

Water Services Association of Australia

***Submission to the Competition Policy
Review Panel Draft Report***

17 November 2014



**WATER SERVICES
ASSOCIATION OF AUSTRALIA**

Key messages

1. The Water Services Association of Australia (WSAA) supports the recommendation that objective of competition policy should be to ensure markets work in the long-term interests of consumers
2. WSAA also supports the recommendation that all governments recommit to national action to progress urban water reform
3. A national approach should focus on
 - Improving economic regulation to ensure that water utilities can continue to meet the long term interests of their customers.
 - resolving the appropriate role for competition in urban water
4. Current economic regulation of urban water
 - Like utilities, needs to be more customer-centric
 - Does not provide sufficient incentives for innovation and productivity
 - Is not sufficiently predictable, transparent and consistent to enable greater private investment in the future
5. WSAA recommends expanding the National Water Initiative through COAG to put in place minimum standards for economic regulation to be met by all jurisdictions. Minimum standards should be developed around
 - Establishing regulation which is independent from Governments
 - Setting a clear objective for regulators to act in the long term interests of customers
 - Establishing incentives for productivity and innovation
 - Assessment of financial viability as a cross check on that revenue is sufficient revenue to cover efficiently incurred costs over time.
 - Strong and transparent customer engagement within the regulatory framework
 - Merits review and appeal mechanisms for water businesses and other stakeholders

1.0 Introduction

The Water Services Association of Australian (WSAA) is the peak body representing the urban water utilities in Australia and New Zealand. Our members provide water services for over 20 million Australians.

WSAA welcomes the opportunity to respond to the Competition Policy Review's Draft Report. We note that the Review Panels overarching framework is to develop competition policy which is in the long term interests of consumers. This strongly aligns with WSAA's vision for the urban water industry which is *Customer driven, enriching life*. As discussed further in this submission it also aligns WSAA's recommendation that the objective of economic regulation of the urban water industry should be to meet the long term interests of customers.

While the Draft Report covers many issues, WSAA notes that it identifies water as a priority area for reform. Specifically, the Draft Report recommends the need to re-commit to a national framework for water focusing on economic regulation. This submission summarises the views and recommendations of the Review Panel that relate to the urban water industry and provides WSAA's response, including why WSAA supports the recommendation for national action to progress urban water reform.

Competition in urban water could take a number of forms. Utilities extensively employ competitive tendering for capital and operations. Beyond this there are few successful models world-wide to draw upon. An advantage of a national approach is that it could assist resolving where bulk water markets, retail competition and contestability would be of benefit to consumers.

2.0 The Panel's views on urban water

The Draft Report traverses the full breadth of competition issues. Infrastructure in general, and water infrastructure in particular, is viewed as unfinished business arising from the competition policy reforms of the 1980s and 1990s.

The Review Panel's key finding is that that a national approach is necessary to complete water reform. It says that:

Progress in the water sector has been slower than reforms in electricity and gas.

While there are clear differences between the sectors, the approach taken in the energy sector may prove instructive in terms of furthering reform, particularly in relation to the creation of national institutions and national agreements in areas of State sovereignty.

In the first instance, there is merit in governments re-committing to a national water agreement, with specific regard to promoting consistent economic regulation in the water sector and the potential for a national regulator. Governments should also recommit to introducing efficient and cost-reflective pricing in water as far as it is practical to do so. (p.128)

The Draft Report recommends that:

All governments should re-commit to reform in the water sector, with a view to creating a national framework. An intergovernmental agreement should cover both urban and rural water and focus on:

- economic regulation of the sector; and
- harmonisation of state and territory regulations where appropriate.

The Panel recommends that responsibility for access and pricing regulation be separated from the Australian Competition and Consumer Commission and undertaken by a stand-alone body. It suggests that were there to be national water regulation the body responsible for its implementation should be the Panel's proposed national access and pricing regulator (see Draft Recommendation 46).

Finally, the report recognises the benefits of privatisation and private sector involvement, but also the need to first address issues of market structure.

Well-considered privatisation of remaining infrastructure assets is likely to drive further consumer benefits through lower prices flowing from greater discipline on privatised entities. Governments need to approach privatisation carefully, to ensure that impacts on competition and consumers are fully considered and addressed.

3.0 WSAA's views

WSAA supports the Panel's call for a national approach to progress urban water reform.

