

Our reference: 15/391

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29 June 2015

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Dear Mr Sims,

SUBMISSION TO REVIEW OF WATER CHARGE (INFRASTRUCTURE) RULES 2010 (WCIR)

Thank you for the opportunity to provide a submission on the WCIR. Our experience as an economic regulator of water, energy and transport utilities over more than 20 years makes us well placed to contribute to your review.

IPART regulated bulk water across NSW until 2014, when economic regulation in the Murray-Darling Basin (the Basin) passed to the ACCC under the *Water Act 2007* (Cth) (the Act). We have recently applied to the ACCC for accreditation under the WCIR, which if granted would allow us to commence a review of WaterNSW's Murray-Darling Basin valleys' maximum prices in May 2016 for prices to be effective from 1 July 2017. This determination would be subject to the WCIR.

We consider the WCIR provide a good framework for regulation of bulk water in the Basin. However, we also recognise that this review of the WCIR offers the opportunity to refine the rules to better serve the Basin water charging objectives of the Act, by aiming to maximise the incentives to achieve prudent and efficient outcomes.

Our submission focuses on the approval or determination of regulated charges of Part 6 operators, and therefore Part 6 of the WCIR. Our key recommendations are that the WCIR should be amended to:

- ▼ Allow an ex-post review of actual capital expenditure when calculating the Regulatory Asset Base (RAB). This will give the utility an incentive to ensure that its investments are prudent, and allow the regulator to set efficient prices.
- ▼ Allow the regulator to review the appropriate share of costs that customers should fund through charges. This will allow the regulator to provide efficient pricing signals and inform future efficient investment decisions.

- ▼ Provide for variations of determinations during the regulatory period to be:
 - initiated by the regulator (in addition to the utility); and
 - triggered by changes in regulatory or taxation conditions only.

This would ameliorate uncertainty surrounding changes to regulatory and taxation obligations during a regulatory period, allowing for both increases and decreases in costs to be passed through into prices.

- ▼ Allow the regulator some discretion in determining an appropriate regulatory period. This will allow the regulator to set a regulatory period that balances the incentive power of a longer regulatory period with the level of uncertainty regarding the utility's operating environment.
- ▼ Enable an economic regulator to review and pass through only the efficient costs of Murray-Darling Basin Authority (MDBA) and Border Rivers Commission (BRC) activities to water users.

With respect to a potential appeals mechanism, we support the status-quo with any appeal undertaken through the *Administrative Decisions (Judicial Review) Act 1977*. However, should the WCIR be changed to include a merits review process, the review mechanism should:

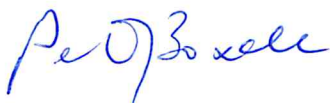
- ▼ allow appeals on specific issues to be undertaken only in a whole-of-determination context
- ▼ require the body responsible for the review to 'stand in the shoes' of the economic regulator and consider only the information that was before the first-instance decision-maker.

We also note our general support for the Water Charge (Planning and Management Information) Rules 2010 (the WCPMIR).

Our submission on these key issues is attached.

If you have any questions associated with this submission, please contact John Madden, Director, Water Pricing on (02) 9113 7780.

Yours sincerely



Peter J. Boxall AO
Chairman

IPART SUBMISSION TO THE ACCC'S REVIEW OF WATER CHARGE (INFRASTRUCTURE) RULES ISSUES PAPER

This submission sets out IPART's recommended changes to the WCIR. These recommendations primarily relate to Part 6 of the Water Charge (Infrastructure) Rules 2010 (WCIR) – ie, the approval or determination of regulated charges of Part 6 operators¹ – and therefore Chapter 5 of the ACCC's Issues Paper.

We consider the WCIR generally provide a good framework for regulation of bulk water in the Basin. Our submission includes recommendations to enhance this framework.

WCIR should be amended to include an ex-post review of capital expenditure

An ex-post review of capital expenditure involves a review of the actual capital expenditure incurred over the current regulatory period to determine whether it is prudent and efficient, and therefore whether it should be rolled into the Regulatory Asset Base (RAB) at the commencement of the upcoming regulatory period.

An ex-post review would better meet the Basin water charging objectives than the current WCIR. It would promote the economically efficient and sustainable use of water infrastructure assets and of government resources (objectives (a)(ii) and (iii)), by providing a disincentive for gold-plating and other forms of imprudent investment. It would avoid perverse or unintended pricing outcomes (objective (e)), by excluding inefficient investments from the RAB.

