

Submission to the Productivity Commission's inquiry into Australia's Urban Water Sector

Dr Ron Ben-David
Chairperson
Essential Services Commission

Dr Ron Ben-David is the Chairperson of the Essential Services Commission of Victoria. The Commission is the economic regulator of the Victorian water industry. It has determinative powers in relation to the pricing of water and sewerage services and it administers a state-wide performance monitoring framework. It is currently implementing a trade waste code and has provided advice on a third party access regime. Dr Ben-David has written widely about governance of the water sector. In this submission, he argues that the Productivity Commission's draft report into Australia's urban water sector does not adequately demonstrate that governance reform can replace economic regulation of the sector.

The opinions expressed in this submission are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures made herein.

Submitted to the Productivity Commission on 9 June 2011

I don't think I have to convince anyone here of the value of an evidence-based approach to public policy. After all, it is not a novel concept.

Gary Banks AO ¹

¹ Gary Banks AO (2009) Chairman, Productivity Commission, *Evidence-based policy making: What is it? How do we get it?* (February 2009)

Preamble

There is a very famous drawing by the renowned Australian cartoonist, Michael Leunig. Drawn almost forty years ago, it shows a man and a boy, presumably a father and son, sitting before an old-fashioned television set. They seem transfixed as they watch a beautiful sunset on the screen before them. The father appears to be gesticulating knowingly to his son about the sunset's beauty. Just over the father's shoulder there is window. Through that window we can see something the father and son have seemingly chosen to ignore or failed to notice — namely, the same beautiful sunset.²

² See Attachment A.

[A] Introduction

This lengthy submission responds to matters raised in Productivity Commission's Draft Report into the urban water sector. The discussion is limited to that report's findings and recommendations in relation to governance and economic regulation. These matters are largely contained in chapters 5 and 11 of the Draft Report.

This submission is motivated by a profound concern that the Draft Report reaches conclusions and recommendations that are not supported by the analysis it has undertaken.

The Chairman of the Productivity Commission has been a powerful advocate for the importance of evidence-based policy advice. These views are fully endorsed by this submission. So too the view that sometimes evidence must be based on reason alone.

*“Now I am not saying that policy should never proceed without rigorous evidence. Often you can't get sufficiently good evidence, particularly when decisions must be made quickly. And you can never have certainty in public policy. All policy effectively is experimentation. But that does not mean flying blind — **we still need a good rationale or a good theory. Rationales and theories themselves can be subjected to scrutiny and debate, and in a sense that constitutes a form of evidence** that can give some assurance about the likely outcomes.” Gary Banks AO³*

Unfortunately, the Draft Report provides neither sufficiently robust reasoning nor the necessary empirical evidence to support its conclusion that economic regulation should be abandoned in favour of improved governance arrangements. While improved governance is highly desirable and ought to be pursued in its own right, it does not meet the necessary or sufficient conditions required for weakening price regulation in the urban water sector.

Perhaps the analytical short-comings of the Draft Report in this regard are due to a decision made early in the report when it states:

“This chapter puts to one side the current configuration of the sector to examine the underlying principles that should guide the design of the role of governments.” (p.76)

³ Gary Banks AO (2009) Chairman, Productivity Commission, *Evidence-based policy making: What is it? How do we get it?* (February 2009)

In so doing, the analysis may have locked itself into a view that is far too stylised with respect to:

- the administration of the urban water sector;
- the interests of communities and governments in that sector;
- the opportunities to be gained from improved governance of the sector; and
- the place of economic regulation within the sector.

This submission demonstrates that as the complex realities associated with each of these issues is re-introduced into the analysis, the Draft Report's conclusions regarding economic regulation become self-evidently untenable.

These shortcomings need to be addressed as a matter of urgency by the Productivity Commission. It is evident from submissions made to the inquiry, that vested interests are already endorsing the finding that price regulation is unnecessary (with little regard to the Commission's other related recommendations). It can be expected that, before too long, this report will be interpreted and cited partially and selectively in order to give strength to the arm of those vested interests.

It might be tempting to argue that an economic regulator is also a vested interest and that this submission is motivated as such. This would be unfortunate. The author trusts that his professional history and track record belie such a view.

To be clear, it is not price regulation *per se* that is at risk. The oversight of pricing decisions will always occur somewhere in the overall governance structure for the urban water sector. Rather, it is the independence, discipline, rigour, consistency and transparency imposed by the well-established processes of economic regulators that is at risk. This risk should not be treated lightly. Nor can this risk be taken on the basis of a highly stylised view of the urban water sector.

The remainder of this submission proceeds as follows:

Section B argues that **there is a logical inconsistency in the construction of the Draft Report's argument** regarding the future of price regulation. The report's analysis is far more tentative than its conclusions suggest. A conclusion cannot be more certain than the premise upon which it is predicated. To suggest otherwise, requires an

appeal to doctrine over reason. It is therefore suggested that a report of this kind requires a much higher burden of proof than has been assumed in the Draft Report.

Section C expresses concern that **the Draft Report simply assumes that regulation impacts on public and private entities in the same way.** This assumption requires testing. Where the costs and consequences of regulating the urban water sector are found to be manifest and material, it will be necessary to identify the relevant causal factors if policy makers are to be properly informed about reform options.

This section also notes that incumbent utilities can exploit their position to impose a form of ‘pseudo-regulation’ in order to limit new entry.

Section D argues that **the community’s relationship with ‘water’ is far more complex, and sometimes contradictory, than has been acknowledged** by the Draft Report. These complexities and contradictions are reflected in the many roles expected of, and played by, governments.

This submission argues that **it is odd that the Draft Report suggests that these trade-offs would be best addressed by making economic efficiency the ‘overarching objective’.** Economic efficiency is neither an outcome nor an output. It is not even an input. It tells us nothing about the benefits (gross or net) to be derived by customers, shareholders, communities or the environment.

The presence of so many unavoidable and intertwined interests imposes limitations on the extent to which alternative governance arrangements can deliver ‘optimal’ community outcomes. These ambiguities will manifest themselves in decisions that appear to be inefficient. This submission argues that if this ambiguity cannot be reduced beyond a finite limit, then so too the observed inefficiency.

Section E **strongly rejects the Draft Report’s contention that governance can serve as a substitute for regulation.** Although many of the governance reforms outlined in the Draft Report are supported, it is argued that, of their own accord, they do not extinguish policy makers’ underlying and multiple conflicting interests in the sector. This presents a natural and finite limit on the ability of improved governance arrangements to produce better community outcomes. Within this bounded reality, good economic regulation and good governance

arrangements exists as *complements* rather than substitutes. This is explored diagrammatically in section E.

This section also notes that although greater commerciality would be desirable in the urban water sector, it would also have consequences that are not identified in the Draft Report.

