

Australia Water Association – National Policy Summit – 14 October 2014

Opportunities for reform of the Australian Water Sector

Good evening. I'd like to thank the Australian Water Association for inviting me to speak tonight.

I've been asked to speak on the Opportunities for reform of the Australian water sector.

Tonight, I'd like to focus on the NSW urban water sector – but the principles and key points I raise are also likely to be applicable to urban water throughout Australia.

In my view, reform should focus on ways to remove impediments to – and enhance the potential for – competition in the provision of water and wastewater services.

Why the focus on competition?

Competition, or even the credible threat of competition, in the water market can deliver a number of benefits. These include:

- ▼ *Lower prices* – competition can provide water and wastewater services at lower cost, and facilitate a more optimal use of resources
- ▼ *More innovation* – competition can provide opportunities and incentives for service providers to identify and solve the economic, environmental and technological challenges facing water and wastewater markets
- ▼ *Better services* – competition can enhance the quality and timing of service provision, to meet the needs of customers, and
- ▼ *Greater water security* – competition can increase the diversity of servicing solutions, and therefore enhance security of supply.

In this context, it is important to note that competition is a matter of degree – the more competition, or the greater the threat or likelihood of more competition, the better.

In industries such as water, competition can generally take two forms:

- ▼ First, competition can occur **in the market** – which is the traditional view of competition. Competition in the market occurs where firms compete against each other for greater market share, sales volumes and profit by offering customers better prices, service standards or differentiated products.
- ▼ Second, competition can occur **for the market** – where firms compete for the right to service a particular market, usually through competitive procurement. To date, this has been the most common form of competition in the water sector. Competition for the market can range from an incumbent water utility's competitive procurement of specific services or assets, to competition to be the water utility for a specific geographic area or new development. A recent example of competition for the market is Hunter Water's competitive procurement of operating and maintenance contracts for its treatment plants.

The state of play of the NSW Urban Water market

The urban water market in NSW is dominated by monopolies, which are largely vertically integrated, for example:

- ▼ Sydney Water sources its bulk water from the Sydney Catchment Authority and, to a lesser extent, the Sydney Desalination Plant. It then provides water and wastewater treatment, distribution and retail services.
- ▼ Hunter Water services the Lower Hunter region in NSW and combines integrated bulk water supply, treatment, distribution and retail services; and integrated wastewater distribution, treatment and retail services.

Large monopoly water utilities – including Sydney Water, Hunter Water, the Sydney Catchment Authority, the Sydney Desalination Plant and the Central Coast Councils – are subject to independent price regulation by IPART, the organisation which I Chair.

Independent price regulation is important in ensuring that prices reflect efficient costs, that consumers are protected from the potential abuse of monopoly power, and that monopoly utilities have an incentive to pursue efficiency gains. Price regulation is aimed at replicating the effects of competition as much as possible. However, it is not a perfect substitute for competition.

In line with current Government policy, the metropolitan water utilities that IPART regulates currently charge postage stamp pricing. This means that all customers within Sydney Water's area of operations face the same price – which reflects Sydney Water's area-wide average price – even though the actual cost of servicing different locations within Sydney Water's network can vary.

Also in line with Government policy, water and wastewater developer charges in Sydney and the Hunter are currently set to zero. Prior to 2008, water and wastewater developer charges reflected the additional costs – above and beyond postage stamp pricing revenue – of servicing a new development area.

Over recent years, we have also seen the development of alternative water sources and servicing solutions. This includes the Sydney Desalination Plant and a number of recycled water schemes – including from suppliers other than the incumbent monopolies. These new schemes been developed in response to a combination of factors, including water scarcity during drought, environmental and planning regulations, and the Water Industry Competition Act.

The Water Industry Competition Act – or ‘WICA’ – commenced in 2008, with the aim of encouraging competition and innovation in the provision of water and wastewater services.

WICA includes a licensing regime – which enables new service providers to enter the industry, while protecting public health and the environment.

WICA also includes a third party access regime, covering Sydney and Hunter Water’s areas of operations. This allows new entrants to seek access to existing monopoly infrastructure networks covered by an access undertaking or coverage declaration in order to compete in the provision of upstream or downstream services. For instance, currently under WICA the Bondi, Malabar and North Head wastewater reticulation networks are subject to a coverage declaration, which means new entrants can negotiate with Sydney Water to obtain access to these networks.

To date, 12 schemes have been licensed under WICA in the Sydney and Hunter regions. Apart from the Desalination Plant, these have been relatively small scale, mainly providing wastewater and recycled water services:

- ▼ These new entrants have entered the market on the fringes of the Sydney and Hunter metropolitan areas on the basis of being able to service new development outside of, or in advance of, Sydney Water and Hunter Water’s servicing plans.
- ▼ There are also some cases where they are servicing infill development on the basis that they can supply ‘sustainable’ services to comply with regulatory requirements or consumers’ ‘green’ preferences.

A few WICA licensees are also providing – or plan to provide – potable water to customers, in addition to wastewater and recycled water services. This potable water would be purchased wholesale from Sydney or Hunter Water.

However, after 6 years of WICA there has been relatively little new competition and no third party access seekers. The question is why – despite WICA – is competition in the market limited?

My main message tonight is that there are opportunities for reform, which could encourage more competition and hence better outcomes for water users.

