

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

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Dr Ron Ben-David is the Chairperson of the Essential Services Commission of Victoria. In early June, he submitted a response to the Productivity Commission's draft report into Australia's urban water sector.¹ This supplementary submission responds to comments made during public hearings regarding price monitoring of Victorian ports. Dr Ben-David demonstrates that price monitoring of Victoria's ports has been the consequence of successful reforms rather than a contributing factor to those reforms. He identifies at least four necessary conditions that were satisfied prior to the introduction of price monitoring of port services. He argues that these conditions are not yet satisfied in the urban water 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.

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¹ Dr Ben-David's submission can be found on the Productivity Commission or Essential Services Commission websites.

1. Introduction

I recently submitted a detailed submission to the Productivity Commission's inquiry into Australia's Urban Water Sector.² Since then, a number of references have been made to the regulatory regime for Victorian ports during the Productivity Commission's public hearings. These comments have suggested that Victoria's experience with its ports demonstrates that price monitoring is viable and desirable in the urban water sector. This suggestion also appears on page 278 of the Draft Report.

This Supplementary Submission reflects on the relevance of the deregulation of Victoria's ports and how it might inform the current inquiry into the urban water sector — specifically, Draft Recommendation 11.4 that price regulation be replaced with price monitoring. As demonstrated below, **the necessary conditions that enabled the gradual move from price setting to price monitoring of Victoria's ports, do not exist in the urban water sector.**

Price monitoring is the consequence of successful competition reforms rather than a contributing factor. It represents a late stage in the reform process; one that can only be reached once a set of necessary conditions has been satisfied. Four of these conditions are highlighted in this supplementary submission which draws on Victoria's experience with the deregulation of its ports.

1.1 Background

Between 2005 and 2010, the Essential Service Commission oversaw a price monitoring regime in Victoria's four commercial ports. Since then, and on our recommendation, the three regional ports (Geelong, Hastings and Portland) have been fully deregulated; so too a number of services at the Port of Melbourne. Only a few services at the Port of Melbourne now remain subject to price monitoring.

2. Necessary Conditions

The following discussion identifies four conditions that were satisfied prior to the adoption of price monitoring arrangements in Victoria's ports — namely: (i) clarity of objectives; (2) competition and competitive tension; (3) countervailing power; and (4) long-term stability. (Other necessary conditions may exist and will also need to be satisfied prior to adopting price monitoring arrangements.)

² Ben-David, Ron (2011), *Submission to the Productivity Commission's inquiry into Australia's Urban Water Sector*, available on the Productivity Commission or Essential Services Commission websites.

2.1 Clarity of objective(s)

In Sections [D] and [E] of my original submission to this inquiry, I discuss the complex and often conflicting interests governments have in the water sector. I contend that this creates an irreducible level of ambiguity which places a ‘finite’ and ‘natural’ limit on the outcomes (or community benefit) that can be achieved through governance reforms alone. This limitation establishes the complementary role that economic regulation plays to better governance.

The breadth of interests of successive Victorian governments in ports bare little resemblance to those held with respect to the water sector. Clearly, numerous interests exist but these are dominated by the single interest of promoting ‘economic development’ within (and beyond) the individual jurisdiction. Sometimes this is discussed in terms of ‘State competitiveness’.

This dominance ensures that, although a government may maintain other ‘environmental’ or even ‘social’ interests, these are typically imposed as constraints rather than objectives for port operators and policy makers. Consequently, there is far greater scope for using governance arrangements to focus a publicly owned port operator on delivering the desired outcome. Indeed, the Port of Melbourne Corporation is governed by a document resembling the ‘charter’ advocated in Productivity Commission’s Draft Report. That document is clearly focussed on the Corporation’s responsibilities with regard to promoting economic development via its efficient operations.

The Essential Services Commission’s numerous reviews of the regulatory framework have found that competition reforms and the Port of Melbourne’s governance arrangements are driving outcomes that are at, or near, those that would be competitively efficient. It has only been on the basis of this *ex post* evidence that the Essential Services Commission has recommended, and governments have accepted, the gradual withdrawal of the ports regulatory framework.

2.2 Competition and competitive tension

The Essential Services Commission’s reviews into the regulation of Victorian ports have found that there is either sufficient competition between ports — or at least, competitive tensions between ports. In those areas where ports deliver similar services (for example, bulk handling), the Essential Services Commission has found that competition between Victorian ports is now sufficiently well developed. Even in areas where competition between ports may not exist (for example, container traffic), the Essential Services Commission has found that competitive tension arises by virtue of

major ports in other States offering these services. While the costs for port users of switching between major ports is not insubstantial, that they may do so remains a credible threat over the Port of Melbourne. At a minimum, the potential for the Port of Melbourne to be embarrassed by ‘competition by comparison’ with other major ports was found to be a real and influencing factor in determining its prices and service levels.