An ex-post review of capital expenditure is a key tool in ensuring that customers pay for expenditure only if it is prudent, efficient and valued by the customer. We recommend therefore that the WCIR be amended to include a full ex-post review of capital expenditure.

It is IPART practice in the regulation of utilities to conduct an ex-post review of actual capital expenditure incurred over the current determination period to determine its prudence and efficiency, when rolling forward the RAB to the start of the new regulatory period.² We typically only include in the RAB roll-forward that portion of the actual capital expenditure that we deem as efficient and prudent. This approach provides a check on expenditure, an incentive to utilities to only invest where prudent and efficient, and a safeguard against over-investment or inefficient investment simply being passed through to customers in higher prices.

¹ Under the WCIR, Part 6 operators are non-member owned operators whose maximum volume of managed water is more than 250GL (eg, WaterNSW).

² Our ex-post capital expenditure reviews also examine the final year of the previous determination period, as this figure was a forecast not an actual when we set prices for the current determination period.

We recognise that an ex-post review needs to be appropriately defined, but with our experience in using this approach, we are confident that it works in practice. Rather than unduly jeopardising investment certainty, ex-post reviews can ensure businesses apply rigorous processes to investment evaluation and decision-making (as they have a strong incentive to ensure their capital expenditure during the current determination period is prudent, efficient and able to be justified).

We note that in its 2012 review of the National Electricity and Gas Rules, the Australian Energy Market Commission found that an ex-post review of capital expenditure is appropriate, but included a mechanism to review expenditure in excess of the ex-ante regulatory allowance only. In relation to the WCIR, we maintain our position that the ex-post review should cover all capital expenditure, not only expenditure in excess of the ex-ante cap.

WCIR should be amended to allow the regulator to determine the customer ('user') share of costs

The ACCC's Pricing Principles imply that when making a determination under the WCIR, the regulator is not able to independently consider the most appropriate share of costs between water customers (or 'users') and other parties (eg, the Government, on behalf of the broader community). The Pricing Principles state:

...while the costs associated with an activity that is not funded through regulated charges will be assessed for prudence and efficiency, the source or amount of that funding will not be determined by the regulator.³

When setting prices for bulk water services, we have typically assessed the proportion of total costs of a given activity that should be borne by water users (ie, water entitlement holders). In doing so, we have allocated costs between water users and the Government (on behalf of the broader community) using the *impactor pays* principle.

We consider that the ability to independently review cost shares is important to achieve appropriate pricing signals and inform future investment decisions. It allows the regulator to make a decision on how much of the costs of a certain activity should be passed through to customers via prices. Therefore, we recommend that the WCIR, in conjunction with the ACCC's pricing principles, allow the regulator to review the user-share of costs to be recovered from regulated prices.

This proposal that the regulator be permitted to determine the user share of costs is consistent with the Basin water charging objectives. It would facilitate the efficient functioning of water markets by sending appropriate price signals (objectives (a) and (c)); give effect to the principles of user-pays and pricing transparency (objective (d)); and avoid perverse or unintended pricing outcomes (objective (e)).

³ Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010, ACCC, July 2011, p 65.

WCIR should be refined to limit variations to a determination within a regulatory period, and to allow for both increases and decreases in costs

We consider that there is a limited set of circumstances where it is appropriate for a regulator to vary a determination during the regulatory period. We recommend refining the current provisions of the WCIR to:

- ▼ Limit the circumstances in which the determination can be varied to unforeseen regulatory and taxation change events.
- ▼ Ensure that both appropriate cost increases and decreases can be passed through into prices, by allowing the regulator (in addition to the regulated operator) to initiate a variation.
- ▼ Maintain the current materiality threshold.

We consider that it is appropriate to limit the ability to vary a determination to unforeseen changes in regulatory or taxation arrangements. These changes are outside the control of the utility, requiring government to change relevant legislation. It is fair for prices to be set in order to meet the legislative requirements of the provision of the regulated services.

We recognise that there are other uncertainties that utilities and their customers face during a regulatory period. The key uncertainty for bulk water providers arises from the availability of water. However, the WCIR includes an annual review mechanism to address this uncertainty. Further, as discussed below, the length of the regulatory period could be altered to balance any uncertainties in the utility's operating environment against the incentive powers of a longer regulatory period. Therefore, we consider that the variation process should be limited to regulatory and taxation change events only.

