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Mr Michael Cosgrave
Executive General Manager
Infrastructure Regulation
Australian Competition and Consumer Commission
Via email: waterchargerules@accc.gov.au

Dear Mr Cosgrave,

WaterNSW submission - ACCC Review of Water Charge Rules

WaterNSW is pleased to provide a submission to the ACCC's review of the Water Charge Rules Issues Paper.

WaterNSW welcomes the ACCC's review, and considers it an important opportunity to ensure the Rules are modern, consistent with best practise and promote efficient service delivery, greater infrastructure investment and greater customer service and product innovation.

It is WaterNSW's view that the Rules should place customer outcomes first and foremost.

WaterNSW's response to the Water Charge Rules Issues Paper is enclosed. Joseph Caruana, Senior Regulatory Economist, and Ed Chan, Senior Manager Economics and Business Planning are available to discuss any aspect of our submission with both you and your team at the ACCC, and the Department of Environment.

We look forward to the outcome of the Review.

Yours sincerely,

David Harris
Chief Executive Officer

Executive Summary

WaterNSW proposes improvements to the Rules to allow a greater degree of flexibility than the Rules currently allow. WaterNSW considers that the current prescriptive nature of the Rules are inconsistent with best practice regulation and limits WaterNSW's ability to:

- efficiently manage its business;
- deliver customer focused outcomes; and
- respond to change in the sector.

WaterNSW also considers that more flexibility in the Rules will encourage greater innovation and private sector investment, for the ultimate benefit of customers.

To support proposed amendments to the Rules, WaterNSW :

1. cites examples of how and where the current Rules have prevented WaterNSW from efficiently managing its business and delivering customer focused outcomes (e.g. the Peel Valley trading scheme);
2. illustrates the more robust and best practice regulatory frameworks of the Australian electricity and UK water sectors; and
3. links arguments to the interconnected water trading market, given consistent economic regulation of the interconnected water market was a key reason for the Rules being created in the first place.

In summary, WaterNSW considers that an effective and efficient water market must have the following characteristics:

- Separation of policy advisor, rule maker, rule enforcer and price regulator;
- Legislative objectives that have a primary focus on economic efficiency, with social policy objectives as second order conditions;
- Explicit merits review;
- Regulatory flexibility and incentives for regulated businesses to directly engage with its customers to offer innovative products and provide customer empowerment; and
- Minimal compliance costs.

To facilitate these outcomes, WaterNSW's submission also directly answers questions raised in the Issues Paper and proposes drafting changes to identified specific Water Charge Rules, as requested by the ACCC in the Issues Paper.

Regulatory environment

WaterNSW proposes improvements to the Rules to allow a greater degree of flexibility than the Rules currently allow. WaterNSW considers that the current prescriptive nature of the Rules are inconsistent with best practice regulation and limits WaterNSW's ability to:

- efficiently manage its business;
- deliver customer focused outcomes; and
- respond to change in the sector.

WaterNSW also considers that more flexibility in the Rules will encourage greater innovation and private sector investment, for the ultimate benefit of customers.

The electricity sector in Australia is an example of a more robust regulatory framework compared to the rural water sector. The following best practise economic regulatory elements found in the electricity sector would benefit the rural water sector:

- separation of policy advisor, rule maker, rule enforcer and price regulator;

articulation of the hierarchy of policy objectives in the legislation, starting with economic efficiency, and social policy objectives being second order conditions; and inclusion of an explicit merits review mechanism to both ensure policy objectives are implemented and also encourage private sector investment by increasing regulatory confidence and certainty.The economic regulation of the United Kingdom Water sector is widely recognised as being best-practice, flexible and responsive. WaterNSW recommends its principals should be adopted in the Australian rural water sector to foster product and service innovation, and customer empowerment. Specifically, WaterNSW proposes:

- implementation of a broader reopening provision to allow regulated businesses to engage directly with their customers to introduce innovative products.

Analysis of issues

Continued inconsistent pricing across interconnected markets and the need for best practise regulatory arrangements

A key reason for inconsistent charging arrangements across the Murray Darling Basin is that the *Water Act 2007* and subsequently the Water Charge (Infrastructure) Rules (WCIR) impose the difficult task on the regulator of assessing and making decisions regarding conflicting efficiency and social objectives, with no guidance on how to trade them off.

