



Australian Government
National Water Commission

Chair

Dr Wendy Craik
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Dear Dr Craik

Productivity Commission Draft Report: Australia's Urban Water Sector

The National Water Commission (NWC) welcomes the release of the Productivity Commission (PC) draft report on *Australia's Urban Water Sector* and thanks the PC for the opportunity to respond.

The NWC has recently completed a body of work on critical urban water reform issues. The primary purpose of the NWC urban work program has been to advance the objectives of the National Water Initiative (NWI) and inform the NWC 2011 Biennial Assessment and Review of the NWI. Our work has been led by our *Urban Water in Australia: Future Directions (Future Directions)* report, which was released publicly in early April 2011.

The NWC's *Future Directions* recommendations seek to ensure an efficient, adaptive, resilient and customer-driven approach to managing urban water that can respond to the challenges of increasing population, concerns about the affordability of water services, and the impacts of climate change and extreme variability. The *Future Directions* report is available on our website (www.nwc.gov.au), along with the following recently-released supporting reports:

- *Review of pricing reform in the Australian water sector*
- *Efficient water resource pricing in Australia: an assessment of administered scarcity pricing in urban areas*
- *Externality pricing in the Australian water sector*
- *Competition in the Australian urban water sector*

The NWC is releasing a review of water quality regulation in Australia in coming weeks and will also provide this report to the PC upon its completion.

Overall, the NWC commends the PC for its assessment of the urban water sector. There are close similarities between the PC findings and recommendations, and those of our *Future Directions* report. For example, the NWC concurs that COAG should

adopt an agreed set of national objectives for the urban water sector and general principles to guide reform. In each jurisdiction, governments should ensure that service providers, regulators and other parties have clear objectives and accountabilities, which align with specified roles, functions, resourcing and funding.

Given the different processes adopted by the PC and the NWC, the degree of similarity in our findings and recommendations should provide governments with greater confidence in relation to the case for, and key components of, reform.

There are three aspects of the PC's draft report where the NWC seeks to provide further input to clarify our position and to respond to particular matters raised in the PC's draft report:

- independent economic regulation;
- NWI pricing principles; and
- proposed future role for NWC.

Independent economic regulation

The draft report contains a number of recommendations relating to independent economic regulation of the sector. It suggests that independent economic regulation has had little, if any, benefit but that it imposes substantial costs. *Recommendation 11.4* proposes that jurisdictions "should move away from regulatory price setting to a price-monitoring regime (where some form of price oversight is considered necessary)". Further, it recommends that, within five years, governments should undertake reviews to consider whether there is evidence of abuse of market power warranting any further price regulation. It suggests that independent economic regulation would not be required if suggested governance and other reforms were adopted. It also proposes that Queensland should continue with its price-monitoring arrangements (which it holds up as a model for other jurisdictions), that the NWI should be amended to remove any reference to independent price setting, and various other changes (e.g. a clarification of regulators' objectives to remove conflicts and inappropriate objectives).

The NWC understands that the PC recommendations are based on the argument that:

- price regulation should be used only where there is evidence of abuse of market power (overpricing);
- good governance and other reforms would render pricing regulation unnecessary;
- governance and structural reform have been far more significant in promoting efficiency than has been regulation; and
- the compliance costs (of price setting) are very high and outweigh the negligible benefits.

The NWC believes that further consideration needs to be given to these arguments and the potential negative consequences of moving away from independent economic regulation.

The role and purpose of independent economic regulation

In our view, economic regulation aims to reproduce the disciplines otherwise provided by competition, to ensure that (natural) monopoly businesses do not earn monopoly profits or provide sub-standard services, but still enable them to cover the efficient costs of operating and maintaining the network assets.

In the context of utility industries such as water, regulatory functions typically entail:

- determination or oversight of the prices and service levels provided by monopoly suppliers;
- licensing of suppliers as a means of monitoring and enforcing compliance with these service levels/prices; and
- overseeing competition in contestable elements of these industries (e.g. via regulation of third party access to essential facilities).

Economic regulation seeks to encourage efficient outcomes that would be expected under a competitive market. This is generally interpreted as providing the services that customers want at a price that reflects the costs of producing them as efficiently as possible. Economic regulation is not generally seen as focusing narrowly only on preventing abuse of market power emphasised in the PC report. Indeed, a considerable part of regulatory effort is devoted to ensuring that services are provided efficiently and that the level of service provided is consistent with customers' willingness to pay. Therefore, lack of evidence or apparent motivation for 'price gouging' by government-owned water businesses does not in itself remove the rationale for economic regulation.

It is also important not to equate economic regulation with prescriptive price setting. While directly setting prices is one form of regulation, it is not the only one. As discussed below, the NWC believes that the debate should be more about the form and scope of regulation, rather than whether it is needed at all. In our view, while the introduction of competition into contestable parts of the industry may reduce the need for regulation of those segments, there is likely to be an ongoing need to regulate the natural monopoly network components independently, at least in some form.

