

## **OWNERSHIP: A REGULATOR'S PERSPECTIVE**

**Infrastructure Partnerships Australia (IPA) 2016 Urban Water Symposium**

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I'd like to thank the IPA for inviting me to speak today. I've been asked to speak on Ownership – A Regulator's Perspective.

As background, and as many of you would know, IPART has recently completed price reviews for four state-owned water entities in NSW – Sydney Water, Hunter Water, WaterNSW Greater Sydney (the former Sydney Catchment Authority) and the Water Administration Ministerial Corporation (whose water management services are undertaken on their behalf by DPI Water).

In addition, we are currently conducting our first review of Sydney Water and Hunter Water's prices to their wholesale water and sewerage customers. Wholesale customers buy water and/or sewerage services from Sydney Water or Hunter Water and on-supply these services to end-use customers. Typically, wholesale customers will be privately owned and licensed as water utilities under the Water Industry Competition Act (WIC Act). Therefore, they can be alternative retail suppliers to the state-owned Sydney Water and Hunter Water, and compete with them for customers.

We are also about to commence our review of the Sydney Desalination Plant's prices, for new prices to apply from 1 July 2017. As you know, the SDP is privately owned.

Therefore, issues such as ownership and competition, and the implications for incentives, regulation and efficient prices are front of mind for IPART at the moment.

### **AIMS OF IPART'S REGULATORY REGIME**

We are an independent regulator. IPART is an independent regulator that determines maximum prices that can be charged by monopoly providers of essential services in NSW such as water and transport. We also regulate retail gas prices and monitor retail electricity prices.

We aim to simulate the pressures of competition in monopoly environments by setting prices that reflect efficient costs. We apply incentive regulation, which works in three key ways:

- ▼ By setting maximum prices, we aim to limit the ability of monopolies to exercise market power.

- ▼ By allowing the business to keep any savings or losses it makes over a regulatory period (usually 4 years) relative to the costs we allow for when we set its maximum prices, we create an incentive to minimise costs and innovate, and
- ▼ By setting cost reflective prices, we encourage consumers to use services efficiently.

## BENEFITS OF OUR INDEPENDENT APPROACH

Unlike some other jurisdictions in Australia, IPART is an independent regulator, as I mentioned, that determines prices at arm's length from the Government. As an independent regulator, we simply inform the Minister of the prices that have been set.

This, in our view, provides greater certainty for regulated utilities and their shareholders. We seek to regulate in a transparent, consistent and consultative way – releasing draft reports and determinations for public comment, and publicly outlining the reasons for our decisions.

We try to provide a stable, transparent form of regulation, to allow utilities to make investment decisions with confidence in terms of how they will be assessed by IPART.

A stable regulatory environment, in our view, can also help reduce barriers to private investment or entry into the industry.

## WE APPLY THE SAME REGULATORY PRINCIPLES REGARDLESS OF OWNERSHIP

As I mentioned, we regulate a range of different types of utilities – in the water sector alone we regulate: a government department (DPI Water); a local council (Central Coast – previously Gosford and Wyong), several state owned corporations (Sydney Water, Hunter Water and WaterNSW); and lastly, but not least, a privately owned and operated business (the Sydney Desalination Plant).

Our approach to regulation does not depend on the ownership of a utility. It is indifferent to the private or public ownership of assets and utilities. Our regulatory model looks only to set prices to reflect the efficient costs of the regulated services.

Regardless of the type of business we are regulating, we apply the same principles:

- ▼ We aim to simulate the effects of competition, and
- ▼ We set prices to reflect the efficient costs of service delivery – **not** the regulated business's actual costs.

For example, regardless of ownership, we apply the same general approach to estimating the Weighted Average Cost of Capital (WACC) to provide each utility with a return on its regulated assets. Our objective in determining the WACC for a regulated business is to set a WACC that reflects the efficient cost of capital for a benchmark firm operating in a competitive market and facing similar risks to the regulated business.

This allows us to take account of how an efficient firm, in practice, would finance its operations in a competitive product market. Further, the cost of capital for such a benchmark firm is more readily observable and independent of any specific form of regulation adopted by the regulator.

Similarly, the operating and capital cost allowances we set should reflect the efficient levels required to deliver the monopoly services – regardless of ownership of the actual assets.

In general, we apply the principle of competitive neutrality in regulation. That is, a public sector agency should not be either advantaged or disadvantaged by its state ownership.

Regardless of the type of business we are regulating, economic regulation is also still subject to the same limitations. The biggest challenge we face is information asymmetry – that is, a relative lack of information to set the utility’s efficient cost allowance. We are continuing to refine our approach over time to address this issue. However, I suspect the challenge will remain irrespective of whether we were to regulate the prices of a government or privately owned business.

## WE ARE IN A POSITION TO OBSERVE THE EFFECTS OF DIFFERENT OWNERSHIP MODELS

While we regulate state-owned and private businesses in the same way, we are cognisant of differences between ownership models.

### The importance of active shareholders

One issue is the importance of active shareholders. State-owned and private businesses may have different incentives and measures of accountability or performance.

Private businesses have active shareholders, who will regularly review and assess the firm’s performance, focus on minimising waste and maximising returns, and sell their shares and/or put pressure on Boards and management if performance targets are not being met.

The same level of pressure can be missing from publicly-owned entities, or they can be subject to different pressures or drivers.

We consider that good governance is essential for efficient expenditure and service delivery in the water industry.

Indeed, IPART has outlined a number of ways that this could be improved for state owned corporations in our submission to the NSW Government's review of governance and accountability of State Owned Corporations or SOCs.