Section F highlights that the Draft Report seems to presume an extremely interventionist model of ‘price setting’. It is suggested that the Productivity Commission should describe the full spectrum of regulatory arrangements for pricing. This framework would provide a proper basis for assessing the merits, or otherwise, of the different arrangement operating across the different jurisdictions in Australia.

In support of the Draft Report, it is argued that water utilities must always retain primary responsibility for developing pricing arrangements for their respective services. If this were not the case, utilities would claim to be responsible for the benefits they deliver, leaving regulators to account publicly for the associated costs.

It is then argued that **the Draft Report’s claimed finding of no abuse of market power is based on the wrong test**. This submission contends that analysis of investment patterns, rather than the under-recovery of costs, provides the appropriate test. It is suggested that under-investment occurs (or has occurred in the past) precisely because market power exists and it is (or was) exploited by water utilities. Economic regulation has a role to play in exposing and thereby countering under-investment.

If the Productivity Commission intends to persist with its view that under-recovery of costs is the appropriate test, then it should assess the prevalence of under-recovery and identify whether differences arise between different jurisdictions, different locations and under different ownership arrangements.

Although Section G supports a charter of expectations between the government and each water utility as a means for clarifying the roles and responsibilities of water utilities, it argues that **the Productivity Commission is wrong to recommend that the proposed charter (and accompanying arrangements) could, would and should replace economic regulation**.

Moreover, it is noted that the proposal for on-going assessment of efficiency and efficacy of service provision and investment would

represent an enormous intrusion into the administration of water utilities. This imposition would dwarf current regulatory requirements.

Concerns are also raised about the Draft Report's silence about its expectations of government in the event of non-compliance. By placing great reliance on "appropriate sanctions" to be applied by Ministers, the Draft Report's proposed arrangements would increase rather than decrease the potential for political intervention.

It is argued that by acknowledging that poor (commercial) performance could be "politically embarrassing" for governments, the Draft Report demonstrates that the proposed charter is destined to fail.

Section H concludes the submission with three miscellaneous issues:

- There may be a contradiction in the Draft Report regarding the elasticity of demand for water. The Productivity Commission may want to clarify whether there is a contradiction and, if so, which view it supports.
- The Productivity Commission may want to give further consideration to how a "consumer representative body" can be constituted to represent the diverse interests of the community.
- It is unclear why the Productivity Commission suggests that the Australian Government, through COAG, should be involved in pursuing regulatory reform of the urban water sector.

Finally, it should be noted that the opinions expressed in this submission are those of the author alone. They do not represent the views of the Essential Services Commission, its staff or the Victorian Government. The author takes full responsibility for any errors, omissions or conjectures made herein.

[B] The burden of proof is too benign

- This submission is primarily concerned with the Draft Report's conclusions and recommendations with regard to the economic (price) regulation of the urban water sector.
- In chapters 5 and 11, the Productivity Commission is unequivocal about its proposed way forward — namely, regulatory frameworks involving 'price setting' ought to be abandoned and replaced with 'price monitoring' arrangements. For example:

State and Territory Governments should move away from regulatory price setting to a price monitoring regime (where some form of prices oversight is considered necessary). (Draft Recommendation 11.4)

- On closer inspection of the report, it becomes evident that despite the definiteness of its advice in this regard, the Draft Report is heavily reliant on supposition rather than reasoning or evidence. The report's analysis is far more tentative than its conclusions suggest. As discussed below, this represents a logical inconsistency in the construction of the Draft Report's argument regarding the future of price regulation.
- Some examples of the conjectural foundations for the Report's conclusions are demonstrated in Table B1 (highlights added).

Table B1

Statement from Draft Report	Comment
"There are potentially significant costs associated with complying and administering regulation." (p.87)	This is speculative. Although the text then lists potential costs, it does not provide evidence regarding their occurrence and materiality in practice.
"The dividing line between compliance costs and lobbying costs can be quite 'blurry' in some cases. " (p.88)	Is there evidence that information is presented to regulators in a way that does not represent the facts accurately?
"...over-resourcing of regulators can also be problematic if it results in excessively zealous regulation..." (p.89)	The statement neatly avoids falsifiability, however, the extent of its relevance is not tested at all.

Statement from Draft Report	Comment
"Many of the Commission's concerns about regulation of the urban water sector stem from the presence of regulations that, while providing benefits, might not have net benefits." (p.97)	This is a purely conjectural statement; as such, it does not provide a premise upon which a conclusion can rest.
"[T]here are good reasons to believe that the urban water utilities would benefit from further governance reform." (p.260)	Belief is not a sufficiently 'scientific' basis for an unequivocal conclusion.
"Ministers might, in some cases , also direct the GTE to adopt..." (p.261)	This is speculative without any discussion (or evidence) of frequency or materiality.
"The problem currently with GTEs is that they are typically given a number of conflicting (or even seemingly mutually exclusive) objectives." (p.266)	This assertion has little value in the absence of broad-based evidence and analysis.
" In some circumstances , board members might believe that they are to pursue particular government objectives even in the absence of any formal or informal directives." (p.267)	Conjectural (as above). Also, the nexus between board members "beliefs" and their decisions is not established.
"This has meant prices have often been set at levels well below cost recovery levels, possibly leading to inefficiently high water consumption and probably resulting in underinvestment and deferred maintenance." (p.273)	Speculative (as above)
"Governance arrangements are likely to be more effective than regulation in dealing with under-recovery." (p.275)	This is an assertion. Supporting evidence (for example, including refereed research articles) should be provided.
"Even where water providers have the power to earn monopoly rents, good governance, transparent arrangements, performance reporting and independent review should prevent this..." (p.276)	Conjectural (as above).
"Establishing good governance procedures would render much of the current price regulation of government-owned water utilities unnecessary, and would be likely to provide greater net public benefits when compared to price regulation." (Finding 11.3) (p.278)	This not a "Finding". It is an assertion; moreover, it is speculative.

- Each of the statements shown in Table B1 is only true probabilistically. **A conclusion cannot be more certain than the premise upon which it is predicated. To suggest otherwise, requires an appeal to doctrine over reason.**

All the more so, when it is predicated on multiple tentative premises. In effect, the Draft Report places an ‘and’ between the various probabilistic observations highlighted in Table B1.

In mathematical terms, even if each statement were 90 per cent true, there would be only a 28 per cent chance that all the statements were true. If each statement was true 50 per cent of the time, then there would be only 0.02 per cent chance that the entire argument held together in support of the conclusion.

This mathematical analogy is only intended to demonstrate the inherent problem of reaching conclusions based on arguments that are speculative or, at best, potentially true only.