This was identified in the ACCC paper *International Insights for the Better Economic Regulation of Infrastructure best practise regulation.* The authors concluded that economic efficiency is, and should continue to be, the core objective in infrastructure regulation and broadening the regulator's scope to include other social and environmental objectives needs to be assessed in the light of the costs of specific compromises and the availability of other superior instruments and

institutional arrangements.[1] Applying this principle to the rural water sector, the regulator should be exclusively tasked with regulating natural monopolies in the context to achieve economic efficiency.

However, the *Water Act 2007* and the WCIR not only impose conflicting objectives on the regulator, they dictate that the ACCC must also advise the Government on the policy development of these conflicting objectives, via drafting the proposed WCIR and other rules. It is acknowledged that the Government can reject the proposed Rules, however in practise the ACCC's proposed Rules are mostly accepted without change. For example, the WCIR in place today are largely the same as the original advice the ACCC provided to the Minister in 2009, with the exception of state based regulator accreditation arrangements. Further, the ACCC then create their own guidance materials that regulated entities must follow. Finally, the ACCC are granted exclusive powers to investigate and enforce compliance.

The above situation results in sub-optimal regulatory policy development by making the ACCC devise policy solutions to conflicting objectives with no legislative guidance. In the absence of legislative guidance, the ACCC interprets the importance of the conflicting objectives and from that interpretation, issues its own guidance materials.

In contrast, the economic regulation of the electricity sector is transparent and underpinned by legislation agreed to by all jurisdictions with a clear separation of functions. In summary:

- The Standing Council on Energy and Resources establishes policies for the energy sector;
- The Australian Energy Market Commission administers rule change processes in accordance with the established policy; and
- The Australian Energy Regulator and the Australian Energy Market Operator are responsible for administering specific sections of relevant and respective Acts and Rules.

Such arrangements have proven to provide substantial guidance to achieve conflicting policy objectives, consistent charging arrangements across interconnected systems and a robust national electricity market.

WaterNSW acknowledges that the rural water sector is not as developed as the energy market. However, between 2007-08 and 2012-13 the water allocation trading market has grown from 1,393 Giga-litres (GL) in 2007-08 to 6,058 GL in 2012-13.[2] In comparison, the ACCC Final Decision on State Water Pricing Application: 2014-15 to 2016-17 set 2014-15 forecast water sales at 4,283 GL, with a total 2014-15 revenue requirement of $84.3 million, suggesting the trade market is quite substantial. Best practise regulation and regulatory arrangements are required to ensure the water market continues to prosper and grow.

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[1] Albon & Decker 2015, *International Insights for the Better Economic Regulation of Infrastructure,* Australian Competition and Consumer Commission, pp. 87-88 https://www.accc.gov.au/system/files/International%20Insights%20for%20the%20Better%20Economic%20Regulation%20of%20Infrastructure.pdf accessed 4 June 2015

[2] National Water Commission 2014, *Australian Water markets report 2012-13, table 3.2: Water allocation trading volumes in Australia, 2007-08 to 2012-13*, p. 31 http://www.nwc.gov.au/publications/topic/water-industry/australian-water-markets-report-2012-13 accessed 4 June 2015

It is noteworthy that the Regulation Impact Statement that accompanies the WCIR identifies that at the time the Rules were introduced in 2011:

> *"there is … no common approach to pricing across the Basin since each jurisdiction conducts determinations/ approvals subject to different state legislation. Inconsistent pricing across interconnected markets can create trade distortions leading to an inefficient market with ramifications for the economically efficient and sustainable use of water resources and water infrastructure assets."*[3]

The above point was made under the heading "assessing the problem" and used as a justification for the need to implement the WCIR to regulate non-member owned prices (of which WaterNSW is one), despite NSW already having in place independent economic regulation via the Independent Pricing & Regulatory Tribunal (IPART).

