



**Australian Government**  
**National Water Commission**

**General Manager**  
**Water Markets and Efficiency Group**

Ms Wendy Craik  
Commissioner  
Productivity Commission  
Level 2, 15 Moore Street  
Canberra City ACT 2600

Dear Ms Wendy Craik

In June 2010 the National Water Commission (NWC) commenced the *Developing future directions for the urban water sector* project. The purpose of the project is to identify the scope for further reforms to help the water sector perform and better manage future risks and challenges. As part of the project the NWC has had recognised experts in the water sector prepare assessment reports. The Productivity Commission has expressed an interest in receiving the assessment reports for consideration in the Productivity Commission's public inquiry into Australia's urban water sector.

Mr Ross Knee, Executive Manager Water ACTEW Corporation, prepared the attached paper as an assessment report on the topic area 'business models'. Mr Knee has given his permission for the NWC to forward this paper to the Productivity Commission for inclusion in the public inquiry.

Yours sincerely

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Will Fargher

General Manager  
Water Markets and Efficiency Group

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# Opportunity for Competition

## Context

**The National Water Commission (NWC) states urban water management should aim to protect public health and safety, provide secure and reliable water services, be environmentally sustainable and achieve economic efficiency<sup>1</sup>.**

The objectives of competition would therefore appear to be focussed around improving economic efficiency. Presumably it also about customer service, although that is not mentioned.

In the other utilities, telecommunications (fixed line) has been competitive for the longest, followed by electricity and gas, the benefits of competition appear to be:

- Choice of service provider;
- Reduced prices for the same service, ie improved efficiency;
- Improved innovation and range of products and services; and
- Improved customer service.

The realities are quite different.

While customers can choose their retailer, they are still using the same distributor. So their bill might look different and they call a different call centre to query it, but they are getting the same provider for their phone and electricity wires and gas pipe networks.

Prices for electricity and gas are split into Retail and Distribution, in the ratio of 5%<sup>2</sup>-10% to 90%-95% respectively<sup>3</sup>. Retail is open to competition, distribution is not - that component of the price is set by pricing regulators. Retail margins are often less than 1% of their 5%-10% of the cost, so savings are really only minimal.

The range of products and services has certainly improved in telecommunications with mobiles and broadband and in retail, but less so in fixed line phones, electricity and gas distribution.

Improved levels of service have been experienced in the retail side, to some extent, but not in distribution as a result of (retail) competition.

Telecommunications is seen as the prize performer as a result of introducing competition. Fixed line rental has increased significantly, whereas local and trunk calls have substantially reduced. Overall, telecommunication costs to consumers have increased substantially due to the additional services provided. So consumers are

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<sup>1</sup> National Water Commission, [www.nwc.gov.au](http://www.nwc.gov.au), *Urban water reform*.

<sup>2</sup> Sydney Water, *Meeting Australia's urban water needs into the future: some underlying economics*, presentation to Australian Economic Forum, August 2010.

<sup>3</sup> Telecommunications are slightly different, but basically the same, ie Telstra provides the bulk of the wires. Mobile phones are totally different not being constrained by wires only by mobile towers, which any provider can provide.

generally no better off financially and are often worse off. Within Telstra, significant reductions in staff numbers have eventuated while executive salaries have substantially increased, but it is unclear to the casual observer whether the overall reduced costs are in response to its privatisation or from competition. Telstra's share price has been a disaster.

It is unclear what benefits have accrued from electricity and gas competition apart from choice of retailer.

Competition might also reduce the need for regulation, which is both expensive and considered imperfect<sup>4</sup>. Evidence of this reduction in regulation in telecommunications, electricity and gas is not readily evident.

Bottom line, competition has largely been a failure in achieving its objectives in any significant way.

A review of competition in water is at Attachment A. It shows limited progress overseas and even more limited success in Australia.

**Achieving economic efficiency** as required by the NWC, is assumed to mean not over investing in assets, getting a reasonable return on assets, not over servicing, and not over resourcing. Competition has not helped in the distribution business where the majority of assets, service standards and staff are located. Prices are regulated, capital programs are reviewed by the regulators, so returns are set and little opportunity exists to improve long term as pricing regulators take back any efficiencies gained. Service standards are set by Government technical, environmental and health regulators with little or no regard for economic efficiency. Profit targets are approved by the shareholders, which for water utilities are Government who usually take the majority of profit<sup>5</sup>, which are unsustainable.

