinder secure investment. This problem is also driven by commercial in confidence requirements enshrined and fiercely defended by lawyers and others who love the quick buck and hiding their methods at the expense of industries and communities they should serve with governments. They cling to opacity instead.

The key problem of the Draft NWI Pricing Principles and the related Consultation Regulation Impact Statement (2009) is that both appear to rest on a confused and confusing amalgam of two different theoretical approaches to the market and competition. The Hilmer Report, which introduced national competition policy, defined competition as, '**striving or potential striving of two or more persons or organizations against one another for the same or related objects'** (1993, p.2). Hilmer saw competition as striving for goals which may be social or environmental as well as economic. His concept of competition is reflected, for example, in principles of health care service pricing and provision under the Casemix (diagnostically related group) funding system used by Medicare. With this pricing system one can see how competition ideally assists attainment of service quality, accessibility, equity and cost containment by public and private health care providers and insurers through data gathered for national and regional communities of service users, providers and funders. The Australian Medicare approach produces a better product than the US market does.

However, Hilmer's view of national competition policy, also reflected in health care, was botched in implementation to the Trade Practices Act (TPA), which reflects earlier views of the market and competition. The regulatory approach of the TPA is also contained in some Productivity Commission (PC) papers and reports, but not others. The TPA reflects the outdated assumption that competition is always for money and that the greatest number of market players provides the ideal conditions for the contest, which can only do everybody good. The market is conceptualised as composed of traders driven by laws of supply and demand, rather than composed of producers and consumers who operate in environments where governments ideally identify key goals in the public interest and then set about achieving them in related partnerships with industries and communities.

The NSW Metropolitan Strategy provides a global vision which health services, housing, transport and all related community service planning ideally serve. In the report of his ‘Inquiry into Electricity Supply in NSW’ (2007), Professor Anthony Owen also made the industrial and related community context of his discussion comparatively clear to the generally informed person who is not an expert in his field. However, one remains very ignorant and confused about the industry context and related government and community aims for water, in which discussion of pricing is ideally conducted for best results. The Consultation Regulation Impact Statement for the draft NWI pricing principles appears briefly to recognize some of the problems discussed here in the few lines written under the heading ‘Constraints to pricing policy’ on p.11. Nevertheless, one assumes the Department does not see its role as informing and advising ministers, but merely in reflecting the more naturally confused ignorance one may expect of people plucked from the electorate by their peers, who badly need the clear advice of experts. (Bad luck to all.)

The two objectives of the draft NWI pricing principles are to assist the Commonwealth and state and territory governments to achieve consistency in water charges ‘where water is traded’ and to provide ‘a best practice road map on a number of key areas relating to water pricing methodologies’(draft NWI Pricing Principles p. 2). The principles for recovering the costs of water planning and management activities also state that:

> Water planning and management aim to ensure the long term sustainability of the water resources, thereby enabling continued water use while maintaining the health of natural ecosystems (p. 12).

Q 1: Is it assumed that the term ‘where water is traded’ describes the same processes in regional and urban contexts? What exactly are these processes?

Q 2: How are the terms ‘traded’, ‘produced’ and ‘consumed’ expected to relate to each other in regard to water and to competition in regional and urban contexts?

Q 3: What are the key water businesses in regional and urban contexts?

Q. 4: What is the key asset base for water businesses; how does its current capacity relate to meeting identified government and community goals and what are they?

Q. 5: How is consistent water pricing adequately developed in the absence of clear reference and answers to the above questions on regional and metropolitan bases?

Q. 6: What valuation method for the water asset base, for investment, and for all related pricing are being recommended and why?

TOWARDS CONSISTENCY IN CHARGES ‘WHERE WATER IS TRADED’

NWI definitions are provided for the concepts ‘lower bound pricing’ and ‘upper bound pricing’. ‘Metropolitan services’ refer to water and wastewater services provided in metropolitan areas having in excess of 50,000 connections. Rural and regional' refers to water and wastewater services provided for rural irrigation and industrial users and in regional urban areas with less than 50,000 connections. However, one has no idea how 'a water business' is defined, the types of such business which exist, how they may serve related urban or regional goals, or the nature of those goals in a specific region such as the Murray Darling Basin. This area is specifically referred to in Appendix B of the NWI pricing principles which 'outlines a framework which classifies water planning and management activities' and states that 'the costs of some of these activities will be allocated entirely to government (e.g. water reform, strategy and policy)'(p. 19). This seems like crazy talk to me. What is the status of appendices in relation to the document?

The fact that government goals related to conservation or rehabilitation of the natural environment are key aspects of current government policy is recognized in passing in the discussion of the Consultation Regulation Impact Statement on the draft NWI pricing principles. It is also recognised in the current Productivity Commission (PC) Issues Paper 'Market mechanisms for recovering water in the Murray-Darling Basin'. It is vital to have a broad understanding of the community goals for which clearly defined services are ideally supplied, to fix related pricing principles and to judge their effect. What are these national goals, what is the current production related asset base, and how do water prices ideally relate to the achievement of these goals? Information about these services and the environmental contexts they relate to is lacking in papers under discussion.