We consider that SOCs need an active shareholder. This means shareholders that:

- ▼ Engage in discussions about the strategic direction of the firm, and
- ▼ Regularly review and assess the SOC's performance.

We consider that the shareholders should, like they do in the private sector, focus on minimising waste and maximising returns.

### Ensuring state-owned businesses are not unfairly advantaged or disadvantaged

Another issue is ensuring state-owned businesses are not unfairly advantaged or disadvantaged. State-owned businesses may also have different obligations or rights imposed on them relative to privately owned businesses.

At times, some SOCs have been required to act as quasi-government departments and deliver non-commercial services in the form of community service obligations (CSOs) or other non-core services. This could include, for example, providing sewerage services to a remote area, or participating in government policy or planning development.

These obligations can distort investment decisions, as they may be funded by cross-subsidies from the SOC's commercial operations. They can also dilute management's ability and accountability to run the business efficiently. They may also provide the SOC with an unfair advantage or disadvantage relative to potential or actual competitors - including privately-owned firms.

We consider that:

- ▼ CSOs and other non-commercial services should be separately and transparently funded by the Government, rather than by SOCs.
- ▼ To promote contestability in the provision of services and to ensure CSOs are provided at the lowest cost to the taxpayer, the provision of CSOs should be put to the market and competitively procured by the Government where possible.
- ▼ State and privately owned businesses should be subject to the same rights and obligations.

## REGULATION IS A SECOND BEST SOLUTION – THE AIM SHOULD BE TO PROMOTE EFFICIENT NEW ENTRY TO THE MARKET AND COMPETITION

In any case, as you all know, regulation is a second best solution. The aim should be to promote efficient new entry to the market and competition. While ownership and/or governance arrangements can matter, we consider market structure is the key to enhanced services levels and greater efficiency in the water industry, this will benefit customers and taxpayers.

Economic regulation can mimic competitive pressures up to a point; however it is no substitute for competition.

We therefore support removing any barriers to efficient new entry and support measures to promote competition. Competitive markets are responsive to changes in consumer preferences and drive innovations that lead to more choice and better value for customers.

Competition, or even the credible threat of competition, in the water market can deliver a number of benefits. These would 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 security of supply** – 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.

Generally, competition can work in two ways in network industries such as water: Competition *for* the market and competition *in* the market.

Competition *for* the market is where firms compete for the right to service a particular market, usually through competitive procurement. This can range from an incumbent water utility's competitive procurement of specific assets or services (for example, operating and maintenance contracts), to competition to be the water utility for a specific geographic area or new development.

Competition *in* the market is where two firms compete directly for customers, and is the most powerful form of competition. Within a market, multiple firms competing to provide a product based on price and/or quality creates a strong incentive to innovate and increase efficiency, because the alternative is falling profit margins and market share.

To date, we have not seen much competition *in* the market in the water industry.

However, like the electricity market, there is potentially scope for new entrants to compete in the market by providing contestable services upstream and downstream of the natural monopoly water and wastewater distribution networks – for example, by competing in the provision of retail services and/or wastewater treatment and disposal.

I note that other jurisdictions, in particular, parts of the UK, are making progress on the introduction of retail competition for non-residential customers.

In New South Wales, we are starting to see new entrants – who are alternative service providers to Hunter Water and Sydney Water enter the market. This is occurring to a limited extent. In NSW, the the WIC Act allows new water utilities to enter the market and compete *for* or *in* the market. It includes a licensing regime and a third party negotiate/arbitrate access regime for water and wastewater monopoly infrastructure. We are, however, yet to see any access agreements being made under the WIC Act.

Although, as I mentioned earlier, new privately owned water utilities (which are licensed under the WIC Act) are purchasing wholesale water and/or wastewater services from Sydney Water and Hunter Water to compete with them for the provision of downstream retail services to end-use customers.

In regulating wholesale prices, we are aiming to create a level playing field, so that new entry to the water and sewerage services markets occurs where it is efficient. That is, that new entrants or alternative suppliers to Sydney Water and Hunter Water can compete where they are efficient, leading to overall least cost supply, enhanced service levels and efficiency gains.

We support other measures that create such a level playing field and therefore opportunities for enhanced competition in the water market.

In NSW, the introduction of the WIC Act is changing the industry. Alternative suppliers are providing alternative service solutions.

The scope for competition, or the benefits from competition, cannot be known with certainty in advance, and private actors should be encouraged to invest and innovate where they see an opportunity and where they can enhance service efficiency.

Our ongoing review of wholesale pricing is attempting to achieve this. Our objective in this review is to determine prices that create a level playing field, so that new entry in the water industry occurs where it is efficient. But in doing so, we are not trying to decide beforehand what competition should look like and what new entrants should do. If we achieve our objective of promoting a level playing field, our pricing should help facilitate efficient entry and enhanced competition in the water markets in Sydney and the Hunter.

## CONCLUSION

So, in conclusion, my key points today are:

- ▼ Independent economic regulation is important for ensuring efficient services and pricing in largely monopoly industries such as water.
- ▼ Ownership does not play a role in how we regulate water utilities. We adopt the same principles and approaches to regulating the State-owned Sydney Water as we do the privately owned Sydney Desalination Plant. In fact, we are very mindful of the importance of competitive neutrality.
- ▼ However, we recognise that management's incentives and accountability can change under different ownership models. In turn, this can have an impact on efficiency. For SOCs, we advocate an active shareholder to replicate, as much as possible, the drive for efficiency gains provided by private ownership. We also consider that state and privately owned businesses should be subject to the same rights and obligations.
- ▼ Finally, while ownership and/or governance arrangements can impact on the drive for efficiency, we consider enhanced opportunities for competition in the water industry is most important for improved service levels and efficiency gains over time.