## **Recommendations**

Competition is not a panacea nor is it an objective in itself. It is costly to set up and administer, but is a good instrument for achieving efficiency<sup>4</sup>.

Prior to introducing competition:

- Clear outcomes which are expected from the introduction of competition need to be articulated and how they will be achieved through competition determined and fully documented.
- Stakeholder drivers that will dictate their actions and responses need to be understood.
- Clarity of the weighting between the objectives listed above by the NWC, is essential.

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<sup>4</sup> Simon Cowan, *Competition in regulated industries: some reflections*, Agenda, volume 12, number 4, 2005, pp 351-362.

<sup>5</sup> NWC and Water Services Association of Australia (WSAA) *National performance report 2008-2009 Urban water utilities*, April 2010.

- The method adopted for competition must be consistent with other Government policies which affect water, eg environment, health, etc.
- Benefit cost analysis must be undertaken on the value of competition to the community as a whole.

Annual reporting is required on the achievements of competition against the required outcomes. Regulators must be held accountable against the competition outcomes sought and ensure consistency in their dealings with competitors. Government shareholders need to act like the shareholders of their water business competitors' shareholders. Finally and most importantly, those who introduce competition and administer it, must be held accountable for its ongoing success or otherwise.

### **Barriers to competition**

Insufficient rate of return on investment allowed by pricing regulators. The water utility sector cannot encourage private industry involvement if returns are well below market rates.

Economies of scale are needed to make it worth while for private industry involvement. This is only realistic in major cities, for example in electricity where real competition is restricted to large urban populations and large industrial electricity users. Or, by combining utility services, eg ActewAGL in Canberra, and Power and Water in the Northern Territory.

### **Opportunity for Competition**

Real gains may be able to be achieved by competition in the following areas:

- Source water (catchments, re-use, stormwater, desalination, etc) by providing improved diversity of supply sources and reliability, as occurred with electricity generators<sup>6</sup>.
- Supply (treatment) – eg Sydney Water's use of private industry to operate some of its water treatment plants. Benefits include access to specialised skills and experience from diverse organisations, regions and conditions; economies of scale for operator companies; etc.
- Distribution – duplication of distribution assets is not efficient economics. However, new urban developments provide an opportunity for competition, but there are risks in having numerous small systems within a larger network.
- Retail – readily achievable, but very marginal benefit for a major effort.

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<sup>6</sup> Noting that coal and hydro power seem to have sorted out their positions in the electricity price market, primarily due to their availability/responsiveness, despite the significant cost of supply differences. Wind and solar still require to be subsidised to be price competitive, except where used by preference for environmental reasons.

- Operator contracts – eg SA Water’s use of private industry to operate their network. Competition only in so far as companies have to compete for long term contracts. Benefits in accessing commercial operations.

## **Choice**

The benefit in providing consumers with a choice of provider is in keeping providers honest and focussed on customer service. Provides little or no improvement to economic efficiency as the choice is with retail, not distribution, as explained above.

## **Private Sector Involvement**

Private sector involvement is essential. For economic efficiency, businesses should provide goods and services, with Government providing policy and regulation. The logical extension being the sale of government owned water utilities once and where, real competition exists.

## **Third Party Access**

It is essential that third party access should be provided. For economic efficiency, the business case should decide whether or not a service is provided, not restrictive practices. However, cherry picking of viable opportunities by private industry will mean that the existing utilities will be picking up the non-viable services (as Telstra have). This will result in higher prices for the more remote and low volume customers, as well as making it more difficult for existing utilities to compete effectively.

## **Water Ownership**

Must be Government owned as a resource, until abstracted. Then it should belong to the service provider. This ensures the Government can equitably manage water resources, balancing social and environmental needs against business.

Once abstracted, the service provider must own the water so that they can extract the maximum commercial benefit from it to assist in the viability of the service.

## Competition in the water and wastewater industry

The following is a review of the status of the introduction of competition in the water and wastewater industry across various jurisdictions in Australia as well as in the United Kingdom by Bianca Latimore.