However, we only partially agree with the Panel that water represents unfinished business. Some calls for national action are underpinned by a view that the urban water sector is performing poorly or that

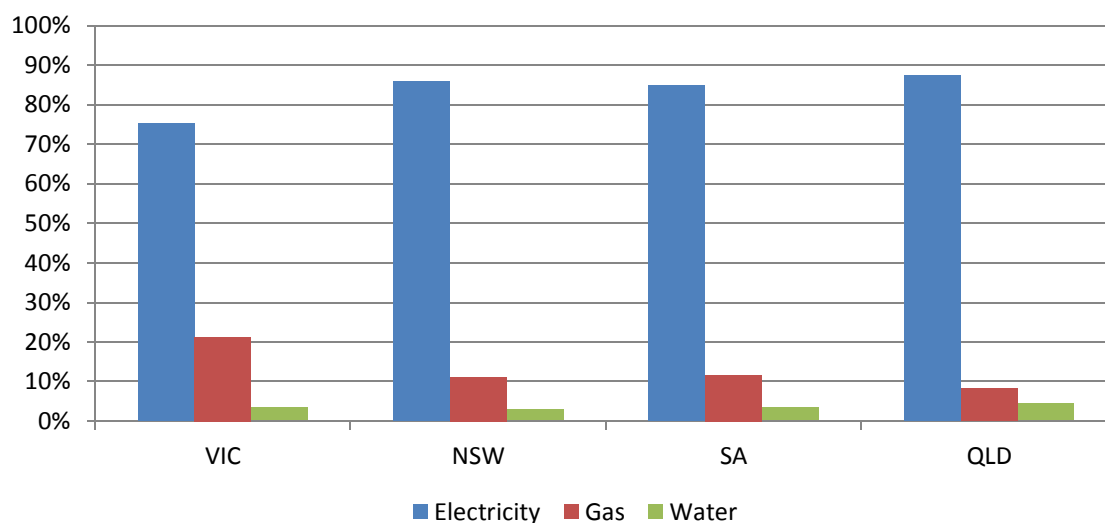
water reform has been slow. WSAA agrees that there are still opportunities for further reform, however, the water supply has been secured, drinking water quality is amongst the highest in the world and customer complaints are low (see next section). It is the future challenges facing the industry which require national action. Our aim is to set out for the Panel these challenges and the case for a national action. We consider that the existing national framework — the National Water Initiative, agreed to by all states and territories — is the appropriate platform to build upon.

3.1 Urban water’s focus on the customer

The urban water industry is entering a new era of greater engagement with, and focus on, meeting our customers’ needs. This is possible due to the solid foundations that have been built over many years to ensure the urban areas of Australia have resilient, diversified and high quality water supply.

The Draft Report suggests that water reform has been slower in water than in electricity. WSAA considers that assessed through the prism of how well we serve customers, the water sector performs strongly compared to other infrastructure sectors. For example, complaints to external ombudsmen concerning the water industry — covering all aspects of the customer experience including bills — are very low (figure 1). The complaints record takes place against a similar pattern of increasing prices across the utility sectors. This suggests that while urban water may not have seen the structural changes applied to other sectors, it is just as, if not more so, focussed on servicing the needs of its customers.

Figure 1 Proportion of complaints by sector 2012-13



Source: State Energy and Water Ombudsman annual reports

While the achievements of the urban water industry are often not recognised, it remains the case that it faces a range of challenges. WSAA supports a national approach because it will place the industry in the best position to meet these future challenges.

3.2 The case for a national approach

In essence a national approach is necessary for three reasons:

- to improve regulation of the industry, particularly economic regulation, to ensure it meets the long term interests of consumers

- to establish the preconditions necessary to ensure that greater private participation in the industry delivers net benefits to consumers and the community
- to resolve the scope for competition in the industry.

Improving economic regulation

Over the last year WSAA has drawn attention to the need for better economic regulation of urban water. Since its first submission to the Competition Policy Review it has released a flagship report on *Improving economic regulation of urban water in Australia (attached)*.

Water utilities occupy a privileged place as the suppliers of essential services with the need to balance commercial, social and environmental drivers while having many monopolistic characteristics. Economic regulation provides protection and assurance to customers and discipline on utilities to demonstrate that they are efficient.

Economic regulation has played an important role in the industry's development and it needs to continue to evolve to meet future challenges. These challenges include adapting to climate change, providing for significant population growth in cities, and maintaining and renewing ageing assets while maintaining the affordability of services. This will require greater flexibility in the regulatory framework to manage uncertainty while keeping costs down.

WSAA commissioned Frontier Economics to review the economic regulation of the urban water industry in Australia and identify improvements that would be in the long term interests of customers and stakeholders.

Governments and local governments, typically the shareholders of utilities, can be conflicted in their role as owners, policy setters and having a quasi-arm's length role in economic regulation.

