

# **Submission into Inquiry by Productivity Commission to Australia's Urban Water Sector**

**Submission in response to the Draft Report**  
May 2011

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## 1 Introduction

We welcome this second opportunity to be able to participate in the Productivity Commission's inquiry into Australia's urban water sector.

The draft report offers a number of issues for discussion. Our response to the Report is focussed on two of these issues, namely:

- ▼ IPART's support for the general direction of the governance reforms proposed by the Commission under the heading of institution-centred reforms
- ▼ Our strong view that good governance and independent pricing regulation are not substitutes and that an efficient Australian water industry requires both given its natural monopoly characteristics. As such, we recommend the Commission reconsider and reverse its suggestion that if governance frameworks are strengthened Governments could, and should, replace price regulation with price monitoring powers.

We also take this opportunity to restate some of our views about scarcity pricing and to note that we are committed to considering the merits of introducing scarcity pricing at a wholesale level in Sydney in the course of the 2011 Sydney Catchment Authority price review.

In responding to the draft report we have drawn on our experience of the Australian water industry and the literature relevant to the regulation of natural monopolies.

## 2 Institution-centred reform

The draft report sets out a number of governance reforms under the heading of institution-centred reforms. With the significant exception already identified, IPART supports the general direction of reform embodied in these recommendations.

Specifically:

- ▼ We agree that governments need to articulate more clearly their objectives for government owned water utilities.
- ▼ We support the concept of a charter for water utilities that sets out governments' expectations and includes transparent processes for decision-making about supply augmentation and other matters.
- ▼ We support efforts to define and separate the roles and responsibilities of the participants of the urban water sector more clearly.
- ▼ We support increased transparency and cost-benefit analysis of decisions about the standards applicable to the water industry.

- ▼ We agree that decisions about future investments by water utilities should be based on consideration of all of the available options to ensure that least-cost solutions are adopted.

We note that the National Water Commission has made a number of similar recommendations in its recent reports about the future of the urban water industry and its regulation. We welcome the commitment of the Productivity Commission to consider the research and recommendations of the National Water Commission in its Final Report.

To some extent, the Productivity Commission's draft recommendations parallel recommendations made by IPART to the NSW Government arising from a review of the productivity of state-owned corporations.

In our review we identified areas where the current institutional frameworks could be strengthened by clarifying the objectives of the corporations and by enhancing the role of the government as the shareholder. The main interests of a diligent and engaged shareholder are in increasing profits by ensuring costs are no higher than they need to be. So provided the prices paid by customers are regulated stringently, an effective shareholder will seek out opportunities to improve productivity.

We note the Commission's confidence that shareholder governments are committed to efficient pricing, which should render price regulation unnecessary.<sup>1</sup> Based on our experience and the available evidence, we believe that confidence is misplaced. Following our analysis of the impact of some government decisions on the productivity of state owned corporations, we do not believe that the shareholder is able to take on sole responsibility for this task. On the contrary, in the absence of price regulation, even an effective shareholder has an incentive to maximise profits and/or reduce efficiency.

There is some support for the view that the role of price regulation is to achieve outcomes similar to those that would accrue from a long term contract between producers and consumers, in part to protect sunk investments. With all their other interests we do not see governments as best placed to balance the producer and consumer interests to achieve longer term efficiency objectives.

For these reasons we do not see strengthened governance as a substitute for price regulation. We would welcome an opportunity to discuss these issues further given their importance to economic regulation in general.

We take the view that good governance, including a stronger shareholder role, robust policy based on rigorous cost benefit analysis of all available options and independent price regulation are all critical pre-requisites for economically efficient government owned monopoly water utilities.

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<sup>1</sup> pg 277

The Commission's discussion on structural reform of the water industry has the potential to be of value as the industry continues to evolve. Of particular value is the manner in which the Commission has sought to identify the circumstances in which the different structures discussed are likely to be of benefit.

In urban Sydney the separation of bulk water and retail/distribution functions has already been achieved and the *Water Industry Competition Act 2006* provides scope for competitive entry into the water market.