### Summary

In the Melbourne and Sydney areas of Australia, the structure of the water and wastewater industry includes a separate catchment management authority provider and distributor and/or retail businesses. South East Queensland has recently restructured its water and wastewater market to separate catchment management but has retained distributor/retailer businesses. The recent trend in Australia has been to allow for access to certain infrastructure, although this has not been the case in South East Queensland.

In the United Kingdom, the recent trend has been to split the retail and distribution parts of the water businesses and allow retail competition amongst business customers. This has already taken place in Scotland and is currently under serious consideration for the rest of the United Kingdom. According to a presentation from Sydney Water, the Retail component of their customers water bill accounts for around 5-6%. The United Kingdom is also considering reform to the upstream water supply licensing regime which includes the creation of new, potentially tradable licenses for water.

### Victoria

The Essential Services Commission of Victoria (ESCV) conducted an inquiry into an Access Regime for Water and Sewerage Infrastructure over the course of 2008 and 2009. A final report was provided in September 2009<sup>7</sup>. At the same time the ESCV released a Water Industry Regulatory Accounting Code<sup>8</sup> to provide guidelines on the unbundling of revenue and expenditure within the water businesses.

The Terms of Reference required the ESCV to make recommendations on:

- what infrastructure services should be subject to access
- the framework for negotiations
- mechanisms for resolving disputes
- changes to legislation and regulations required
- how the access regime should be regulated
- how access prices should be determined
- how financial information should be reported to separate out the services subject to access (accounting ring fencing).

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<sup>7</sup> Essential Services Commission of Victoria, *Inquiry into an access regime for water and sewerage infrastructure services Final report*, September 2009.

<sup>8</sup> Essential Services Commission of Victoria, *Water industry regulatory accounting code*, October 2009.

The final report recommended that an access regime for the Victorian water industry be implemented in four main stages over a three year implementation period. The key findings of the final report are as follows:

- The access regime should cover the entire state. Particular water or sewerage assets or networks within Victoria that display natural monopoly characteristics could be declared to be subject to the access regime.
- The access regime should establish protocols for negotiations between the owners of declared infrastructure ('infrastructure operators') and third parties wishing to use that infrastructure ('access seekers') in order to deliver services to customers.
- The access regime should provide mechanisms for the resolution of disputes between an infrastructure operator and an access seeker. Two models should be available: private arbitration by a commercial arbitrator or arbitration by the independent regulator.
- In most cases, the price of access should be determined using a 'retail minus' methodology (where the regulated retail price for a bundled service is discounted by the costs that are avoided by not providing those components of the bundled service that the access seeker does not require). In some instances, it will be more appropriate to use a 'cost of service' approach (where access prices are determined by estimating the cost to an infrastructure operator of sharing with an access seeker the use of its infrastructure).
- Functional separation of the competitive and non-competitive elements of the relevant water businesses would support the effective operation of an access regime. In the short term, accounting separation of declared assets will be more expedient.
- A licensing system should establish obligations and provide a legal framework for enforcing compliance with respect to resource management, health and safety, water quality and environmental and customer protection.
- Implementing an access regime will involve an extensive work program and detailed consultation with stakeholders. A staged approach over a three-year implementation period is recommended.
- In the first stage and prior to the legislated regime being enacted, the relevant water businesses should be required to make 'access commitments' applying to infrastructure that may be of interest to third parties.
- The Essential Services Commission has the necessary expertise to be the independent regulator of the Victorian water industry access regime. It should prepare the necessary guidelines and frameworks including those that would apply ahead of a legislated regime.

## **New South Wales**

The NSW Government introduced the Water Industry Competition Act 2006 as part of its strategy for a sustainable water future to harness the innovation and investment potential of the private sector in the water and wastewater industries. The Act sets out when a licence is required, the procedures for applying for a licence, how licences and licence fees are determined, and how licences are audited and enforced. The Act establishes mechanisms to resolve disputes between private sector bodies and their customers, and to protect customers in the event of a failure of a new market entrant. A public water utility does not need a licence in relation to water industry

infrastructure situated within its area of operations. The operation of the Act is restricted to scheduled areas, being areas described in Schedule 1 to the proposed Act. The Schedule is capable of being added to by means of a Ministerial order. Initially, they will comprise the areas of operations of the Sydney Water Corporation and the Hunter Water Corporation.