- Speculative and probabilistic statements such as those highlighted in Table B1 are effectively unchallengeable. They insidiously place the onus of *disproof* on the ‘accused’ rather than the ‘prosecutor’. As such, they represent the weakest form of argument.
- Addressing the conjectural nature of the ‘evidence’ proffered by the Draft Report requires removal of the modal qualifications that are present throughout the relevant chapters. Without the benefit of supposition, these premises would require sufficient supporting evidence in order that a clear ‘burden of proof’ has been met. The conditions under which such statements were true would need to be identified and evidence offered as proof of the circumstances under which these conditions were satisfied. This evidence may be quantitative, qualitative or theoretical.⁴
- The Productivity Commission has been a powerful advocate of **evidence-based analysis** — both in terms of its own work⁵ as well as the work of others (for example, see discussion on environmental regulation in chapter 5).
- Given the definiteness of its findings and conclusions regarding governance and regulation of the urban water sector, **it is incumbent on the Productivity Commission to adopt a much higher burden of proof than it assumes in its Draft Report.**

⁴ Examples of theoretical ‘evidence’ might include refereed articles in respected journals.

⁵ Gary Banks AO (2009) Chairman, Productivity Commission, *Evidence-based policy making: What is it? How do we get it?* (February 2009)

[C] A less stylised view of regulation

- Chapter 5 of the Draft Report is titled, *Improving regulation of the urban water sector*. The first three paragraphs of the chapter note that regulation “has an important role in setting boundaries” for the sector. The next eight pages outline the costs (and other concerns) associated with regulation. The list is extensive and includes:
 - compliance costs
 - consumption losses
 - lost investment
 - lobbying costs
 - unclear regulatory objectives
 - excessive prescription
 - redundant regulation
 - poor administration
 - inadequate expertise
 - over-resourcing of regulators
 - regulatory error
 - regulatory capture
 - regulatory risk aversion
 - inadequate accountability
 - micro-management of regulated businesses
 - second guessing of consumer preferences
 - production losses
 - inefficient investment
 - delayed investment
 - poorly designed regulations
 - conflicting regulatory objectives
 - unnecessary complexity
 - poor enforcement
 - excessive reporting requirements
 - regulatory creep
 - under-resourcing of regulators
 - regulatory bias
 - asymmetric information
 - slow decision making
 - institutional self-interest
 - constraints created by earlier decisions
 - duplication of regulation
- This theme is revisited in Chapter 11 which, in relation to price regulation, also adds these potential costs and consequences:
 - significant compliance costs
 - restricting providers’ pricing strategies
 - adverse augmentation decisions
 - disincentive to innovate
 - political interference
 - administration costs
 - limiting flexibility in price-quality trade-offs
 - deterring investment
 - inefficient resource allocation

Materiality and causation of the costs of regulating the water sector

- Despite this very extensive identification of the potential costs and consequences of regulation, the Draft Report does not acknowledge, or explore how, regulation might impact differently when the regulated entity is publicly owned. Indeed, **the Draft Report takes as given that regulation impacts on public and private entities in the same way without testing this assumption.**
- Figure C1 provides a simple schematic of the different combinations of regulation and ownership (in the urban water sector).

Figure C1

		Type of regulation	
		Economic	Non-economic (eg. health, environmental)
Regulated party	Urban water utility (public)	A	B
	3 rd party service provider (private)	C	D

The costs and consequences of poorly considered regulation are well established in relation to private sector providers. It is probably reasonable, therefore, to infer that this would hold true in relation to private operators in the urban water sector — boxes C and D. However, it is not self-evident that these concerns and costs are replicated when a regulated entity is publicly owned (boxes A and B) unless, perhaps, if that regulated entity is operating in a highly commercial environment. This is not the reality that describes the urban water sector. (As discussed in section E, it may *never* describe the urban water sector.)

In completing its review, the Productivity Commission should **explore whether the costs and concerns it has identified with regulation also apply when a regulated entity is publicly owned and has limited commercial orientation.** The urban water sector, and its

different configurations across the country, provides the perfect case study.

- If a well considered analysis based on first principles, as applied to the publicly owned urban water sector, suggests that regulation might have undue costs and consequences, then an empirical analysis should follow to assess the materiality of these findings.
- **Where the costs and consequences of regulating the urban water sector are found to be manifest and material, it will be necessary to identify the relevant causal factors if policy makers are to be properly informed about reform options.**

These causal factors may differ by location, size, ownership structure, jurisdiction and other institutional arrangements. It is these causal factors that are of greatest relevance to the design of alternative governance and regulatory arrangements. If these causal factors are not addressed, then the abolition of price regulation will have little real bearing on outcomes and community benefits. These causal factors are explored in section D of this submission and their implications for governance and regulation are discussed in section E.

Regulation and pseudo-regulation of private interests

- There are, of course, some private service providers operating in the water sector. However, they tend to be either suppliers to, or customers of, existing water utilities (in the latter case they may on-sell their products to customers). However, typically these operators are not subject to the price regulation against which the Draft Report is set (that is, box C in Figure C1 may be unpopulated).

Of course, they may be subject to non-economic regulation (health, safety, environmental), but in this regard they are no different to the publicly owned utilities (boxes C and D). This does not justify poorly designed regulatory interventions, but it does suggest that even poorly designed regulations do not necessarily disadvantage private entrants.

- The more interesting scenario that policy makers should consider arises when **water utilities are playing a *de facto* regulatory role** in relation to third party entrants; entrant who are potentially their competitors.

To some extent, the reason for this is understandable. Encumbent water utilities probably cannot escape the expectation that they will be the ‘provider of last resort’ if the new entrant fails. This may involve assuming responsibility for assets and service obligations. Under such circumstances, it is rational for the encumbent utility to want to limit its exposures and risks.

Nevertheless, it is quite possible that **an encumbent utility will exploit its position to use this form of ‘pseudo-regulation’ in order to limit new entry.** It would seem that the few concerns proffered by private operators, and noted in the Draft Report, typically relate to this form of ‘pseudo-regulation’.

[D] The limits of complex and conflicting interests

- The community's relationship with 'water' is complex and sometimes contradictory. These complexities and contradictions are reflected in the many roles expected of, and played by, governments in relation to 'water' — but it is not just a matter of water. This relationship extends well beyond the physical resource itself. It spreads into the land and the environment from which the water is drawn and to which it is returned. It also involves the communities sustained by the water and the things that those communities consider to be of value.

Objectives and desirable consequences

- The Draft Report (Chapter 3) touches on the complexity of this relationship when it identifies possible objectives for the urban water sector. Based on input from its consultations, the Productivity Commission identifies the following objectives:
 - water security and reliability
 - controlling costs
 - universal and affordable access
 - public health
 - environmental protection, sustainability and amenity
 - flood mitigation
 - water use efficiency and water conservation; and
 - commercial viability and dividends to government.

The Report observes that there are “several valid objectives” for the urban water sector and that this necessitate trade-offs between and within objectives.

- **It is odd, however, to suggest that these trade-offs would be best addressed by making economic efficiency the “overarching objective” for the urban water sector** (see section 3.2). Economic efficiency is neither an outcome nor an output. It is not even an input. It tells us nothing about the benefits (gross or net) to be derived by customers, shareholders, communities or the environment.