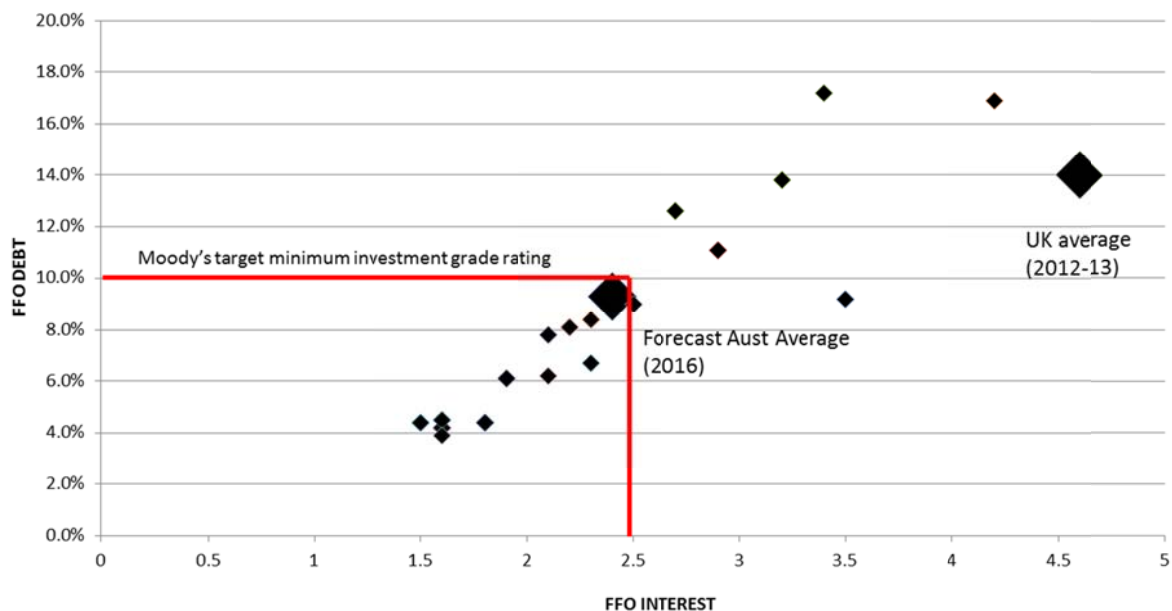
WSAA considers that current economic regulation:

- Can be improved to support utilities move from a compliance culture to a customer focus
- Does not provide sufficient incentives for innovation and productivity
- Needs focus more explicitly on ensuring that that utilities have the long term financial viability to renew and maintain assets without imposing unexpected price increases on customers
- Is not sufficiently predictable, transparent and consistent to enable private investment in the future.

Financial pressure growing in urban water

The best way to compare the financial health of water businesses is the measures used by credit ratings agencies such as Moodys and S&P to assess the financial strength of commercial companies.

These measures show the ability of a business to generate sufficient cash to service its debt. Two important measures are the level of cashflow (funds from operation, FFO) to interest payments and to the total level of debt (FFO debt). In the graph below each point is a water utility.



The graph shows that the average for Australian water businesses is well below the UK. In its last price determination, OFWAT (UK economic regulator of water) set target levels for companies well above the Moody’s minimum and UK firms are meeting or exceeding these benchmarks. The Australian average is just within the ‘ideal’ target level identified by Moodys. However, some water businesses in Australia have little financial room to move if they are to maintain an investment grade credit rating. WSAA’s view is that water utilities are long term businesses that need strong credit ratings for resilience against future shocks including climate events.

Source: WSAA Working Paper - Financial stock take of urban water utilities December 2013 (available on request)

Key findings

The Improving Economic Regulation Report identifies significant gaps in the regulatory frameworks across Australia compared to best practice, the key priorities for reform are:

<p>Establishing regulation which is independent from Governments</p>	<p>This is necessary to ensure regulators are free from undue influence that could compromise regulatory outcomes. It is also important that regulators can determine prices rather than just recommend.</p>
<p>Setting clear objectives for regulators to act in the long term interests of customers</p>	<p>Lack of clarity in objectives leads to inconsistency in decision making and lack of accountability.</p>

Establishing incentives for productivity and innovation	Productivity and innovation are necessary for utilities to drive further efficiency gains. In addition, future efficiency and innovation will be driven in part by greater private involvement in the water industry and by adopting new business models.
Assessment of financial viability to protect the long term interests of customers	The sector needs to be financially sustainable to maintain service levels over the longer term. Regulators need to incorporate financial viability metrics into the price determination process.
Strong and transparent customer engagement within the regulatory framework	Utilities need to better understand customer needs and what drives customer value. It is critical that this understanding is part of the regulatory process.
Merits review and appeal mechanisms for utilities and other stakeholders	These are essential to ensure accountability of regulators for their decisions and are a precondition for further private involvement.