We consider the current arrangements that effectively provide for only an increase in costs, are asymmetrical and therefore inappropriate. It protects the utility from increases in costs, but does not provide for customers to benefit from cost decreases that could arise from unforeseen circumstances.

Determinations should be varied only where prices would materially change as a result of the trigger event. This minimises the cost of regulation, not only on the utility and regulator, but also on other stakeholders who are involved in a review process. We consider that the current materiality thresholds are appropriate.

WCIR should be amended to provide flexibility in setting the length of the regulatory period

As highlighted above, it is important to provide the regulator with sufficient flexibility to set the length of a regulatory period by weighing uncertainties in the operating environment of the utility against the incentive powers of a longer regulatory period. We recommend that the WCIR be amended to provide the regulator with some discretion to determine the appropriate length of the regulatory period.

The WCIR specify that the regulatory period for a Part 6 operator is four years (after the initial determination period of three years). While a four-year regulatory period is generally reasonable, there are times when shorter or longer periods may be appropriate. A different regulatory period may be justified by uncertainty regarding:

- ▼ a potential change in the scope or scale of a regulated agency
- ▼ the timing or scale of a large capital project
- ▼ a potential governance or regulatory change.

We recommend the WCIR be amended to give the regulator discretion to set the regulatory period at between three and five years. This will allow the regulator to exercise judgement when setting the regulatory period, where there is sufficient uncertainty in the short-term and to balance this against the incentives provided under a longer regulatory period.

We note that, under Rule 24, the WCIR currently include the scope to potentially vary the four-year regulatory period if the Part 6 operator is:

...also a supplier of urban water services the charges for which are set by an agency of a state, under a law of the state...⁴

In these circumstances, the Part 6 operator that supplies urban water services can apply to align the regulatory period of the approval/determination under Part 6 of the WCIR with the regulatory period applying to the determination of charges for their urban water services.

While the delivery of urban water services may be a valid reason for selecting a regulatory period other than four years, there may be other reasons relating to Part 6 operators. These include the following:

- ▼ delivery of bulk water services to valleys outside the Basin (eg, Water NSW provides bulk water services both inside and outside the Basin)
- ▼ the provision of bulk water services to an urban water service provider (eg, Sydney Water sources the majority of its bulk water from Water NSW's Sydney Catchment operations).

Aligning the regulatory period of a Part 6 operator to the regulatory period of other associated services or agencies may provide a more efficient overall regulatory framework.

⁴ Rule 24(1) of the WCIR.

As such, if the WCIR are not amended to provide for more regulatory discretion in setting the regulatory period between three and five years, we recommend that Rule 24 be expanded to include:

- ▼ other regulated services delivered by the Part 6 operator; and
- ▼ other regulated agencies directly associated with the services provided by the Part 6 operator.

The appeal mechanism included in the rules is appropriate and should not be changed

We consider that it is appropriate to retain the judicial review provisions currently in the WCIR.

Under the WCIR, pricing decisions made by the ACCC are potentially subject to judicial review under the *Administrative Decisions Judicial Review Act 1977 (Cth)* (**ADJR Act**). There have been no applications for judicial review under WCIR to date.

In its Issues Paper, the ACCC has sought feedback on the pros and cons of introducing alternative appeal mechanisms in the WCIR such as a merits review process. There is currently no provision in the WCIR for a merits review process.

We consider that the current arrangements in the WCIR are appropriately set. We are satisfied that they enable the application of regulatory processes that are robust, transparent and comprehensive and that the grounds for any appeal under the ADJR Act are appropriately limited to errors of law. As such, we recommend that the WCIR not be amended to include a merits review process.

Should the ACCC consider introducing a merits review process to the WCIR, we consider that where a business contests a specific regulatory decision, the review body should consider this decision in the context of the whole determination, and not be confined to the specific item(s) contested by the business or interveners. This would give further incentive to Part 6 operators to consider whether they could end up worse off as a result of the appeal and would limit ‘cherry-picking’.

Regulators necessarily exercise discretion in making price determinations. Informed discretion is required in making both constituent decisions and in making the overall revenue requirement decision. A merits review body should be able to undertake the same balancing process as the regulator.