As at June 2015, almost 5 years after the introduction of the WCIR and 6 years until they are due to automatically sunset, a common approach to pricing has still not been achieved and there still remains no consistent application of economic principles within the basin. This was made clearly evident with the significantly different regulatory determination outcomes of Goulburn Murray Water (GMW) and WaterNSW (formerly State Water Corporation).[4]

In fact, the economic outcomes of bulk water regulation in 2015 look very similar to that of 2010 before the WCIR were introduced. It is noted that

- the ESC continues to regulate Victorian bulk water operators;
- the NSW Parliament passed legislation on 3 June 2015 for IPART to seek accreditation to regulate NSW bulk water infrastructure;
- there is no independent economic regulation of Murray Darling Basin Authority (MDBA) costs; and
- the WCIR are not applicable to South Australia (although the Essential Services Commission of South Australia has since become the economic regulator for South Australia, independent of the WCIR) and most of Queensland.

Serious consideration should in fact be given to the repeal of the WCIR as they have not removed the market failure they were introduced to solve. This would leave the pre-existing state based regulation that had already seen the implementation of the National Water Initiative in NSW, prior to the introduction of the WCIR.

Such an outcome is consistent with the following terms of reference:

- *consistency with the Australian Government's deregulation objectives*; and
- *…opportunities for amending the rules to improve regulatory clarity or efficiency, or to reduce regulatory burdens while maintaining effective standards.*

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[3] Commonwealth of Australia 2010, *Regulatory Impact Statement Water Charge (Infrastructure) Rules 2010*, p. 13 http://www.comlaw.gov.au/Details/F2011L00058/Download accessed 3 June 2015

[4] See *State Water Submission to the 2014 Review of the Water Act 2007 (Commonwealth)* for further discussion

Need for a merits review

Economic regulation in the Australian rural water market would benefit from an independent merits review process to facilitate robust and consistent economic outcomes. The ACCC research paper, *International Insights for the Better Economic Regulation of Infrastructure* concludes that judicial and merits review are common across the 17 international jurisdictions surveyed in the paper and broadly speaking, such review processes increase the credibility of regulation by ensuring that the regulator exercises its powers lawfully and within its pre-determined policy mandate.[5] This point is further supported by the recently released *Australian Infrastructure Audit*. One of the audit's conclusions is:

> *Ineffective and inconsistent regulation has had adverse outcomes for infrastructure users and the Australian community. These include … poor pricing decisions leading to potential problems in the future water sector …Greater independence of regulatory oversight would improve the quality of decision making.*[6]

In addition, WaterNSW notes that a review mechanism has been recognised as a way to address the risk of outside influences 'creeping into' the regulatory process in the energy sector, as noted in the Standing Council of Energy and Resources Review of the Limited Merits Review Regime Interim Stage One Report:

> *First of all, the scrutiny of the appeals system or perhaps just the existence of an appeals system should improve the quality of decision making ... Secondly, the existence of an appeals system and its operation should increase confidence in the system as a whole ... Thirdly, it is a safeguard against regulatory capture, regulatory inertia or regulatory timidity which with the best will in the world may creep into any regulatory system, from time to time.*[7]

Further, the existence of a merits review mechanism would further lower the likelihood of errors being made by the regulator during the determination process. The potential for utilities to appeal a determination outcome to an independent review panel provides incentives for the regulator to implement preventative measures to address the potential for regulatory errors during the decision making process, thereby improving the quality of pricing decisions under the *Water Act 2007*, resulting in best practice and cost effective regulation for customers.

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[5] Albon & Decker 2015, *International Insights for the Better Economic Regulation of Infrastructure,* Australian Competition and Consumer Commission, pp. 72-74 https://www.accc.gov.au/system/files/International%20Insights%20for%20the%20Better%20Economic%20Regulation%20of%20Infrastructure.pdf accessed 10 June 2015

[6] Infrastructure Australia 2015, *Australian Infrastructure Audit, our Infrastructure Audit findings*, p. 7 http://www.infrastructureaustralia.gov.au/policy-publications/publications/files/Australian-Infrastructure-Audit-Key-Findings.pdf, accessed 10 June 2015

[7] House of Lords, Select Committee on the Constitution, The Regulatory State: Ensuring Its Accountability, 6th Report of Session 2003-04, Volume I, 6 May 2004, at [93] as quoted by the Standing Council of Energy and Resources Review of the Limited Merits Review Regime Interim Stage One Report and Consultation Papers 1 & 2.

