IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Water pricing and regulation

Water pricing, regulation, governance and reform

Jim Cox, PSM
CEO, Independent Pricing and Regulatory Tribunal NSW (IPART)

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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 (eg. 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

Price regulation cont.

- In our draft report on Sydney Water's prices, we required Sydney Water to make and 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

Water pricing cont.

- 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

Questions