IPART’s preference for any merits review process is that the review body “stand in the shoes” of the regulator. This ensures that any review of aspects of a determination under the WCIR is conducted in a thorough, balanced and holistic manner.

Further, we consider that, if a merits review process is introduced, the body selected to undertake the review should be an administrative body with experience in economic regulation (such as a specialist review panel) rather than a court-like body such as the Australian Competition Tribunal.

We consider that the appeal should be a ‘desk-top’ review, relying on the information available to the first-instance regulator. No new or further information should be able to be introduced by the parties.

In summary, IPART recommends that the WCIR should not be amended to introduce a merits review process. We recommend maintaining the status-quo, with any appeal undertaken under the ADJR Act.

However, if the WCIR are amended to include a Merits Review process, that they:

- ▼ allow appeals on specific issues to be undertaken in a whole-of-determination context
- ▼ require the body responsible for the review to ‘stand in the shoes’ of the economic regulator, and
- ▼ that the review body responsible for the review only be able to consider the information before the original decision-maker.

WCIR should be amended to allow the regulator to assess costs associated with the Murray-Darling Basin Authority (MDBA) and the Border Rivers Commission (BRC)

There is little or no scope within the WCIR for the regulator to assess the efficiency of MDBA and BRC costs passed onto water users through prices. We recommend the ACCC adopt a mechanism (either through the WCIR or other arrangements) to ensure the regulator can assess the efficiency and prudence of any proposed MDBA and BRC costs to be recovered from water users through prices.

The Issues Paper acknowledges that there is scope for the MDBA and BRC to impose user charges to recover its costs, and that should the MDBA and BRC elect to impose charges directly those charges would be subject to the WCIR. However, the Issues Paper also notes that, instead, the MDBA’s costs are funded through contributions from the Commonwealth and Basin State governments, and that “these contributions are recovered from water users by Basin States in different ways and to different extents.”

When the MDBA and BRC costs are passed through to water users indirectly⁵ through a Part 6 operator’s prices, the regulator should be able to assess the prudence and efficiency of these costs – as is the case with all other costs recovered via regulated prices. This is important in ensuring that water users only pay the efficient costs of bulk water services, and therefore that the Basin water charging objectives are met.

⁵ Rather than directly to users as customers of the MDBA or BRC.

To ensure that only efficient MDBA and BRC costs are passed through to water users via regulated prices, we recommend the ACCC considers the following options:

- ▼ Allow the regulator to review the activities and expenditure of the MDBA and BRC when making a price determination of a Part 6 operator. This includes an assessment of the activities undertaken, the efficient costs of those activities and the appropriate user share of efficient costs.
- ▼ Have the MDBA's and BRC's activities, costs and user-share of costs reviewed by an independent entity (eg, the ACCC) prior to, or concurrent with, a price determination. The independent finding on the user-share of the MDBA's and BRC's efficient costs would then be passed through to customers in the subsequent price determination of the Part 6 operator.
- ▼ Have the MDBA and BRC bill customers directly for services.⁶ This would require a full price determination under the WCIR and ensure that activities and costs were independently assessed by the regulator.

Each of these options would ensure that MDBA and BRC activities and expenditure are subject to independent review. The WCIR should ensure there is appropriate independent oversight of any costs passed onto users via prices. We would support the approach which is found to achieve this outcome while imposing the least cost to all parties involved.

Water Charge (Planning and Management Information) Rules 2010

We support the intent of the Water Charge (Planning and Management Information) Rules 2010 (the WCPMIR) to improve the consistency, scope and availability of information about water planning and management charges across Basin States.

We also support the objective of cost-reflective water planning and management charges across Basin States, consistent with the user pays principle. This is important in ensuring the efficient functioning of water markets.

The Water Administration Ministerial Corporation (WAMC) is responsible for water management in NSW. WAMC's water planning and management activities are delivered by the NSW Office of Water (NOW). IPART sets maximum prices that NOW can charge for the water management services delivered on behalf of WAMC. In doing so, we determine NOW's efficient costs of its water management activities, allocate these costs between water users and the broader community using the 'impactor pays' principle, and then set prices to reflect water users' share of NOW efficient costs.

We note that NSW has complied with the WCPMIR, at relatively little cost.

⁶ Prices related to MDBA and BRC activities could be included as a separate line item under existing billing arrangements for Part-6 operators, as is the case for the NSW Office of Water Charges which are included on WaterNSW bills.