WaterNSW is also of the view that an independent merits review mechanism would facilitate greater infrastructure investment. This is because potential investors will have greater confidence that regulatory decisions promote economic efficiency and provide an adequate return on investment, commensurate with market conditions and irrespective of geographic location.

The fragmented nature of economic regulation in the Australian water sector and its constraint on private sector involvement is identified as a specific audit finding in the *Australian Infrastructure Audit* paper.

> ***Economic regulation of the [water] sector is fragmented*** *and may not effectively protect the long-term interests of consumers: objectives are often not clearly specified; links between economic, health and environmental regulation are not well identified;* ***and existing economic regulation does not provide the consistency, certainty and transparency necessary to support further private involvement in the sector.***[8] *[Emphasis added].*

It is acknowledged that the *issues paper* identifies that price approvals or determinations of regulated charges in Part 6 and 7, are **potentially** subject to judicial review under the *Administrative Decisions Judicial Review Act 1977* [emphasis added].[9]

WaterNSW notes that the use of the word 'potentially' provides some doubt of the ability to use this mechanism as part of the water economic regulatory framework. Further, if this mechanism is in fact available (subject to a judicial test case to determine a precedent); it is limited to points of law on the administrative decision. This is vastly different to merits review. As an example, a review under the *Administrative Decisions Judicial Review Act 1977* within the current regulatory framework could not be called upon to hold all stakeholders to account to implement the economic and social policy objectives in schedule 2 of the *Water Act 2007* in a consistent and transparent manner.

The right to judicial appeal should be explicitly set out in the *Water Act 2007* for the avoidance of doubt. This is consistent with the energy sector where judicial review is explicitly set out in the pricing arrangements for that sector.

Limited reopening provisions

Rule 40 of the WCIR allows an infrastructure operator to make an application to the Regulator to vary pre-determined regulated charges only under the following constrained circumstance:

- An unforseen event that materially and adversely affects the operator's service infrastructure or business; and

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[8] Infrastructure Australia 2015, *Australian Infrastructure Audit, our Infrastructure Audit findings*, p. 10 http://www.infrastructureaustralia.gov.au/policy-publications/publications/files/Australian-Infrastructure-Audit-Key-Findings.pdf, accessed 10 June 2015

[9] ACCC 2015, *Review of Water Charge Rules Issues Paper*, p. 26 https://www.accc.gov.au/regulated-infrastructure/water/water-projects/review-of-the-water-charge-rules-advice-development/issues-paper

- the total amount required during the remainder of the regulatory period to rectify the material and adverse effects of the event exceeds $15 million or 5% of the operator's regulated asset base (RAB), whichever is the lesser amount; and
- The operator can demonstrate that it cannot reduce other expenditure to avoid the adverse impacts of the unforseen event.

The Explanatory Statement describes the policy intent behind this variation clause is solely to provide a safeguard for infrastructure operators when an adverse, unforseen and material event occurs.[10] Whilst the inclusion of a re-opening provision is a step towards more robust regulatory outcomes, it falls well short of the flexible and responsive best practise regulation exhibited in the United Kingdom.

In 2012, Ofwat produced the document *Future price limits – statement of principles* to guide its future determination decision making. The central goal of the document was to outline the ways OfWat will modernise its regulatory approach and make it more flexible and responsive. Two key principles outlined by OfWat to achieve this included:

- Ownership, accountability and innovation - OfWat has committed to setting prices that empower their regulated entities to take ownership and accountability to deliver customer requested outcomes.
- Flexibility and responsiveness - OfWat has committed to design and use its regulatory tools to allow for innovation to meet the needs of the adaptive water industry.

It is clear that customer empowerment and innovation are at the heart of these principles.[11]

In contrast, the economic regulation of the Australian bulk water industry under the Rules is rigid by comparison and as such constrains innovation and customer empowerment.