The Productivity Commission would never suggest that economic efficiency ought to be the overarching objective of a private firm (say: BHP Billiton, Coca Cola Amatil, Origin Energy or KPNG). There would be little argument that the overarching objective of these firms is anything but maximising shareholder value. Likewise, the Productivity Commission would be most unlikely to recommend that economic efficiency be made the overarching objective in public service provision (say: childhood obesity programs, primary school education or mental health services). Presumably, the reason for these interventions is related to their intended positive impact

Economic efficiency is not an objective for any organisation. Indeed, it is meaningless to describe it in these terms. Economic efficiency describes the consequences of operating in a certain way; a way of delivering objectives — objectives that may include profit maximisation or community impact.

Economic efficiency is, however, completely relevant to the design of governance institutions and regulatory structures. Indeed, it is through the interaction of good governance and good regulation that urban water providers are provided with the incentives to act in a way that displays ‘economic efficiency’.

It would seem that the Draft Report’s approach to governance and regulation originates, in part, from this misattribution of economic efficiency as an objective rather than a desirable consequence.

The role of government

- Anyone who has worked in or with the water sector will be very familiar with the refrain, “But water is different”. This refrain should not be taken at face value, but nor should it be dismissed at face value.
- Despite the reasonably comprehensive overview of the many objectives often ascribed to the urban water sector, **there is no accompanying discussion or analysis about the many interests that governments have in the sector.** These are the interests that actually give rise to the various objectives listed in the Draft Report.

- This submission observes that government interests in the urban water sector include, but are not limited to, the following:
 - ❖ guardian of the community's sense of entitlement to water (even it must pay to exercise that entitlement)
 - ❖ whole-of-system manager (security of supply)
 - ❖ protector of consumer interests (consumer rights, health, safety)
 - ❖ customer advocate (representing otherwise atomistic and uncoordinated consumer interests)
 - ❖ collective negotiator for buyers of water services
 - ❖ upholder of socially 'fair' (and possibly equitable) outcomes
 - ❖ arbiter of land availability and land use
 - ❖ occasional benefactor (for example, of gifted assets)
 - ❖ promoter of economic and regional development (jobs creation)
 - ❖ creator and protector of property rights
 - ❖ steward of the natural environment
 - ❖ champion of cultural and national values and heritage
 - ❖ mediator over indigenous association with the land (and its water)
 - ❖ legal shareholder
 - ❖ shareholders' representative (where citizens view themselves as the ultimate shareholders)
 - ❖ employer (direct or indirect)
 - ❖ sometime banker and always banker of last resort
 - ❖ standby administrator
- These many different and often conflicting interests coexist in time and in place; and in the minds of policy makers. They are not neatly separable and they are ever-present. Each interest creates its own incentives for, and resultant behaviours by, ministers and governments. To put it colloquially, governments wear 'many hats' in their relationship with the water industry and its customers. They are

usually wearing more than one hat a time and they might sometimes not even know which hat(s) they are wearing.

There is probably no other area of government policy that is so imbued with simultaneous and conflicting policy interests. In this regard, water is truly ‘different’.

The presence of so many unavoidable and intertwined interests imposes limitations on the extent to which alternative governance arrangements can deliver ‘optimal’ community outcomes. These limitations are discussed in section E of this submission.

- Each of these interests, in some way, reflects the many and often contradictory concerns held by the community. It is not particularly important whether these community concerns are objectively rational or whether economists can explain them. After all, economists do not require that consumers demonstrate the rationality of their preferences for particular products. Rather, economists accept consumer preferences as exogenously determined and accept that these exogenously determined preferences will drive behaviours.
- Similarly, it must be accepted that policy makers’ many interests in the water sector originate from the community and they exist exogenously; and it must be accepted that the conflict between these exogenously determined interests will drive behaviours that are ambiguous, unavoidable and irreducible beyond a certain finite limit. **These ambiguities will manifest themselves in decisions that appear to be inefficient; but if the ambiguity cannot be reduced beyond a finite limit, then so too the observed inefficiency.**
- The Draft Report makes a passing reference to this irreducible ambiguity, albeit understated: “*there are likely to be residual inefficiencies*” (p.83) The reasons provided for these “residual inefficiencies” are not sufficient. They only include: actual or perceived political pressure imposed on water utilities; weaker incentives for efficiency and innovation; and the costs and limitations of performance monitoring.
- By not properly and fully recognising this unavoidable and irreducible ambiguity and its consequent inefficiencies, the Draft Report’s subsequent advice, regarding governance and regulation of the water sector, is constructed and offered on a two dimensional view of a three (or more) dimensional reality.

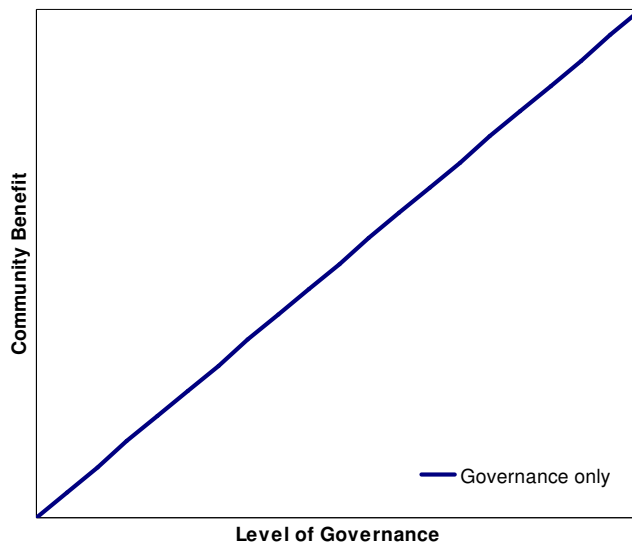
[E] Governance is not a substitute for regulation

- The Draft Report suggests that economic regulation, particularly price regulation, should be abandoned in favour of improved governance arrangements. Alternatively stated, improved governance is seen as a substitute for independent economic and price regulation in the publicly owned water industry.

The Draft Report outlines a suite of governance reforms. Although **this submission is supportive of many of these governance reforms, it rejects the contention that governance can serve as a substitute for regulation.**

- If better governance alone could deliver better community outcomes, then it could be expected that there would be a positive relationship between the two. This positive relationship is presented illustratively in Figure E1. For simplicity, a linear relationship is assumed.