The findings are not surprising, nor controversial, and highlight that no one jurisdiction has it completely right. Some jurisdictions meet most elements of a best practice model, but no jurisdiction meets them all. For example, of the eight regulatory jurisdictions:

- Only four have clear objectives
- None has well developed incentives for productivity and innovation
- Only two have (recently) begun to consider financial viability of utilities
- Only two jurisdictions have merits appeal processes.

WSAA recommends a national urban water agreement through the Council of Australian Governments to further the reform process. There is an opportunity to build on the existing National Water Initiative and put in place clear minimum and agreed standards for economic regulation to be met by all jurisdictions.

Further WSAA recommends that minimum standards be developed around:

- Establishing regulation which is independent from Governments
- Setting clear objectives for regulators to act in the long term interests of customers
- Establishing incentives for productivity and innovation
- Assessment of financial viability to protect the long term interests of customers and stakeholders
- Strong and transparent customer engagement within the regulatory framework
- Merits review and appeal mechanisms for water businesses and other stakeholders.

National pricing and access regulator for water

While we consider consistency across the State-Based regulators is important via a national agreement, given the different institutional structures across jurisdictions, we believe it would be premature to consider the merits of having a national regulator.

Establishing the pre-conditions for private involvement

There is an important link between increasing efficiency and private sector involvement. The industry has always used the private sector to deliver services to efficiently source services and capital through

tendering and contracting arrangements. WSAA provided the data in table 1, to the Productivity Commission’s 2010 review of urban water. At that time, nearly all capital expenditure by major water utilities was delivered by the private sector, and a significant proportion of operating expenditure was also outsourced. Since then the industry has continued to market test operations and the proportion of outsourced services has increased. For example, in 2013 Sydney Water contracted private providers to provide mechanical and electrical maintenance services, and Melbourne Water has announced the outsourcing of its IT services.

Table 1 Proportion of total expenditure outsourced by WSAA members

WSAA member	2009-10: % Capital expenditure outsourced	2009-10: % Operating expenditure outsourced
Water Corporation	93	30
Sydney Water	94	72
Sydney Catchment Authority	99	64
Melbourne Water	100	73
South East Water	90	42
Yarra Valley Water	98	58 (with further 33% benchmarked)
Hunter Water Corporation	100	65
ACTEW	100 (28 to ACTEW/AGL, 72 to other alliances)	100 (outsourced to ACTEW/AGL)
SA Water	94	65

The focus on improving efficiency is driven by utilities own business plans to improve customer service, supplemented with the targets set by economic regulators.

While the urban water industry has always worked closely with the private sector, it remains that most urban water infrastructure is government owned. There is growing interest from within the industry and from policy makers in new forms of private involvement. This includes:

- Extending outsourcing and alliancing models
- New forms of private financing of water infrastructure
- New private entrants to service different parts of the water market
- Sale of existing assets or businesses.

Decisions on privatisation are matters for governments as the shareholders of water utilities to determine. However, WSAA agrees with the assessment by the Panel that privatisation needs to be pursued carefully.

WSAA’s aim in discussing private involvement in the urban water industry is to provide information and analysis to create a platform for good decision making. Setting the preconditions for the success of private involvement forms the core agenda for state government and national action. WSAA considers that the key test for policy makers is to maintain and enhance the public and private values that are provided by water utilities. This includes preserving the financial value of utilities but also extends to the role they perform in protecting public health, managing the environment and promoting liveability in urban areas.

As noted in the previous section, a more transparent, consistent and certain regulatory framework is a key precondition for greater private participation. Also key are forming a long term view of the appropriate market structure for the industry and resolving the scope for competition.

Competition

A national approach is also necessary to resolve the appropriate role for competition in urban water. State action to date has been piecemeal. The Water Industry Competition Act in NSW is most advanced but still lacks a vision for the market structure. From an efficiency perspective, it is necessary to pool resources and expertise to progress these complex issues.

The Productivity Commission (PC) examined the role of competition in urban water in its 2011 Report, concentrating on the bulk water sector. WSAA considers that the PC reached a balanced view. The PC saw a case to 'introduce greater competition and promote innovation where cost effective' and considered the gains could be substantial, particularly for bulk water supply. However, it noted:

The potential gains in urban water are likely to be more modest [than other utility industries] because:

- limited forms of competition have already been introduced through contracting out and build, own and operate arrangements
- compared with other utility sectors, a greater proportion of costs are in natural monopoly elements of the supply chain (for which competition in the market would be inefficient) (p. 245).