As an example, in 2014 WaterNSW (formally State Water Corporation) sought to introduce a trading scheme between the Peel and Namoi valleys as an innovative solution to encourage a higher usage volume by incentivising inactive water entitlement holders to trade their entitlement, thus providing WaterNSW the opportunity to recover its ACCC determined prudent and efficient costs. It is also noted that the ACCC Final Decision set prices in the Peel Valley *below that required to meet efficient costs*.[12] If certain assumptions were met, the Peel-Namoi trading scheme would have enabled a reduction in Peel Valley prices.

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[10] Commonwealth of Australia 2010, *Explanatory Statement Water Charge (Infrastructure) Rules 2010 Division 4 – Variation of approval or determination in certain circumstances*, p. 20 http://www.comlaw.gov.au/Details/F2011L00058/Download accessed 3 June 2015

[11] OfWat 2012, *Future price limits – statement of principles* pp.1, 11 https://www.ofwat.gov.uk/future/monopolies/fpl/pap_pos201205fplprincip.pdf accessed 3 June 2015

[12] The ACCC *Final Decision on State Water Pricing Application: 2014-15 to 2016-17* set prices in the Peel Valley such that revenue generated was $231,000 (17% of customer tariff revenue) below efficient costs in 2014-15, on the assumption the NSW Government would provide a subsidy to make up the short fall. The NSW Government did not provide a subsidy and ultimately the ACCC Final Decision meant that WaterNSW's forecast revenue from regulated charges did not meet that part of the prudent and efficient costs of providing infrastructure services that is not met from other revenue as required by Rule 29 (2) (b) of the WCIR.

However, as a result of the limited re-opening provisions in rule 40 of the WCIR and sub rule 8(2), WaterNSW was unable to levy a new charge as it had not been approved or determined by the ACCC. The only time WaterNSW can seek permission to levy a new charge (outside the limited re-opening provision) is via the three-to-four yearly price determination process. Thus, the trade scheme became inoperable and was suspended. Ultimately, this removed the incentive for WaterNSW to develop and implement innovative products to better meet customer's needs.

Relevant questions raised in the issues paper and proposed amendments to the WCIR

Are the requirements that must be met before an approval or determination of regulated charges can be varied set appropriately?

No. The limited re-opening provisions outlined in Division 4, sub rules 40(1) and (2), coupled with Division 2, sub rule 8(2), constrain innovation and investment in the water sector. WaterNSW recommends the following amendments to the WCIR to promote best practise regulation:

Add sub rule 40(1) (c): the operator proposes to implement a new or altered product or service, with the agreement of its customers.

What are the advantages and disadvantages of the ACCC's pricing principles defining terms used in the BWCOP and/or ordering them into a hierarchy to guide the discretion of regulators and provide greater certainty to industry participants?

The *Water Act 2007*, or at the very least the WCIR should define terms used in the BWCOP and order them into a hierarchy. This will foster consistent charging arrangements, promote investment and trade. Such an approach is consistent with the robust and transparent economic regulation of the electricity sector.

To this end WaterNSW recommends the following amendments to the (WCIR) at a minimum:

Amend sub rule 29 (4): In approving or determining regulated charges under this rule, the Regulator must achieve the Basin water charging objectives and principles set out in Schedule 2 of the Act, with the primary objectives of promoting economic efficiency and supporting infrastructure development, without resulting in pricing outcomes that distort market activity.

If this was done via the ACCC pricing principles, it would further promote the ad-hoc administrative economic regulatory arrangements that are currently in place in the rural water sector. Further, there is a risk that the ACCC guidelines may be inconsistent with the policy intent of the *Water Act 2007*. This could lead to a situation where the regulator delivers a decision that is consistent with regulatory guidelines, but inconsistent with the objectives of the *Water Act 2007*.

Are the provisions regarding the annual review of regulated charges for Part 6 operators appropriate?

The provision for an annual review of charges is a step towards best practise regulation. However, the WCIR should be amended to allow the regulated entity discretion as to whether they seek approval for an annual review, instead of it being a mandated requirement. Further, the WCIR should also provide further guidance on what constitutes a price shock and include a requirement for sufficient revenue to meet pre-determined efficient costs in the regulatory period.