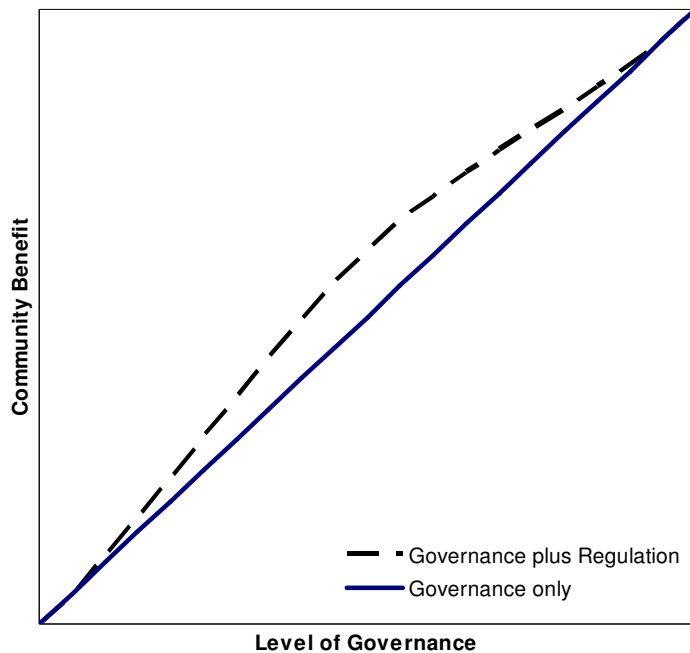
Figure E1



The Draft Report suggests that community benefit can be maximised by focussing on better governance arrangements. The assumed maximum community benefit is represented by the top right-hand corner of the box in Figure E1.

- Within the context of the Draft Report, the case for economic regulation looks weak because any additional benefits from regulation can also be delivered through improved governance. This is shown in Figure E2. At any point on the solid line (governance only), community benefit can be increased by either investment in governance or regulation — but ultimately, the Draft Report asserts that high levels of community benefit can be attained without regulation.

Figure E2



- However, both experience and first principles (as discussed in section D) suggest that there are natural and finite limits on the community benefits that governance alone can deliver; but there is at least one other reason why these finite constraints would exist even with ‘first best’ governance in the urban water sector — namely, unleashed commercial incentives.

In chapter 11, the Draft Report identifies that commercial incentives would become more dominant with improved governance arrangements. This submission agrees with this observation and agrees that **greater commerciality would be desirable in the water sector**. However, greater commerciality would also have consequences that are not identified in the Draft Report — namely, as commercial

interests increasingly come to the fore, the Boards and management of water utilities would (and should?) display behaviours more akin to the private sector. This would include rent seeking. This would *inter alia* include water utilities exploiting their political advantage over policy makers. The extensiveness of the conflicting interests identified in section D would leave policy makers highly exposed to this type of exploitative behaviour.

No matter how well other elements of the Productivity Commission's governance structure are implemented, of their own accord, they do not extinguish these political exposures. They do not extinguish these political exposures they do not extinguish policy makers' underlying and multiple conflicting interests in the sector.

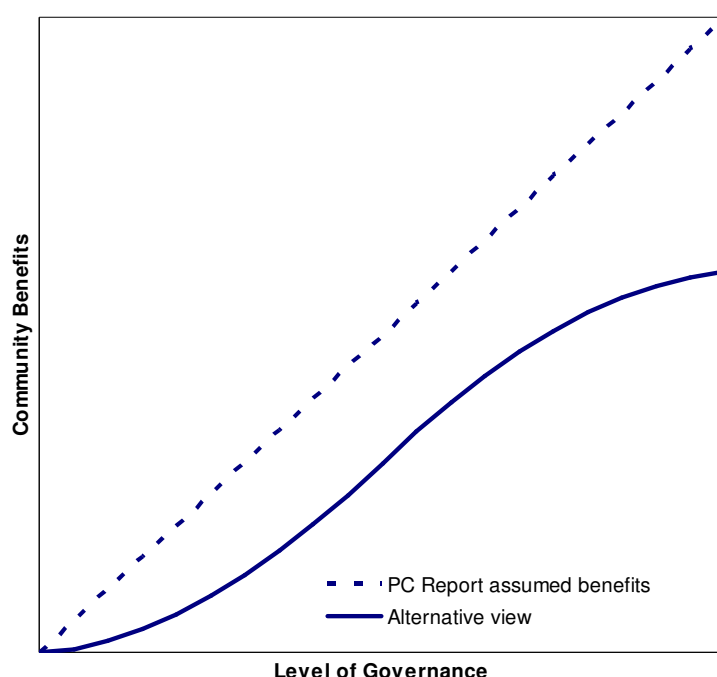
- The natural* and finite** limit on the ability of improved governance arrangements to better community outcomes is labelled as 'alternative view' in Figure E3.

Note

* 'natural' refers to the many interests that policy makers simultaneously represent and pursue; and

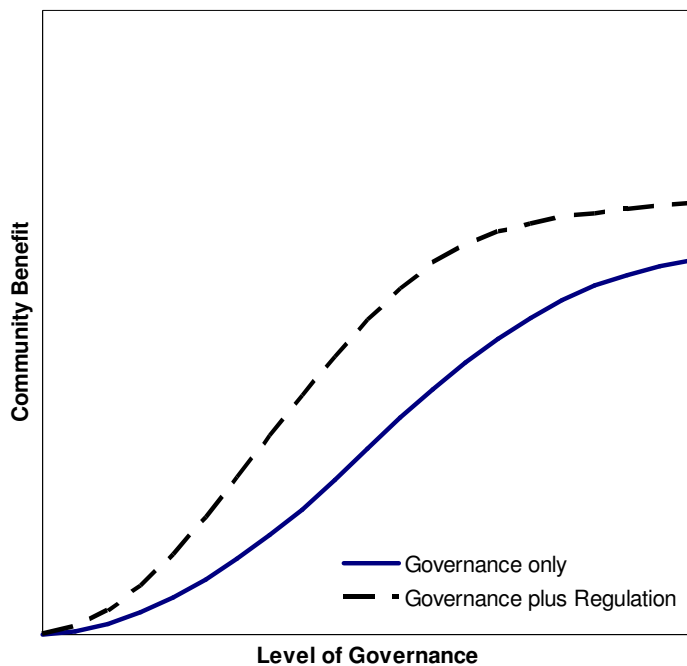
** 'finite' refers to the limited separability of those interests into discrete and mutually exclusive concerns.

Figure E3



- Importantly, the relationship between governance and community benefit in Figure E3 remains positive — suggesting that **there are always positive returns to be gained from better governance** (at least in gross terms). However, it also seeks to illustrate that governance is limited with respect to the community benefits it can deliver.
- Within this bounded reality of governance, good economic regulation exists as a *complement* to governance rather than a substitute (as suggested by the Draft Report). This complementarity is illustrated in Figure E4.

Figure E4



- Some of the main themes conveyed by Figure E4 include:
 - ⇒ At any level of governance, economic regulation complements governance in order to produce a better outcome for the community — even when governance arrangements are relatively sophisticated.
 - ⇒ Unlike in Figure E2, for any level of governance, the benefits to be derived by implementing good regulatory arrangements are not as

readily ‘leap-frogged’ by relatively small improvements in governance arrangements.