The PC reached the conclusion that competition is unlikely to 'naturally' develop in urban water. It also questioned whether the benefits of established competition via administered markets outweighed the costs at this time.

If well-functioning markets already exist, competition in the market can develop 'naturally'. Alternatively, competition in the market can be administratively established (that is, markets can be created).

Naturally occurring competition depends on a number of preconditions being met, for example:

- many producers offering a relatively similar/homogenous product
- many consumers that can choose between competing providers
- low or no transaction costs
- low or no barriers to market entry or exit (over the long term), and so on.

Where these conditions do not hold, and competition in the market does not occur naturally, there might be a case for *establishing* competition. The National Electricity Market provides an example of this approach.

Administering competitive markets is a complex and costly task, and has relatively onerous preconditions. The Commission is not convinced that there is a compelling case for creating this type of competition in the urban water sector at this time — a view strongly supported by inquiry respondents. The absence of any international precedent of urban water markets compounds the risk and uncertainty associated with establishing competition of this kind in the Australian urban water sector at this time. (p.334)

WSAA was pleased that the PC recognised the complexities of the water industry. A significant proportion of the services in the water industry are subject to competitive tendering, and the industry has shown a preparedness to work with new players. However, competition in the market in its traditional form is more difficult to introduce in the water industry than in most industry sectors and is challenging even by infrastructure sector standards. The UK is introducing retail competition for non-residential customers (Box 1). Retail competition in Scotland illustrates that competition can co-exist

with public ownership of utilities. However WSAA notes that in Australia, the retail segment is a very small proportion of the total value chain and comprise less than 5% of the total bill. This means that bill reductions are unlikely in a retail-only competition model.

Box 1 Retail competition in the Scotland and England

In 2008 full retail competition was introduced in Scotland for businesses and public sector organisations. The *Water Services (Scotland) Act 2005* established the framework for competition and required the separation of Scottish Water's wholesale services from its retail function, both of which remain publicly owned. The retail company is called Business Stream. The Water Industry Commission for Scotland is responsible for implementing the framework set out in the Act, including licensing all participants in the market. Currently there are 16 licensed suppliers.

- Scottish Water Business Stream Ltd
- Anglian Water Business (National) Ltd
- Aimeria Limited Wessex Water Enterprises Ltd
- Severn Trent Select Ltd
- Thames Water Commercial Services Ltd
- Veolia Water Projects Limited
- United Utilities Water Sales Ltd
- Clear Business Water Ltd
- Cobalt Water Ltd
- Real Water Edinburgh Ltd
- Commercial Water Solutions Ltd
- Source for Business Ltd
- Castle Water Ltd
- Blue Business Water Ltd
- NWG Business Ltd

A Central Market Agency (CMA) was set up to administer the new market. The CMA registers who is the licensed supplier of each business customer in Scotland. The CMA also calculates the money owed by each supplier to Scottish Water for wholesale services. All licensed suppliers in the Scottish market are required to:

- become party to the Market Code and a member of the CMA;
- undergo a process of assurance and technical checks performed by the CMA.

The Water Industry Commission of Scotland suggests that the benefits of multiple retail supplies for customers are: a higher standard of service; services that are more closely tailored to business needs; better value for money and advice about how to use water more efficiently.

Retail competition is now being extended to the UK. The Water Act 2014 includes measures which mean all business, charity and public sector customers in England can switch their water and sewerage supplier from 2017. The Act also provides that:

- new businesses can enter the water sector and provide new sources of water or sewerage treatment services
- a national water supply network will be established to make it easier for water companies to buy and sell water from each other
- owners of small-scale water storage can sell excess water into the public supply.

Contestability of service provision (competition for the market) in new growth or infill areas is the most likely form of competition in the short term.

As the Draft Report notes, the NSW Independent Pricing and Regulatory Tribunal has also recognised that national consistent principles should guide the development of competition in urban water.

[!]t [is] important to develop nationally consistent principles in relation to competition and private sector participation in the water market, similar to the reform of water entitlements from the 2004 National Water Initiative. (page 20)

This is significant as by virtue of the Water Industry Competition Act, NSW and IPART are the most advanced in considering competition in urban water, yet recognise there are still benefits in a national approach.

Contact details

WSAA welcomes the opportunity to provide a submission to the Panel on this important matter. If there are any details you wish to follow up on please contact:

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