WaterNSW recommends the following amendments to the (WCIR):

Amend sub rule 34 (1), A Part 6 operator whose regulated charges in respect of a regulatory period have been approved or determined under Division 2 and, if varied under Division 4, as so varied, ***may*** apply to the Regulator for approval or determination of its regulated charges in respect of the second year and each subsequent year of the regulatory period, as reviewed in accordance with this Division.

Add sub rule 37 (2) (c), in approving or determining regulated charges under this rule, the Regulator must have regard to, and describe how, the regulated charges contribute to achieving the Basin water charging objectives and principles set out in Schedule 2 of the Act.

Are there better alternatives for updating regulated charges when demand or consumption forecasts change?

Cost reflective tariffs are the most robust methodology to overcome variable extractions. This removes the need for potentially large price annual price variations to overcome large changes in consumption.

What models for review of administrative decisions have been successfully adopted in other infrastructure sectors? What are the arguments for and against these models to the water sector under the WCIR?

Appeals mechanisms (both judicial and merits) have been operating in numerous jurisdictions (both international and domestic) with broad success. WaterNSW is of the view that an independent merits review process:

- increases the credibility of regulation by ensuring that the regulator exercises its powers lawfully and within its pre-determined policy mandate
- is recognised as a way to address the risk of outside influences 'creeping into' the regulatory process in the energy sector
- ensures outcomes are free of regulatory error
- facilitate greater infrastructure investment

WaterNSW recommends the following amendments to the (WCIR):

- Add part 9 rule 70 to give effect to a merits review process.[13]

Who should have the ability to appeal a decision under the WCIR?

The appeals mechanism should be symmetric and open to both regulated businesses and customers.

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[13] It is acknowledged that the *Water Act 2007* is the most appropriate legislative instrument to explicitly provide for a merits review. However, supporting material should be included in the *Water Charge (Infrastructure) Charge Rules 2010* to give effect to this policy objective should it be included in the Water Act 2007. See State Water Submission to the 2014 Review of the Water Act 2007 (Commonwealth) for a further discussion on merits and judicial review in the context of the *Water Act 2007*.

Reduce reporting burden

WaterNSW's is also of the view that the Rules should be amended to increase the efficiency of determination processes and reduce compliance costs through:

- incentivisation of the regulator to be prudent and efficient in their review process;
- addition of a materiality test and objectives threshold to enable the regulator to focus on material and relevant information during a determination process; and
- streamlining the new prices reporting requirements..

Analysis of issue

Additional information requests by the regulator during a determination process

Rules 27(b) and rule 36 (b) (ii) sets out an obligation to publish all additional information received from a Part 6 operator in response to a request for further information from the Regulator. It is noted that during the 2014 determination, the ACCC and its consultants requested State Water answer an additional 400 separate information requests, each with multiple questions. Under rules 27(b) and 36(b), the ACCC were of the view that all this additional information was required to be published on its website, unless State Water claimed confidentiality. It is noted that this was not the process for the Goulburn Murray Water determination undertaken by the ESC. This different regulatory approach again enforced inconsistent regulatory outcomes.

Further, rule 26 currently does not place a restriction on the regulator on the type of questions they can ask and use to activate the "stop-the-clock" provisions. This includes publicly available information, or information beyond the regulated entity's control. This was the case for the State Water determination where the ACCC requested various pieces of information that were both publicly available and beyond State Water's control. An example is available water determinations which are administered and published by the Office of Water.

The above issues significantly increased compliance costs and added very little to public transparency. It is recommended that a materiality test is included in rule 27(b) and a restriction is placed on the regulator such that all information requests must be accompanied by an outline of its objective and how it relates to achieving the BWCOP and not include publicly available information, or information not owned or controlled by the regulated entity.

Relevant questions raised in the issues paper and proposed amendments to the WCIR

Are there ways to reduce the regulatory burden of information requirements relevant to part 6 operator without compromising the regulator's ability to properly approve or determine the operator's regulated charges?

Amend rule 27(b) and 36(b) (ii) a copy of any further information received in response to a request under rule 26; ***subject to materiality.***

Amend rule 26 (b): For further information requested under rule 26, the regulator must outline how its information request relates to achieving the BWCOP and not include publicly available information, or information not owned or controlled by the regulated entity.