Governance and other reforms would render price regulation unnecessary

A key plank of the PC proposals is that (1) the introduction of various governance and other structural reforms would render economic regulation unnecessary, and (2) such reforms would be likely to provide greater net public benefits when compared to price regulation. These proposed governance arrangements include establishing Charters for urban water utilities, specifying the requirements for the performance of the businesses and setting out details on matters such as obligations to serve, processes and procedures for choosing supply augmentations, principles for setting prices and service offerings, and processes and procedures for setting prices that involve public consultation.

In relation to the first point, the PC suggests that an end to price regulation should not lead to under-recovery or over-recovery of costs, assuming governance arrangements for water utilities are adequate (i.e. "given that their shareholder governments are

committed to efficient pricing and set the objectives of the providers”). The draft report states that “if governments have committed themselves to pricing involving full cost recovery, where they own monopoly water providers they can simply instruct them to price in a manner that generates adequate revenues but not in such a way that would result in ‘excessive’ profits”. These arrangements would entail “the utilities reporting regularly on their commercial performance, with the process overseen by a suitable agency or regulator to flag any issues relating to perceived under- or over-recovery of costs”.

The NWC agrees that improved governance arrangements will be critical to enabling the water sector to meet the service challenges of the future efficiently and effectively. The NWC also agrees that good governance arrangements can play a role in ensuring that water service providers deliver efficient services at efficient prices. It is, however, concerned that the PC’s conclusion that a substantial winding back of regulatory oversight is based on unrealistic assumptions about the speed at which such governance reforms can be implemented, the consistency with which they are adhered to in practice, and the likely effectiveness of such reforms alone. The PC itself notes (p. 99) that in the past, governments have let “political considerations influence pricing decisions for water, often leading to under-recovery of costs and subsequent underinvestment in infrastructure”. The NWC observes that there have also been occasions where their owner governments have used water businesses as revenue-raising instruments. While, in a perfect world, governments would commit to and abide by such commitments to implement principled reform, including efficient pricing and full cost recovery, the experience with implementation of NWI commitments over many years suggests that this is much harder to achieve in practice when governments face many conflicting pressures (see our *Review of pricing reform in Australia* report).

In the NWC’s view, rather than good governance and independent economic regulation being seen as alternatives, effective independent economic regulation can reinforce and complement good governance and constrain the temptation by governments to intervene in a non-transparent manner.

Further, the PC’s proposed governance arrangements, which require utilities to report regularly on their commercial performance, rely heavily on public reporting. But, unless the agency is independent of government with a clear mandate for transparency, there could be risks to full disclosure of such information in practice. Similarly, it is difficult to see how compliance with a Charter which required utilities to fully recover costs (incorporating an appropriate return but not monopoly returns) could be assessed without undertaking the type of analysis currently undertaken by economic regulators to which the PC appears opposed. It, therefore, appears to the NWC that many of the key components of the PC’s proposals for good governance effectively require many of the elements that characterise effective economic regulation as it is already practised today—most notably transparency and independence.

Overall, the NWC has concerns about transparency and conflicts of interest where state governments provide pricing and performance oversight. In line with the guidance provided by the COAG 1994 water reform framework, the NWC has a strong preference for economic regulation that is fully independent from government.

In relation to the second point above, the PC (p.275) asserts that “the governance reforms undertaken over the last two decades or so would have been far more significant in reducing [this] x-inefficiency than has been regulation.” However, it provides no evidence to support this statement. While acknowledging that it is difficult to attribute the productivity improvements achieved by the urban water industry since the 1990s to specific elements of the institutional arrangements, the NWC’s *Review of pricing reform in Australia* identified many price determinations where regulators have identified cost savings for the customer. Perhaps more importantly, as reflected in our *Future Directions* report, there is overwhelming agreement by those familiar with economic regulatory processes in the sector (including the industry itself, governments and customer representative groups) that independent economic regulation has been a key driver and enabler of improved outcomes. The NWC considers that a further investigation of the evidence is warranted before making this finding and recommendation.

The cost of regulation and the appropriate form of independent economic regulation

The PC suggests that price regulation involves significant administration and compliance costs, potentially restricts the pricing strategies of providers, limits flexibility in terms of price-quality tradeoffs, potentially influences supply augmentation decisions, and can deter investment.

The NWC acknowledges that regulation involves costs and strongly supports adoption of cost-effective regulation. However, it is also important to keep the administrative or compliance costs of independent economic regulation in perspective. In our view, many of the costs of the price-review process require systems and processes that should be undertaken by utilities as part of good business practice. It is also the case that a significant part of the compliance costs are incurred in setting up for the introduction of economic regulation and that compliance costs then level off in future price reviews. Nevertheless, the NWC concurs with the PC that some aspects of current approaches to regulation impose unnecessary costs. Our *Future Directions* report raised concerns about economic regulators adopting overly prescriptive and inflexible regulatory approaches.