Opportunities for further reform of the water sector

First, there should be opportunities for the market to inform strategic land use planning processes:

- ▼ Currently, there is a tendency for government strategic land-use planners to rely on information from the incumbent public water utility to inform their decisions on the location and sequencing of land release, rather than also seeking information or expressions of interest from the market – that is, other potential water and wastewater service providers. In turn, this can favour the incumbent public water utility and give them a ‘head start’ on potential new entrants in servicing new development areas.

Second, prices or developer charges should be as cost-reflective as possible:

- ▼ Currently, through a combination of postage stamp pricing – which reflects the utility-wide average cost of service, rather than location-specific costs – and a lack of cost-reflective developer charges, large public water utilities have no alternative than to cross-subsidise their provision of services to new development areas. This provides little opportunity for new entrants to compete on the basis of the costs of servicing the new area.
- ▼ Postage stamp pricing, combined with a lack of cost-reflective developer charges, can also distort location based investment decisions, as it removes price signals about the costs of servicing different locations.

Also related to pricing, a form of pricing that reflects the scarcity value of water in the urban water market could be considered. Ideally, scarcity pricing would be introduced at the wholesale or ‘bulk water’ level, which would then be reflected in retail water prices:

- ▼ At the bulk water level, it would signal the cost of water to retail water businesses, and provide an incentive to procure water from the least cost combination of water supply sources. It would also provide a scarcity price signal to suppliers, and potential new suppliers, of bulk water, and encourage efficient investment in the bulk water supply market.
- ▼ At the retail level, it would send a scarcity signal to customers, and encourage them to reduce their discretionary consumption when dam levels are low, either in conjunction with, or as an alternative to, water restrictions.

A further reform would be to clearly define the provision of non-commercial water services or CSO activities, make them contestable and funded by Government:

- ▼ Currently, public water utilities, such as Sydney Water, can be required to deliver some Community Service Obligations or ‘CSOs’ – such as sewerage certain remote and high cost residential areas under the ‘Priority Sewerage Program’. Government could consider competitively procuring these services by calling for bids from the market, rather than requiring, or granting the right to, public water utilities to provide them. Under a competitive procurement model, the public water utility could be a bidder or public sector comparator, and default supplier. Thus, there would be a ‘safety net’ for the provision of these services.

In looking at opportunities to reform the water market, the regulatory regime needs to be robust to protect consumers, public health and the environment, while complying with best-practice regulatory principles:

- ▼ For example, in a market with potentially more, and newer, service providers, robust and efficient supplier of last resort arrangements need to be in place.
- ▼ It is also important to ensure that there are no unnecessary restrictions or impediments placed on new entrants. For example, currently new entrants are not able to acquire water from public water utilities unless they also obtain water from other sources, even if they pay the appropriate price and meet health and environmental requirements.

In this context, I note that the Government is proposing amendments to WICA, with the WICA Amendment Bill currently before Parliament. These proposed amendments include measures to strengthen supplier of last resort arrangements, enhance the licensing system, and allow new entrants to source water from public water utilities provided there has been investment in new physical water infrastructure.

Also related to the regulatory regime: market based, outcomes-focused instruments, rather than overly prescriptive approaches, could be used to achieve environmental or other policy objectives, such as water conservation targets:

- ▼ For example, pollution mitigation is a major driver of costs in sewerage management. At present, most environmental regulations license a business or sewage treatment plant to pollute to a certain amount in each period. Creating a cap and trade scheme within a given catchment or area would lead to a more efficient allocation of pollution rights, and allow environmental objectives to be met at least cost. This would, for instance, facilitate greater competition in the provision of sewage treatment – particularly inland, where pollution mitigation costs are greatest.

- ▼ Similarly, a market based mechanism, like the NSW energy sector’s Energy Savings Scheme, might be employed to meet quantitative water conservation objectives. For instance, activities that reduce potable water demand, such as building a recycled water plant or replacing inefficient appliances, could generate water savings certificates. These could be tradeable, and water utilities could achieve their water conservation targets through the purchase or generation of water savings certificates.

Reform opportunities should also look at ways to expand and enhance the third party access regime, to increase the potential for competition in the urban water and wastewater markets. This could occur, for example:

- ▼ by expanding the range of infrastructure that is declared open for access – for instance, to include more of the incumbents’ water and wastewater distribution network – where it is of natural monopoly scale
- ▼ by encouraging incumbents to establish and ultimately publish approved access undertakings – outlining the proposed terms and conditions for access, including access pricing, and
- ▼ by encouraging incumbents to provide or publish other information relevant to access, such as the capacity of their existing water and wastewater infrastructure.

Finally, nationally consistent principles and regulatory frameworks in relation to competition and private sector participation in the water market could enhance the opportunity for utilities to expand horizontally across large urban water markets in Australia, and therefore facilitate greater investment and competition in the sector.

Concluding comments

In conclusion, in recent years WICA has been effective in enabling new utilities to enter the water sector in NSW and at introducing innovative water and wastewater servicing solutions.

In this sense, WICA has led the way in reform and is a good start.

However, there are many other reform options such as more cost-reflective prices and developer charges, contestable CSOs and enhancements to the third party access regime which, together or singularly, would ensure that the benefits of competition flow through to the people who pay water bills.

Finally, in considering reform opportunities, I’d like to leave you with this thought....

One might ask why economists continue to advocate reform initiatives and ideas when policy makers appear not so receptive. When Milton Friedman was asked why he continued to advocate flexible foreign exchange rates during the Bretton Woods era of fixed exchange rates – he replied to the effect that it was important to have your ideas ready on the shelf, otherwise policy makers would reach up and grab someone else’s policy in a time of need.

Thank you.