### **3 Regulatory price setting regime**

#### **3.1 Concerns about the rationale underpinning a recommendation that government's replace price regulation with monitoring**

The draft report includes a recommendation that Governments move to a framework for the price monitoring of the Australian water industry before ultimately removing all forms of price regulation. We understand that the rationales for this recommendation are the Commission's views that:

1. Governance reforms arising from the National Competition Policy have been more significant than price regulation in reducing inefficiencies in the water sector and that additional governance reforms would further reduce the relevance of price regulation.
2. Price regulation is justifiable where it prevents inefficiencies associated with the use of market power but that the Commission doubts that market power is present in the water industry.
3. If market power is present monopoly abuse is unlikely, as while water utilities have some a history of under recovery, the Commission finds that they do not have a history of gouging monopoly rents.<sup>2</sup>

Having considered the draft Report, we would make a number of points in response.

In relation to the first point, we note the Commission's views about the relative benefits of different elements of the National Competition Policy reform agenda.<sup>3</sup> In jurisdictions such as NSW, where the National Competition Policy has been comprehensively implemented, it is difficult to disentangle the relative contributions of these reforms. IPART has not attempted to do so. In the absence of empirical evidence to the contrary,<sup>4</sup> we favour a standard economic theory perspective and accordingly take the view that both of these pillars of the National Competition

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<sup>2</sup> pg 275 to 279

<sup>3</sup> page 275

<sup>4</sup> We are not aware of any empirical analysis undertaken to evaluate that question.

Policy are necessary to ensure the economic efficiency of government owned natural monopolies.

In relation to the second and third issues identified by the Commission, we note the strong body of academic literature around the identification of natural monopoly characteristics, the market power of monopolies and role of price regulation in ensuring efficient outcomes.

A natural monopoly arises when a market is served most cheaply by a single firm, rather than by a multiplicity of competing firms. In the draft report the Commission acknowledges that the Australian water industry exhibits strong natural monopoly characteristics.

An often cited example of the abuse of the market power by monopolies is the capacity to charge prices that generate excessive profit. For reasons largely arising from the government ownership of water utilities, this form of abuse has not been prevalent in the Australian water industry.<sup>5</sup>

However, other forms of market abuse do exist in the Australian water industry. For example, market power can also be exhibited by a limited focus on efficiency, by the under supply of services resulting in welfare losses or the under recovery of costs resulting in prices that act to prevent competitive entry. The draft report acknowledges that a natural monopoly firm has an incentive “to set prices in such a way that the level of output is below that which would have been provided in a more competitive market, resulting in a loss of net benefits to the community.”<sup>6</sup> The Commission’s own draft report identifies examples of both of these types of abuse of power in its analysis of the responses of utilities to the most recent drought.

Further, while there may be little evidence of monopoly water utilities using their power to generate excessive profits at an aggregate corporate level, there is greater evidence of the use of market power to exploit particular market segments or customer classes. These gains may be dissipated before a profit is declared, but this does not change the reality that monopoly power was exercised. Moreover, our experiences suggest that water utilities are motivated by aggregate revenue targets to the detriment of efficiency gains that can accrue from efficient price structures.

Robust, transparent regulatory arrangements are complements to governance reform. In the context of the Australian water industry, robust regulatory arrangements require more than price monitoring. This conclusion is grounded in our understanding of the past experience of the industry’s poor pricing practices and under performance in service delivery. In our view price regulation:

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<sup>5</sup> In the absence of price regulation, where price setting is a political decision, there are strong incentives to set prices that under-recover costs.

<sup>6</sup> pages 76-77

1. complements governance reforms by strengthening efficiency incentives by providing a hard budget constraint in much the same manner as the competitive market does for other businesses
2. strengthens the transparency of performance through the establishment of public service, cost and performance targets and the requirement that performance be reported against these. This is particularly important for government-owned businesses where financial incentives are weaker (notwithstanding the efforts to improve governance and commercial frameworks)
3. improves the efficiency of pricing by removing the hidden cross-subsidies and underpricing that have been endemic in water services for many years. Water pricing is a socially sensitive area but through the process of transparent, independent engagement with the community, good regulation can educate the community and garner broadly based support for water pricing reform.