The NWC believes that there is merit in examining more flexible, innovative and light-handed approaches to independent economic regulation. For example, the NWC concurs with the PC that utilities should have responsibility for setting tariff structures and service offerings. Our recommendations encourage debate about:

- the appropriate form of independent economic regulation (e.g. price setting versus price monitoring);
- the most appropriate form of price control (e.g. revenue versus price caps);
- and

- the scope of the activities that are regulated (e.g. contestable versus non-contestable natural monopoly elements).

Our reports also outline potential models for light-handed economic regulation and draw attention to the potential to adopt tailored and cost-effective approaches to economic regulation that suit the individual circumstances of utilities.

The NWC has some reservations about adopting the price-monitoring system currently applying as an interim measure in Queensland as a model. It is our understanding that the procedures and internal workings of Queensland's reviews mirror those of price reviews in New South Wales and Victoria in nearly all respects.

As with New South Wales and Victorian regulators, the Queensland Competition Authority (QCA) requires regulated businesses to develop and submit water plans that generate forecasts of their revenue requirement over a forward period based on standard building-block financial models. Similar to New South Wales and Victoria, the revenue generated by the prices being monitored by QCA are then compared against this revenue requirement.

The current Queensland framework was explicitly developed as an interim arrangement in the lead up to full deterministic regulation. Adoption of this model on an ongoing basis raises some concerns. The first is that, as an annual process, it is significantly more resource-intensive than the cyclical (4 to 5 year) reviews currently undertaken in NSW and Victoria. Secondly, the monitoring approach does not address the question of what to do if price monitoring uncovers monopolistic behaviour or other inefficiencies.

Conclusion

The NWC considers that a rethink of the approach to economic regulation is timely and supports some aspects of the PC's proposals. For example, the NWC strongly concurs with the PC's view that water pricing should be used as a tool to achieve economic efficiency rather than equity or other objectives. However, the NWC is concerned that adoption of the PC's recommendations to abolish or substantially weaken independent economic regulation would constitute a major backward step in the pursuit of the efficient outcomes that the PC is seeking to achieve.

The NWC believes that independent economic regulation has been a crucial part of the national water reform framework since 1994. It has helped drive economic efficiency in the provision of water and wastewater services and has been critical in enabling water utilities to move to full cost recovery in a political environment where pricing objectives based on economic efficiency are highly contested. In our view it should continue to play a key role in the urban water sector in Australia, but should be critically reviewed to ensure that it does not inadvertently discourage innovation.

Consequently, our *Future Directions* report recommends that governments should "broaden the coverage of fully independent economic regulation across all urban systems, and ensure that economic regulation is more flexible, to encourage

innovation in price and service offerings and better reflect the value of water” (page 46).

The NWC is concerned that the draft recommendation may too readily assume away the practical challenges of implementing and subsequently adhering to best-practice governance arrangements in the absence of independent price and performance oversight that promotes economic efficiency and protects customers.

NWI pricing principles

Draft Finding 7.5 states that “the National Water Initiative pricing principles are unclear and provide scope to implement pricing policies that are not necessarily in line with the principles of economically efficient pricing”. The NWC is supportive of this finding and refers the PC to our *Review of pricing reform in the Australian water sector* report (section 4.5) where this matter is discussed further.

Overall, the NWC found that the nationally-coordinated approach to pricing reform under the COAG 1994 agreement and the NWI played a subtle yet important role in influencing the pricing reform direction and implementation in all jurisdictions.

However, if nationally-coordinated effort is to continue, then the NWC believes that changes are required. The NWC is supportive of a revised set of national pricing principles and objectives that: are focused on the primary objective of economic efficiency; are not overly or inappropriately prescriptive; and are complemented by an effective monitoring and compliance framework, and reform actions tailored to the needs of each jurisdiction.

Draft Recommendation 11.4 includes the statement that “the National Water Initiative pricing principles should be amended to remove any reference to independent regulatory price setting, except where it can be demonstrated that a more light-handed approach as described above would be unlikely to present an abuse of market power”. The NWC suggests that this element of the PC’s draft recommendation be reviewed in line with our comments above.

Proposed future role for NWC

The PC recommends that COAG put in place a new intergovernmental agreement on the reform program for the urban water sector. The agreement would explicitly incorporate any universally applicable reforms, according to an agreed timetable. The NWC supports this proposal, which is consistent with the recommendations of our *Future Directions* report.

The draft report identifies a role for the NWC in monitoring progress with reform implementation. *Draft recommendation 14.3* states that “progress against COAG agreed water reforms should be subject to monitoring. The National Water Commission would be the most logical body to undertake such monitoring”. The NWC supports the need for independent monitoring and reporting of reform progress, noting that its role beyond June 2012 is a matter for COAG, following an independent review of the NWC.

Further information

In conclusion, the NWC wishes to reiterate its support for the PC's draft report findings and recommendations. We believe that the strong degree of alignment of your findings and recommendations with those of our *Future Directions* process highlights that the case for reform and key elements are clear. The NWC looks forward to further discussions with the PC in coming months and is happy to assist you in the process.

Yours Sincerely,

Chloe Munro
Chair
National Water Commission

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