- ⇒ The return on good regulatory arrangements is always positive — that is, the dashed line is always positively sloped. However, the return on regulation does not increase indefinitely (that is, the gap between the solid and dashed lines initially widens but begins to narrow as the level of governance improves).
- ⇒ A gap remains between the maximum identifiable community benefit (the top right hand corner of the diagram) and the benefits which can be achieved even when good regulatory arrangements are in place and complementing a sophisticated level of institutional governance. This gap can be considered as representing **the dead weight loss associated with the community’s (and consequently, the policy maker’s) complex and often conflicting interests** in relation to the management of the greater water resource.

[F] Assessing price regulation and market power

- The complementary nature of good governance and good economic regulation outlined in the preceding section raises two separate issues that need to be considered, namely: What is price regulation and what is its purpose?

What is price regulation?

- The term ‘price regulation’ describes a wide spectrum of arrangements that may be assigned to utility regulators. The range of institutional arrangements is not properly described in the Draft Report. It simply refers to the two alternatives of ‘price setting’ and ‘price monitoring’ as though their meanings are self-evident. For example:

“[T]here are strong reasons to question whether price regulation (and particularly, price setting) of the urban water sector is still needed.” (p. 276)

“...it is perhaps surprising that the sector is subject to price setting, the most heavy handed form of price regulation, when other more light handed options, such as price monitoring, are available.” (p. 277)

- The term ‘price setting’ can be misleading. It would seem that the Draft Report presumes an extremely interventionist model whereby the regulator takes full responsibility for determining the prices to be faced by customers. Individual water utilities seem to be viewed as rather passive onlookers in the regulator’s determinative processes.
- **This submission holds that water utilities must always retain primary responsibility for developing pricing arrangements** for their respective services. It would never be desirable to transfer responsibility and accountability for determining prices so completely to the regulator. If this were indeed the case, it would lead to complacency. It would render any attempt at establishing independent governance arrangements as meaningless. It would institutionalise a break in the nexus between benefits and costs. Boards would claim to be responsible for benefits leaving regulators to account publicly for the costs.
- In Victoria, the onus is correctly placed firmly on the State’s water utilities to develop their own ‘water plans’ which must include:

- their intended expenditures and investments for the regulatory period (five years);
- demonstrable improvements in service delivery (which are then reported annually via a state-wide performance regime administered by the Essential Services Commission);
- identification of the resultant revenue requirements and proposed pricing framework; and
- extensive and open consultation with customers before submission of the proposal to the Essential Services Commission.

It is only then that the Commission reviews each authority's water plan to assess the reasonableness and efficiency of its claimed proposals. Amongst other things, this process of review includes:

- challenging the assumptions used
- evaluating the deliverability of proposed projects (cost and timelines) and the claimed outcomes
- assessing the adequacy of consultation processes; and
- confirming adequate attention has been given to understanding and addressing customer impacts.

The Essential Services Commission only approves the proposed pricing framework once the robustness of all these aspects of a water plan is proven.

It is worth noting that although there are some 'regulatory costs' to the water authorities from complying with this process, most of these costs would (or at least should) be incurred in any event if the water authority is operating efficiently and effectively.

Despite the onus for developing pricing arrangements lying squarely with Victorian water utilities, it would seem that the Draft Report would classify the Victorian regime as 'price setting' — with its implied heavy-handed and disproportionate intervention by the regulator in order to determine prices.

- Whether this interpretation of 'price setting' was intended or not by the Productivity Commission, it needs to be clarified in subsequent

reports. **The spectrum of regulatory arrangements that might be classified as ‘price setting’ should be identified and the merits, or otherwise, of each arrangement should be assessed** in the Productivity Commission’s final report.

- A similarly transparent analysis should be undertaken for the broad range of institutional options simply classified as ‘price monitoring’ in the Draft Report.
- A framework that covers the full spectrum of regulatory arrangements would provide a robust and analytical basis for the Productivity Commission final report. It would support a comprehensive and more robust comparison of the merits of the various regulatory arrangements operating across the different jurisdictions in Australia.

What is the purpose of price regulation?

- Section 5.5 of the Draft Report is titled, *When should regulation not be used?* It would seem that this is intended as a somewhat rhetorical question. Two areas are identified where the Productivity Commission “considers the benefits of the involvement of regulators have been significantly overstated.”

The first area identified is where “regulators increasingly appear to be involved in decisions about whether pricing regimes for water have redistributive elements to them.” This submission supports the Draft Report’s first observation that redistributive issues are more efficiently addressed by governments rather than individual water authorities. However, it is an inescapable truth that the directors and staff of non-metropolitan water utilities are often drawn from the local community. As such, they will be far more directly exposed to their respective communities’ complex and conflicting interests (as listed in section D); including concerns about affordability. As one managing director recently wrote (to this author):

“I attended an interesting discussion with the Productivity Commission the other day, their view is that water corporations ought to just go about their business and let others worry about the impact of prices. This is very easy said, but I live in my community and I care.”

The second area identified in the Draft Report is where the goal of full cost recovery is otherwise considered unachievable due to the

potential for “political considerations [to] influence pricing decisions for water, often leading to under-recovery of costs and subsequent underinvestment in infrastructure.” For the reasons outlined below, this submission contends that this is not a self-evident reason for rejecting price regulation.

- Chapter 11 returns to the inadequacy of under-recovery as a reasonable purpose for price regulation on a number of occasions.

“Independent economic regulation of urban water utilities has been seen as important in the absence of competitive markets because the alternative has traditionally been high levels of political interference in pricing. This has meant prices have often been set at levels well below cost recovery levels, possibly leading to inefficiently high water consumption and probably resulting in underinvestment and deferred maintenance.” (p.273)

“[T]he Commission does not consider it a proper role for regulation to prevent under-recovery of costs. Rather, price regulation should be about preventing abuse of market power where such power can be shown to exist.” (p.275)

“...the major concerns in the urban water sector have traditionally related to poor rates of return, under-pricing and, at times, underinvestment.” (p.275)

“Given the poor rates of return in the sector historically, it is perhaps surprising that the sector is subject to price setting, the most heavy handed form of price regulation, when other more light handed options, such as price monitoring, are available. This is particularly so given that many proponents of regulation state that political interference has tended to keep prices charged artificially low, thereby leading to underinvestment. As noted, the Commission does not see this as an argument for price regulation. Rather, price regulation should be about preventing inefficiencies associated with market power.” (p.277)

“Given that many proponents of ongoing independent price regulation argue it should be maintained to prevent under-recovery of costs...” (p.280)

- The Draft Report clearly holds the view that the “abuse of market power” is the main purpose for price regulation. The issue with which it then contends is whether market abuse occurs in the water sector. It concludes that the sector typically displays under-recovery and therefore any market power that may exist in the sector, is not being exercised. On this basis, the Draft Report concludes there is no case for price regulation.
- This submission is concerned that **the Draft Report’s claimed finding of no abuse of market power is based on the wrong test of market power.**

The economic theory of the firm suggests that where market power exists, a firm will exploit its position in order to restrict the quantity supplied and raise prices above the socially optimal outcome. In so doing, it maximises its profits and imposes a dead weight loss on society.