In our view price monitoring would not provide the hard budget constraint, the clear reporting against targets, or the transparent engagement with the community that is needed to facilitate more efficient price structures.

### **3.2 Other concerns**

The draft report suggests that the incentives of a natural monopoly to undersupply the market could be tempered if sufficient competition could be encouraged.<sup>7</sup> However, the very nature of the industry means that competition is likely to be limited. The characteristics of natural monopolies will remain and hence a deep competitive market is unlikely to emerge. The experience to date of competition reform in NSW is that the majority of new entrants are small-scale, niche operators rather than direct challengers to the market power of the monopolies.

Further, in our view, any analysis of the most efficient structure for the regulation of water utilities' prices should take account of the government ownership characteristics of these monopolies. The experiences of Australia and other jurisdictions reveals a strong tendency towards social or political pricing, extensive non-transparent cross-subsidies and underpricing, even where utilities have been established on a more commercial basis. Under the current price regulation framework these pressures for hidden subsidies are contained through the regulator's processes of transparency and public participation and through the clear separation of the policy, shareholder and regulator roles. We are concerned that a move to mere price monitoring would allow greater political intervention in pricing to go undetected and/or otherwise lead to inefficient pricing outcomes.

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<sup>7</sup> page 76

### 3.3 The benefit of price regulation in practice

The Commission questions whether the cost of price regulation exceeds its benefits. This question can be considered in the context of the outcomes that price regulation has achieved to date.

IPART was established in 1992. IPART price regulates the major water utilities of NSW. We are also a licence regulator of both government and private service providers. We have also provided advice to Government on water industry structure and other matters.

For almost two decades, our decisions have had important efficiency and consumer protection benefits. When we commenced regulation, water utilities in NSW exercised their monopoly power to provide extensive subsidies from businesses (especially small businesses) to residential customers. These subsidies, which imposed costs on the economy as a whole, have now been largely removed.

We have had a central role in the transformation of NSW water utilities from tax raising statutory authorities to entities that now face the prospect of competition from private sector service providers. Along the way we have devoted considerable effort to identifying and aiding improvements in the productive efficiency of the water utilities. It is often overlooked that monopoly rents are more likely to be appropriated by management and workers than owners where utilities are government owned. We have also focussed on introducing more efficient price structures that better reflect the underlying costs of service provision.

By way of example, in 1993 more than a third of Sydney Water's total revenue was derived from property value based taxes and a further 40% from fixed service charges. At that time, only 20% of total revenue was generated from charges that depended on the amount of water consumed or sewage discharged.

Since that time, IPART has removed the property value component of water charges for residential and non-residential customers. This removed a major inefficiency. We have set water charges using a two-part tariff, with a water usage or volumetric component that varies between properties according to the volume of water consumed. We set water service charges that vary with the size of the water meter. Meter size is used to reflect the potential demand placed on the water supply system by the customer or the capacity that must be set aside to serve those demands.

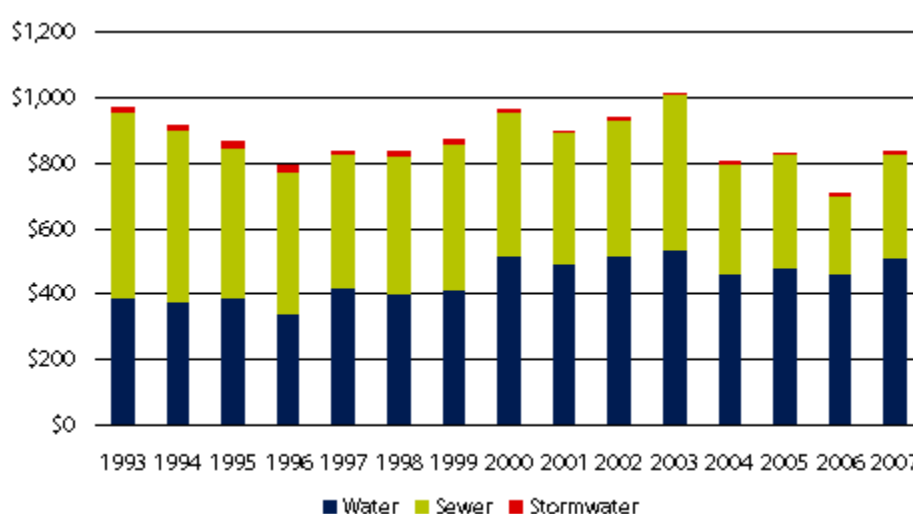
IPART has also removed the property value based element of sewerage prices in the interests of promoting more efficient charge structures. The removal of property value based charges and reform of pricing structures has reduced cross subsidisation of the residential sector.