On 19 December 2008 the New South Wales Government applied for certification by the National Competition Council (the Council) of the WICA Access Regime as an effective access regime. On 11 May 2009 the Council provided its final recommendation to the Commonwealth Minister and on 13 August 2009 the Minister for Competition Policy and Consumer Affairs made his to accepted the Council's final recommendation and determined that the regime be certified as effective for a period of 10 years<sup>9</sup>.

In recommending that the WICA be certified, the Council identified several aspects of the WICA Access Regime that it considers warrant further consideration by the NSW Government (and by other governments developing third party access arrangements for water infrastructure services). The Council sought additional information and opinions on these aspects from potential access seekers and other parties to assist it in making its final recommendation on the effectiveness of the regime. The aspects on which the Council sought additional information were:

- the effectiveness of the safeguards in the regime (such as the processes for decision making and arrangements for reviewing decisions) regarding coverage, revocation of coverage and binding non-coverage declarations given the broad discretions given to IPART and decision makers and the involvement of the NSW Government in the NSW water sector through ownership of Sydney Water Corporation (Sydney Water) and Hunter Water Corporation (Hunter Water)
- the implications of the ability for the Premier to add geographic areas to Schedule 1, so having the effect of expanding the services that are subject to the WICA Access Regime and
- the impact of the requirements for water licences, and in particular whether the requirement that parties seeking a licence for retail water supply obtain sufficient quantities of water from non public utility sources (sub-section 10(4)(d)) would have the effect of unduly limiting the use that might be made of the WICA Access Regime.

## **Queensland**

The Queensland Water Commission released its findings on Our water Urban water supply arrangements in South East Queensland in May 2007<sup>10</sup>. The report recommended an Enhanced Water Grid Manager Model be adopted and implemented over a two year period. Under the Model, the structure of the South East Queensland Water Industry was to be redesigned to incorporate a Water Grid Manager, two Bulk Supply Businesses, a Distribution Business and three Retail Businesses.

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<sup>9</sup> [http://www.ncc.gov.au/index.php/application/nsw\\_water\\_industry\\_access\\_regime/](http://www.ncc.gov.au/index.php/application/nsw_water_industry_access_regime/)

<sup>10</sup> Queensland Water Commission, *Our water urban water supply arrangements in South East Queensland*, May 2007.



The report also recommended that during the period in which the structural reforms were implemented, there be a detailed evaluation of the introduction of retail competition within the water sector in SEQ, including the scope and preferred timing of contestability to be introduced.

Subsequent to the May 2007 report, the Council of Mayors South East Queensland (CoMSEQ) put forward an alternative model whereby the distribution and retail functions are integrated in a number of entities coincident with local government boundaries.<sup>11</sup>

In September 2007<sup>12</sup>, a new model was announced by Gov. The new model incorporated one regional distribution body and up to 10 retailers. They were to be owned by local council and retailing of water was to be split from distribution effective from July 2010.

In May 2010<sup>13</sup>, legislation for a new framework was passed under which the restructure of the South East Queensland Water Industry included three distributor-retailers from July 2010 that were Council owned. There was no longer any mention of a possible future split between retail and distribution.

## **United Kingdom**

In April 2009, Professor Martin Cave finalised an independent review of competition and innovation in water markets in the United Kingdom<sup>14</sup>. The review recommended that after an initial threshold of five megalitres, the Government should allow all nonhousehold customers (1.5 million in England and 110,000 in Wales) to choose their water and wastewater retailer. The retail divisions of water companies should be made legally independent from their network business, except in the case of the smallest companies where it would not be in customers' interests to do so.

The review also recommended that the Government should reform the upstream water supply licensing regime by giving the Environment Agency new powers to tackle over abstraction and to facilitate the trading of abstraction and discharge licences.

Progress on the take up of the recommendations in the Cave review has been slow. There was initially almost universal support for at least starting the process towards greater competition, with retail leading the way.