The Draft Report applies this test to suggest that water providers, being local monopolies, might be expected to “increase prices above efficient levels and reduce water consumption (creating so-called ‘dead weight losses’ of monopoly).” After noting that water utilities apparently do not behave in this way, the Draft Report concludes that while market power may exist, it is not being abused (and so price regulation is not required).

“The Commission agrees that water utilities possess market power, but heavy handed regulation is only required if there is a “strong likelihood of them using their market power in a way that damages economic efficiency”. (p.277)

This submission does not question the well-established economic theory of the firm, rather it challenges whether the Productivity Commission has applied the right ‘test’ of market power.

In assessing whether economic regulation is warranted, it is also pertinent to ask: **What behaviours could have been expected had the firm been operating in a competitive market?** If those behaviours are not observed in the monopolistic market, then consideration should be given to employing regulatory interventions to create the necessary incentives to promote these competitive-like behaviours.

Two particularly important behaviours worth questioning with regards to the locally monopolistic urban water sector are: (1) the level and quality of investment in capital upgrades; and (2) the level of investment in product development.

In a competitive market, failure to invest adequately in capital upgrades and product development would be a form of ‘commercial suicide’. Monopolists do not face this threat (other than, perhaps, over the very long term). Therefore, commercial and intellectual under-investment is only possible where considerable market power exists.

Anecdotally at least, it would seem that, overall, the water sector is characterised by underinvestment in capital upgrades and a low level of attention to enhanced product offerings. While the Draft Report does not specifically address the latter, it does note the likelihood of underinvestment. (For example, see quote above from page 273.)

Unfortunately, the Draft Report draws precisely the wrong conclusion from its own observation — namely, it concludes that even if market power does exist in the water sector, it does not appear to be “damage[ing] economic efficiency”.

This submission contends the exact opposite conclusion holds true. Under-investment occurs precisely because market power exists and because it is being exploited by water utilities (and their respective shareholders). This leads to outcomes for customers that are less efficient than those that would prevail had competitive forces been at play.

Because market power exists and is being exploited to the detriment of customers, **economic regulation has a role to play in exposing and thereby countering under-investment**; or more accurately, the highly transparent processes employed by economic regulators (see discussion above about the Essential Services Commission) represent a Damoclean sword waiting to drop on the inept water utility.

For the reasons outlined in section D, it would be sheer folly to place this threat completely in the hands of policy makers who are constantly subjected to the community’s complex and often conflicting demands in relation to management of the water resource.

(And of course it should be noted that politicians and parliaments do ultimately wield far greater weaponry than is, or should be, available to economic regulators. While their arsenal is far more powerful, it is typically also far more ungainly and unedifying. Therefore, it should only be deployed as a last resort.)

- This submission also notes that the Draft Report has only asserted that there is systematic under-recovery in the urban water sector.

If the Productivity Commission intends to persist with its view that under-recovery of costs is the appropriate test, then it should assess the prevalence of under-recovery and identify whether differences

arise between different jurisdictions; in different locations (metropolitan, regional and rural); and under different ownership arrangements (state government and local government). This is undoubtedly a large task in its own right. Unfortunately, without this quantitative analysis, the suggestion that water utilities are systematically under-recovering their costs (and therefore not abusing their market power), is nothing more than an assertion.

- Two additional claimed purposes for economic regulation are mentioned-in-passing and then summarily dismissed in the Draft Report, namely:

“The Commission does not consider the role of regulation to be providing customers with assurance that price rises are justified, or to protect water utilities from criticism when they put up prices.” (p.276)

This submission fully supports the Productivity Commission in its conclusion that it is not the role of economic regulation or regulators to “protect” the reputation of individual water utilities. Their reputations should, and will, depend on the ‘value’ they deliver to their customers.⁶

The summary dismissal of the second claim is more tenuous.

‘Promoting the long term interests of consumers’ typically appears (in some form) in most independent economic regulators’ governing legislation — indeed, it is the Victorian Essential Service Commission’s only objective. These long term interests will, to some extent, depend on customers’ confidence in the integrity of the overall framework for water services. Independent verification of prices is therefore a legitimate reason, though maybe not a sufficient reason, for price regulation, if it provides customers with some form of assurance about the integrity of the governing framework for urban water services.

⁶ See Ben-David, R. (2010) *Governance and the water industry: The challenge of defining, creating and delivering value*. Presentation to VicWater 2010 Annual Conference (2 September 2010). Available at: esc.vic.gov.au

[G] A charter is desirable but limited

- The Draft Report, having determined that price regulation is not required, offers an alternative governance arrangement for imposing discipline on the urban water sector. As it states:

“If governments wish to provide customers with reassurance, they can do so through the use of transparent governance arrangements (such as the Commission’s proposed charter), by employing regular performance reporting and through regular independent reviews of the utility’s performance.” (p.276)

Indeed, the Draft Report’s entire alternative governance arrangement rests on the proposed charter. It would provide the necessarily comprehensive administrative framework.

“[T]he charter could require utilities to fully recover costs (incorporating an appropriate return on the shareholder government’s investment) but not to price in a manner that would allow a return above this or in some other way that damages economic efficiency.” (p.280)

In turn, the entire viability of the proposed charter rests on the rationale that utilities can be simply instructed to act efficiently.

“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.” (p.99)

Public reporting and external monitoring would then ensure compliance with this simple instruction.

“The Commission envisages that utilities would regularly report information on their performance against the charter and publish it on their websites. To provide customers with reassurance, the process could be overseen by the auditor-general’s office (or even an economic regulator). The auditor-general could also report on the efficacy and efficiency with which services are provided.” (p.262)

Sanctions would be applied where breaches of the charter were found. Presumably, this would include identified cases of inefficiency and inefficacy in service provision.

“What is required is monitoring against a well defined policy objective...with jurisdictional governments applying appropriate sanctions to directors and councillors for non-compliance.” (p.99)

Public reporting would also ensure that government would be unable to turn a blind eye to any short-comings in the rigour with which the charter’s intentions were implemented by individual utilities.

“Although there would still be political incentives to keep water prices low, there would also be potential for performance reports to be politically embarrassing if they found evidence of poor commercial performance (not just perceived ‘excessive’ returns). Reports could also find evidence of inefficiency or poor investment decisions.” (p.280)

Government’s would also be able to ‘reward’ individual utilities who had exceeded the charter’s intentions.