The reform process has yielded clear efficiency gains. At the start of the 1990's there was considerable scope for the water utilities to make cost savings. By 2005, Sydney Water employed less than half the staff it had employed when IPART was established in 1992.



These staff reductions also translated into reductions in operating expenditures. As illustrated in Figure 1, over the four years to 1996 Sydney Water, at the behest of IPART, was able to reduce operating expenditures by almost 20%. Close and ongoing regulator oversight meant that pressure was able to be maintained on operating expenditures over the following decade to the benefit of the consumers of Sydney Water's services.

**Figure 1** Sydney Water operating costs, 1993 to 2007 (\$m - \$ of 2006/07)



The National Water Commission's recently released *Review of pricing reform in the Australian Water Industry* includes further analysis of the actual cost savings arising from increased scrutiny by price regulators such as IPART.

While significant and extensive progress has been made over the past two decades it should not be assumed that the task is complete. There is an emerging mindset evident in some regulated utilities that the pursuit of revenue is the over arching objective with scant regard to how that revenue might be obtained. This suggests that the potential for monopoly abuse is alive and well and that ongoing vigilance will be required from regulators.

A further matter of concern is the increasing attempts being made to limit or otherwise fetter the discretion and independence of price regulators. In the case of NSW provisions have been included in section 16A of the *Independent Pricing and Regulatory Tribunal Act 1992* which allow relevant Ministers to direct the Tribunal to include in maximum prices determined the efficient cost of complying with specified requirements imposed on a regulated entity. Use of this power limits the scrutiny which certain proposals are obliged to undergo in the price regulation process. NSW is not alone in seeking to impose such limitations.

Regulators have responded by passing on the relevant costs into prices while also sharply focussing public attention on the reasons why prices are increasing as a result of government directions. This in turn is seeing pressure build for policy change. The benefits arising from the increased level of transparency that is evident as a consequence of the public processes of independent price regulation would not be available in the absence of those regulatory processes.

## **4 Scarcity pricing and other forms of flexible pricing**

To maximise benefits to the community, prices need to reflect the efficient costs of providing a good or service. Prices which reflect costs provide signals that guide behaviour on both the demand and supply sides of the urban water sector.

In setting prices, decisions on efficient costs and price structure are required. In our reviews decisions on price structure are made on a case by case basis. This process ensures that the price structure chosen is as cost reflective and as efficient as circumstances permit.

In making decisions between price structures a range of factors need to be considered. Examples of the factors to be evaluated in a decision about price structure include: cost structure; the robustness of information available to set prices, including forecast of sales and water availability; price elasticity; community acceptance; transaction costs; barriers to implementation; and risk.

Given the inevitable differences between water utilities there can not be a single ideal price structure that is applicable to all. We recommend that the Commission's Final Report identifies those matters that should inform selection of a suitable price structure and clearly emphasise the importance of robust evaluation of alternatives in informing decisions about price structures.

As one of many forms of price structure, IPART has previously considered the implementation of scarcity pricing in its reviews. We have clearly signalled that we intend to undertake further analysis of its merits as part of the 2011 review of the Sydney Catchment Authority's prices.

We note that the National Water Commission has recently released a study commissioned from Frontier Economics that develops some models for the introduction of scarcity pricing. We intend to consider this study as part of our review of the merits of scarcity pricing for the Sydney Catchment Authority.

Once again we thank the Productivity Commission for the opportunity to participate in this review.