For example, Appendix B of the draft NWPI Pricing Principles refers to capital costs and corporate services costs in relation to the National Water Initiative Murray-Darling Basin Agreement, but provides no further information about water related aims in this or any other geographic context. Although the recent PC paper states the Murray Darling Basin is home to many environmental sites identified under the Ramsar Convention, and that the Basin is Australia's largest and perhaps most important river catchment, which accounts for the majority of irrigated agricultural production, no more such information, which is vital for government and private sector decision making and related pricing and investment is provided. Can one discuss water pricing principles to achieve aims which are not identified in a production and related geographic community vacuum? I think not. Am I in favour of 'postage stamp' pricing? (Pricing Principles, p.9). God knows.

It is also unclear to me how competition is expected to relate to water pricing nationally or in related urban and regional contexts. For example, draft NWI Pricing Principles state 'for a range of reasons, the operation of water trading in an urban context is limited, and in some cases, is likely to remain so due to physical limitations'…….As urban water markets become subject to greater contestability it is likely that competitive pressures will have a greater role in determining water charges. (p. 9). These are mysterious statements to me. What assumptions and evidence are they based on?

According to the Consultation Regulation Impact Statement for the draft NWI pricing principles the Allen Consulting Group found that prices do not necessarily reflect fundamental supply and demand conditions in Australia as government and/or economic regulators rather than market forces determine urban water prices. The

Australian Competition and Consumer Commission also advised that the information about water planning and water management activities and charges in the Murray Darling Basin lack transparency (p. 25). Their solution, however, would probably be different to that of Hilmer, as the ACCC is fundamentally constrained by the older view of the market inherent in the TPA, rather than accepting the new approach to triple bottom line accounting- which may achieve social, environmental and economic goals – as reflected in Medicare Casemix funding methodology and as advanced by Hilmer and by governments, before they were killed off by older legal and financial forces and the TPA.
(Just when you think you've got out, that's when they pull you back in.)

A 'BEST PRACTICE ROAD MAP' FOR WATER PRICING METHODOLOGIES

The COAG Best Practice Regulation Handbook 'requires that regulatory impact statements should identify a range of viable options and demonstrate consideration of a range of policy options and the benefits and costs of these options' according to the Consultation Regulation Impact Statement on the draft NWI pricing principles (p. 13). However, this is not done clearly in regard to any current Commonwealth, state or territory context. The reader of both documents is confused about what pricing methodologies are being used anywhere currently, what pricing methodologies are ideally recommended for the future and why. This is discussed in relation to some principles for existing and new assets below, but the same problem exists in regard to the discussion of 'upper bound' and 'lower bound' service pricing, or to 'scarcity pricing' which is referred to in passing, along with a great many other accounting concepts.

Principle 1 Cost Recovery of the draft NWI Pricing Principles refers to the basic desirability of identifying a 'Weighted Average Cost of Capital' (WACC). According to the draft NWI Pricing Principles document, the Expert group that played a role in developing the COAG pricing principles recommended the adoption of the **deprival value methodology for asset valuation and charging purposes** (p.4).

However, it is also stated that the two main approaches used to calculate the revenue requirement for capital investment are:

a. the annuity approach; and
b. the Regulated Asset Base (RAB) or building blocks approach.

Furthermore, a footnote (p.5) states that the initial asset base may be valued in a number of ways including through:

- Depreciated replacement cost (DRC)
- Depreciated optimised replacement cost (DORC)
- Optimised replacement cost (ORC)
- Economic valuation
- Optimised deprival value (ODV)
- Depreciated actual cost (DAC)
- Or using another recognised asset valuation method

Principle 3: Valuation of legacy assets states that legacy assets which are to be retained should be valued at DRC, DORC, ORC, indexed actual cost, ODV, or using another recognized valuation method. Legacy investment decisions are defined as 'decisions made prior to the legacy date', which may be no later than 1 January 2007.

Principle 5: Rolling forward asset values after the legacy date requires the use of the DRC or DORC methodology

Principle 6: New contributed assets requires the use of the RAB methodology

Appendix A entitled 'COAG Water resource pricing principles' makes somewhat different statements about the current pricing principles but I have no idea of its relative status to the apparently later pricing principles. For example, it states that:

2. The deprival value methodology should be used for asset valuation unless a specific circumstance justifies another method

3. An annuity approach should be used for asset valuation unless a specific circumstance justifies another method.

Principle 8: Transparency stated that prices should be transparent, understandable to users and published to assist efficient choices. However, it is not clear to me what consistent valuation method for the water asset base and for water asset investment is recommended and why. The same is so for all related water pricing and treatment.

One therefore recommends going back to the National Water Initiative agreement made in 2004 by COAG and trying to agree upon the national goals for water and related pricing principles in the light of all the work which has been done so far. I recommend asking the advice of Stephen Duckett or another competent health care economist.

See attached related problems in regard to the PC Issues Paper 'Market mechanisms for recovering water in the Murray-Darling Basin' and also in regard to planning in NSW.

Thank you for the opportunity to make this submission, although with all the lawyers and their financial mates swarming over anything that moves one may wonder why I bother.

Yours truly

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