“There would be merit in allowing utilities to achieve greater rates of return if they could demonstrate efficiency gains (to ensure there were incentives to avoid inefficiency).” (p.280)

- **A charter of expectations between the government and each water utility is strongly supported by this submission as a means for clarifying the roles and responsibilities of water utilities.** This submission certainly does not support the view that ambiguity should be delegated to individual water utilities to resolve; and it opposes the view submitted to the Productivity Commission that:

“Dealing with conflicting objectives is core business for a water utility ...we have to balance social needs against the costs of these projects against their environmental impacts...” (p.266)

- In Victoria, many aspects of the proposed charter are already implemented via an instrument called a ‘Statement of Obligations’ issued by the Minister to each water authority. **However, the Productivity Commission is wrong to recommend that the proposed charter (and accompanying arrangements) could, would and should replace economic regulation.** As highlighted below, it would not achieve the claimed benefits.
- The tenuousness of Draft Report’s logic is demonstrated by the following observations.

- ❖ The observation (p.99) that governments could “simply instruct” water utilities to price and operate efficiently is particularly peculiar. If it was as simple as the Draft Report suggests, then it could be reasonably expected that agencies of all kinds would be similarly instructed. This might include: health networks, defence materiel or even government departments.

And while it might be somewhat apagogic to extend the Draft Report’s argument in this regard, if it were as simple as suggested, then government could also pass legislation that ‘simply’ required all firms to “price in a manner that generates adequate revenues but not in such a way that would result in ‘excessive’ profits”. Clearly, this is nonsensical.

- ❖ The extensive reporting and auditing arrangements being proposed would largely mimic those currently in place. Moreover, the suggestion that there should be an on-going assessment of efficiency and efficacy of service provision and investment would represent an enormous intrusion into the administration of water utilities. This imposition would dwarf current regulatory requirements.

(Also, the suggestion that Auditor’s General might undertake this work is misguided. Their interests and expertise do not lie in the area of *economic* efficiency.)

- ❖ The Draft Report is silent about its expectations of government in the event of non-compliance — including failure to operate and invest efficiently and efficaciously. The lone observation it makes in this regard is that government should apply “appropriate sanctions to directors and councillors for non-compliance.”

As noted in section F of this submission, governments and parliaments have considerable but unwieldy tools at their disposal. It is not clear how the Draft Report envisages that these options might be deployed in order to impose “appropriate sanctions”.

Moreover, by placing great reliance on ministerially applied “appropriate sanctions”, the Draft Report’s proposed arrangements would increase rather than decrease the potential for political intervention. Even perceived threats can have very real consequences.

- ❖ The suggestion that efficient water utilities might be ‘rewarded’ by allowing them to earn a higher rate of return is completely contradictory to the intended purpose of the charter. It would introduce a level of discretion and potential arbitrariness into the governance of the urban water sector. It is not at all clear who or how this would be administered or how this discretion would not fall prey to the political interests about which the Draft Report is so rightly concerned.

Moreover, it begs the question as to why other parameters might not similarly be subject to ‘reward’ or ‘penalty’ and therefore, how they might also become subject to ‘political interests’.

- ❖ The Draft Report’s acknowledgement that poor (commercial) performance could be “politically embarrassing” demonstrates that the proposed charter is destined to fail.

The entire purpose of the proposed charter is to distance water service providers from governments in order that they may act commercially and efficiently. Conversely, this distance is intended to insulate governments from taking responsibility for the operational decisions (failures) of water utilities. That they may still incur the opprobrium of political embarrassment indicates that they would remain responsible in the eyes of the community. In which case, what has really been achieved?

- By its own arguments, the Draft Report demonstrates that the proposed charter would do little to alter the dynamics of the urban water sector — that **none of the claimed benefits of the proposed charter support the removal of economic regulation.**

[H] Some other matters for further consideration

A contradictory view regarding demand elasticity?

- In Chapter 8, the Draft Report express concerns for the losses imposed on the community from restrictions.

“Restrictions generate costs to households, businesses and the community. They do so by denying consumers the opportunity to choose how to use water in the ways that are most valuable to them. Quantitative estimates indicate that the costs of restrictions are significant and can amount to several hundred million dollars per jurisdiction per year where they have been in place.” (p.195)

- In chapter 11, the Draft Report observes holding prices at an artificially low level promotes over consumption.

“This has meant prices have often been set at levels well below cost recovery levels, possibly leading to inefficiently high water consumption and probably resulting in underinvestment and deferred maintenance.” (p.273)

- There may be a contradiction in these two views. The first view, that the community incurs “significant costs” appears to imply that the demand for water is reasonably inelastic. Conversely, the second view, whereby lower prices lead to “inefficiently high water consumption”, appears to suggest a moderately elastic demand for water. The Productivity Commission may want to clarify whether there is a contradiction and, if so, which of the two views it supports.

The challenges of properly representing consumer interests

- Regulators across the country and internationally continue to grapple with ensuring that consumer interests are properly understood and represented in their regulatory frameworks and decision-making processes. While advances have been made, no regulator would claim to have found the ideal arrangement.
- Perhaps it is ironic that when water authorities were (are) very small, they could call a town hall meeting in order to fairly accurately ascertain community attitudes and interests.

- Today's water authorities, some with hundreds of thousands of customers, have grown in the pursuit of efficiencies accompanying economies of scale. It is unavoidable that they consequently become more distant from their customers — indeed, their customers often represent vastly diverse interests and attitudes. For example, a single authority may have customers from small and big towns, diverse socio-economic realities, and with an even more diverse set of social and environmental values.
- This submission contends, without critical judgement, that existing consumer representative organisations tend to focus their attention on customers 'doing it tough'. While this is obviously warranted, it does tend to leave other 70 or 80 or 90 per cent of the population somewhat unrepresented.
- The Draft Report's suggestion that a "consumer representative body" be established is worth exploring. The Productivity Commission may want to give further consideration to how such a body can be constituted to represent the diverse interests noted above.

The Australian Government has no role in urban water reform

- The Draft Report's approach to the issue of national regulation of the urban water sector is ambivalent. It notes the potential advantages and disadvantages in chapter 11 and, for now, seems to avoid taking a position.
- For reasons not explained in the Draft Report, the Productivity Commission does foresee a role for COAG (even in the absence of a national regulatory framework).

"If price regulation of the urban water sector is to continue, COAG could look at developing principles to ensure more nationally consistent economic regulation of the urban water sector." (p.294)

- It is beyond the scope of this submission to debate the merits of federalism but it is worth noting that the urban water utilities do not cross state borders. Their operations exist completely within a single jurisdiction and the consequences of their actions are also largely contained within that jurisdiction.

- This lack of inter-jurisdictional issues, at least in net terms, is acknowledged by the Productivity Commission when the Draft Report finds:

“State, Territory and Local Governments will be the major beneficiaries of the Commission’s proposed reforms to the urban water sector. While some costs will be incurred, these are expected to be outweighed by the benefits from more widespread cost recovery and increased dividend payments. Therefore, there is no case for Australian Government funding to promote urban water reforms.” (Draft Finding 14.3)

- On this basis, it is unclear why the Productivity Commission also suggests that the Australian Government, through COAG, should be involved in pursuing regulatory reform of the urban water sector.

ATTACHMENT A

'TV Sunset' by Michael Leunig

