Water pricing and regulation

Water pricing, regulation, governance and reform

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IPART’s Role

Set maximum prices for:
- NSW metropolitan water agencies
- Bulk water services
- Water resource management

Administer licences of public and private providers

Oversee water industry competition in NSW
Industry Structure

- Water supply and sewerage services
  - State or local government owned
  - Natural monopolies

- Bulk water
  - Sydney – 2 suppliers, SCA and Sydney Desalination Plant
  - Rural – State Water Corporation (Government owned)

- Price regulation
Need for regulation

- In a market, prices are determined by the forces of demand and supply.

- Prices are regulated to correct for significant market failures (e.g. monopoly supply).

- Price regulators are required to make a series of judgments in determining the regulated price.

- Their over-riding concern is the reasonableness of the outcome. The judgments required cannot be expressed in a formula.

- However, regulators have developed methodologies to assist in this task (e.g. building blocks).
The role of Governance

- Governments should articulate more clearly their objectives for government owned utilities
- Transparent processes for decision-making about supply augmentation and other matters should be developed
- The roles and responsibilities of participants in water sector should be clearly defined and reported
- Decisions about standards should be based on increased transparency and cost-benefit analysis
- Decisions on future investments should ensure that least-cost solutions are adopted
The role of price monitoring

- Productivity Commission recommended:
  - Replacing price setting regulation with a price monitoring regime
  - Potentially removing all price regulation and replacing it with a comparison and transparency obligation

- While price monitoring has lower regulatory compliance costs, it holds no hard incentives to drive efficiency

- Risks maintaining or increasing cross-subsidies between customer groups

- Less transparency and credibility with customers
Price regulation

- Regulatory compliance costs for agencies higher than for price monitoring
- Provides a hard budget constraint that strengthens efficiency incentives
- Stronger transparent frameworks for the evaluation of cost and performance.
- Full cost-recovery including efficient capital and operating expenditure and return on equity
- Improves efficiency by removing cross-subsidies
- Opportunity for customer involvement and debate regarding levels of service and associated prices
In our draft report on Sydney Water’s prices, we required Sydney Water to make an additional capital efficiency gain of 5.3% per year.

Regulation provides incentives for shareholders to improve productivity and lower costs.

History shows government is not best placed to balance consumer and producer interests without price regulation.

Governance reform and price monitoring is not a substitute for independent price regulation.

Supervision necessary given public ownership and monopoly status.
Water pricing models

- Building block model which aims to target revenue to recover:
  - Efficient operating costs
  - Depreciation
  - Cost of capital (debt and equity)
  - Tax

- Robust assessment of efficient costs
- Customers only pay for efficient costs
- Shareholders earn market return on investment
More to pricing than costs and revenue targets

Tariffs send signals to customers and potential market entrants regarding costs of services

IPART’s recent report on pricing reform proposed:
  - Similar customers should pay similar charges – regardless of ownership structure (eg. strata vs non-strata units)
  - Reduced sewerage usage charge to better reflect marginal cost and not distort investment decisions of end users (eg. on-site recycling)

Leads to more equitable and more efficient outcome
Scarcity pricing

- Theoretically rations scarce resources to highest value end uses, maximising total welfare

However:

- Low price elasticity of demand means very high prices would need to be used to balance supply and demand
- There is broad community acceptance of restrictions
- Administrative costs may outweigh any benefits
- Where investment decisions are optimal, Long Run Marginal Cost pricing approximates scarcity price
Scarcity pricing cont.

In Sydney:

- Operating rules surrounding SDP and the SCA make scarcity pricing redundant to upstream market
- Usage charge would need to be 350% higher to replicate demand reduction at level 3 restrictions
- Increase capacity from Desalination plant means significantly less probability of restrictions in medium term
Competition

- Some components of water supply are potentially competitive (bulk water, treatment, retail)

- *NSW Water Industry Competition Act 2006 (WICA)* provides framework for new entrants to deliver bulk or retail services

- Sydney Desalination Plant Pty Ltd is largest WICA licensee

- Other WICA licensees are smaller

- In urban areas, there is the possibility of competition:
  - For bulk water sources
  - For new and innovative sources of water (eg recycled water)
Summary

- Governance reform is complementary to price regulation – not a substitute.
- Independent price regulation provides the most efficient outcome where utilities are monopolies.
- Tariffs need to send accurate signals to customers regarding costs to minimise cross-subsidies and promote appropriate customer decisions.
- Scarcity pricing is best reflected through Long Run Marginal Cost pricing in Sydney and an optimal investment program.