Clearly, there is no competition between urban water providers. Competition by comparison is actively pursued through the performance reporting regime administered by the Essential Services Commission. While definitely influential in driving improved service levels, experience suggests that the reach of performance reporting is far more circumscribed when it comes to imposing market-like disciplines among retailers.

The Essential Services Commission has undertaken considerable work in developing a third party access regime for water and sewerage infrastructure. Such a scheme, if properly administered, introduces ‘competitive tension’ through the threat of new entry at different points in the ‘supply chain’.

2.3 Countervailing power

In its most recent review of the regulatory framework for Victorian ports, the Essential Services Commission found sufficient evidence of countervailing power even in instances where there was little competition on the supply side. As such, we concluded that ports users have recourse to commercial forms of resolving problems — at a minimum, we concluded, these forms of recourse were no less efficient than regulatory mechanisms for resolving disputes.

Port users are, in all instances, commercial interests and will act accordingly; moreover, they are relatively few in number and therefore have far greater capacity to self-organise (either directly or via bodies such as the Victorian Employers’ Chamber of Commerce and Industry). Furthermore, it is reasonable to suppose that these interests would be reasonably uniform and more readily corralled.

By contrast, Victoria’s 16 urban water authorities have between 15,000 and 700,000 customers. With the exception of a few large commercial users, individual businesses and households have no countervailing power in negotiating service levels or prices — or the trade-off between the two. A water utility’s customers are too small and too atomistic in their interests. This means that customers’ capacity for self-organisation is effectively non-existent. Where it occurs, it tends to be focussed on very particular local issues rather than overall service standards or prices.

Whether this impediment to self-organisation can be overcome genuinely, and whether it would even provide water utility customers with sufficient countervailing negotiating power, is worth further consideration (as noted in the Productivity Commission's Draft Report).

2.4 Long-term stability

Price monitoring never represents a steady-state regulatory arrangement. It represents a transitional stage on the path to either deregulation or reregulation. This is self-evidently true by virtue of the observation that where price monitoring is in place, governments (or regulators) reserve the option of intervening in the price setting process. This threat of 're-entry' is identified by the Productivity Commission in its discussion of the ACCC's price monitoring of airport services and its recommended approach viz. urban water services. It also exists within the price monitoring regime for Victorian port services.

Prior to implementing arrangements involving a threat of regulatory re-intervention, policy makers must assess the likelihood that the threat will indeed be exercised.

If the initial state involves a heavily regulated industry (as was the case with Victoria's ports and as remains the case with the urban water sector), then where the likelihood of re-intervention is low, it would seem that there would be a net benefit (risk-weighted) from trialling a period of price monitoring before moving to the final state of de-regulation. If the *ex ante* likelihood of intervention is assessed to be high — in other words, the deregulated and long-term steady state is highly unstable — then any attempt to implement price monitoring would be gratuitous and potentially a waste of resources. Between these two states, where the likelihood of future intervention is assessed to be greater than 'possible' but less than 'probable', policy makers need to exercise their best judgement about whether to proceed or not.

Prior to making its recommendations regarding a move to price monitoring of the Port of Melbourne, the Essential Services Commission assessed the likelihood of its re-intervention in the price setting process. This likelihood was assessed as being low for all the reasons identified above — namely: clarity in the Port of Melbourne's objectives; the presence of competition or competitive tension; and countervailing market power.

The Productivity Commission's draft report provides no assessment of the likelihood of re-intervention were price monitoring to be adopted as recommended in the urban water sector. This submission contends that whereas the conditions requisite

discussed above (and in the earlier submission) did exist in the Victorian ports sector and were tested over successive regulatory reviews, they do not exist in the urban water sector. Care therefore needs to be exercised in not over-stating the relationship between price monitoring of the Port of Melbourne and the Productivity Commission's recommended shift to price monitoring of the urban water sector.

3. Conclusion

The adoption of price monitoring in Victoria's four commercial ports, and now the Port of Melbourne only, occurred gradually and as a result of successful prior reforms. These reforms addressed matters of governance and market structure. The Victorian Government only adopted price monitoring once these reforms were shown to have met the necessary conditions for a more light-handed approach to price regulation.

The urban water sector is well behind the ports sector with respect to its governance arrangements and its market (or market-like) structures. It remains open to question whether or not it is even possible to undertake these reforms in the urban water sector. That is a matter worthy of great debate.

In the meantime, the Productivity Commission's analysis should distinguish more clearly between: the objectives of reform; the means for achieving those objectives; and the potential consequences from the successful implementation of that reform process. Price monitoring is neither a reform objective nor a means for achieving reform. It represents only a milestone within a much broader reform framework.

The Productivity Commission should avoid conflating a move to price monitoring with the other reforms it is recommending for the urban water sector. Price monitoring could be identified as a potential future milestone along the path of reform — though its attainment will depend on whether a set of necessary conditions, some of which are identified in this submission, have been first satisfied.