Momentum now seems to be building following the English elections. In July 2010, the English water regulator, OFWAT, put together an expert advisory panel that will help it with a review of regulation, a substantial programme of work to explore possible changes across all parts of the water cycle and many aspects of the regulatory

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<sup>11</sup> Council of Mayors South East Queensland, *SEQ water reform*, 6 and 26 June 2007

<sup>12</sup> Deputy Premier, Treasurer and Minister for Infrastructure The Honourable Anna Bligh, Council feedback shapes new water system, September 2007

<sup>13</sup> South-East Queensland Water (Distribution and Retail Restructuring) and Other Legislation Amendment Act 2010, May 2010

<sup>14</sup> Professor Martin Cave, Independent review of competition and innovation in water market Final report, April 2009.

framework<sup>15</sup>. It has also already asked incumbents to separate their retail functions for accounting and reporting purposes. In September 2010, the Environment, Food and Rural Affairs committee announced an inquiry into outstanding flood and water management legislation<sup>16</sup>. The inquiry will look at what legislative measures are required to implement effective flood and water management policies in England and Wales. One of the key issues is the outcome of the Cave review of competition and innovation in water markets.

The outcome remains to be seen. Debate is continuing on possible thresholds for competition amongst business customers and the introduction of upstream competition, that is, the trading of abstraction licences, bulk water trading and competition in the treatment market.

## **Scotland**

Competition for business customers in Scotland was introduced on 1 April 2008, under the Water Services etc. (Scotland) Act 2005<sup>17</sup>. This framework for competition required the separation of Scottish Water's wholesale services from its retail function. It also allowed new licensed suppliers to compete in a retail market for business customers. There are over 130,000 business customers in Scotland (all customers who are not households) eligible to choose their supplier.

Suppliers (licensed providers) are able to compete for the custom of all business customers in Scotland. Suppliers buy services at wholesale from Scottish Water. The Central Market Agency (CMA) was set up to administer the new market. The CMA facilitates the transfer of customer information between suppliers, registers who is the licensed supplier of each business customer in Scotland and calculates the money owed by each supplier to Scottish Water for wholesale services.

All licensed suppliers in the Scottish market are required to:

- become party to the Market Code and a member of the CMA;
- undergo a process of assurance and technical checks performed by the CMA.
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The Water Industry Commission of Scotland (WICS) is responsible for implementing this framework. They are also the licensing authority for the market. In order to compete in the market, suppliers must be awarded licences by WICS.

The chairman of the Water Industry Commission of Scotland has noted the lengthy process in introducing the reforms to the industry. Work on the opening of the Scottish market started back in 2001, and seriously got under way only in 2004.

Six months after the introduction of competition to business customers, the Chairman believed that the “systems work, customers can and are switching and they are getting a better deal.”<sup>18</sup> This was despite an early setback with one of the main new entrants

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<sup>15</sup> Utility Week, OFWAT selects regulation review panel, 13 July 2010.

<sup>16</sup> Utility Week, Environment committee to investigate future water legislation, 8 September 2010.

<sup>17</sup> [http://www.watercommission.co.uk/view\\_Competition.aspx](http://www.watercommission.co.uk/view_Competition.aspx)

<sup>18</sup> Utility Week, Alan Sutherland gives a progress report on water competition in Scotland, 19 September 2008

going into administration. The company had initially attracted around 60 customers away from the incumbent.

The Chairman also believes that competition has had a substantial impact on the incumbent, Scottish Water. Scottish Water had identified savings resulting from the separation of their retail and network businesses that was reflected in its price proposal to WICS for 2010-14.

Two years after the introduction of competition, the Chief Executive of Business Stream, the name of Scottish Water's retail arm, has said that competition has been a resounding success.<sup>19</sup> He states that since competition was introduced, customer satisfaction has risen by 19 per cent, there has been more than £7 million savings in reduced water consumption, there has been almost £9 million of discounts to the market and more than 50 new services developed.

Following the successful first phase of market reform, the regulator is keen to continue developing the market, and is currently consulting on the transfer of more customer-facing activities. More margin will be available to retailers in return for managing greater responsibility from trade effluent, developer services and meter connections and disconnections. This can only create a more dynamic retail market and stimulate greater innovation and service.

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<sup>19</sup> Utility Week, Business Stream's Mark Powles hails success of Scot water competition, 7 May 2010.