

Submission in response to Preliminary Advice of the Independent
Reviewer

Review of economic regulation, governance and efficiency in the Victorian water sector

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WATER SERVICES
ASSOCIATION OF AUSTRALIA

Overview of WSAA

WSAA is the industry body that supports the Australian Urban Water Industry

Its members and associate members provide water and wastewater services to over 20 million Australians and many of Australia's largest industrial and commercial enterprises.

The Association facilitates collaboration, knowledge sharing, networking and cooperation within the urban water industry. It is proud of the collegiate attitude of its members which has led to industry-wide approaches to national water issues.

WSAA can demonstrate success in the standardisation of industry performance monitoring and benchmarking, as well as many research outcomes of national significance. The Executive of the Association retain strong links with policy makers and legislative bodies and their influencers, to monitor emerging issues of importance to the urban water industry. WSAA is regularly consulted and its advice sought by decision makers when developing strategic directions for the water industry.

Comments or questions should be referred to:

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Review of economic regulation, governance and efficiency in the Victorian water sector

1	Executive summary	iii
2	Introduction	1
3	Objectives and guiding principles	2
4	Governance arrangements	3
5	Methodology and process for economic regulation	5
5.1	Introduction	5
5.2	The characterisation and assessment of the current building blocks approach	6
5.3	The need to also consider improvements within the building block model	7
5.4	The need for more detail on the proposed 'price-based' model to properly evaluate it	10
5.5	The risk to long-term investment and other regulatory objectives	12
5.6	Regulatory methodology - overall assessment	13
6	Institutional arrangements for economic regulation	15
6.1	The importance of independent economic regulation	15
6.2	The proposal for an 'independent reviewer' to set prices	16
7	Reform path	18
8	Next steps	19

Executive summary

WSAA welcomes the opportunity to respond to the preliminary advice from the Independent Reviewer on economic regulation, governance and efficiency in the Victorian water sector.

We agree that there are opportunities to improve economic regulation of urban water. To that end, Frontier Economics has been working with us to identify best practice. While that work is ongoing, we would like to share some of the insights of that study. Our key comments are as follows.

Objectives and principles

WSAA supports the position that, consistent with other regulatory regimes, the primary objective of economic regulators should be framed as being to promote the long-term interests of consumers. This is broadly consistent with the Independent Reviewer's view that economic efficiency should be the primary objective of economic regulation of Victoria's water corporations.

The principles set out to guide the review appear broadly appropriate. In our view an additional principle is also important: that of consistency and predictability. This is particularly important for an industry with very long-lived assets where long-term planning and maintenance is critical.

WSAA also supports the observation in the Review report that the regulatory framework can only be properly considered in the context of the wider institutional arrangements, and in light of how different regulators and agencies work together. In this context, considerable care is required in attributing perceived failings in the current arrangements to particular elements of the overall framework.

Governance

WSAA fully supports the principle espoused in the Review that the role and objectives of government, water corporations and regulators should be clear, and that the Government should set clear and consistent objectives for water corporations which are aligned with government policy and clearly defines their purpose and establishes clear accountabilities for Boards.

WSAA supports strong shareholder oversight and target setting as envisaged under the corporatisation model for government owned enterprises. In WSAA's view some aspects of the proposed governance arrangements may run counter to the principles of clear roles and accountabilities. In order to comment more fully, the independent reviewer's proposal, particularly the role and scope of the proposed water sector performance unit, needs to be more clearly articulated. Our main concern is that, contrary to the intention of the Review, the independence and accountability of Boards is not diluted.

Independent economic regulation is critical!

We strongly endorse the continued setting of prices independently from government as a guiding principle for the review. We note that the current framework has a number of institutional and legislative arrangements that go a long way to both supporting independence and to maintaining it over time.

The proposed changes to the institutional framework for economic regulation outlined in the current proposal lack the detail necessary for WSAA to make informed comment. The governance arrangements for the proposed independent reviewer need to be clarified to ensure genuine independence is achieved. This is a crucial component in the ability of an independent economic regulation regime being able to achieve its underlying objectives, namely the long-term interest of customers. Unless independence is assured, these long-term objectives might be undermined by short-term political goals.

WSAA is also concerned that the proposal to introduce a second independent economic regulator to set prices may add additional compliance costs, unnecessarily complicate the regulatory framework and confuse accountability.

Price or cost regulation?

Consistent with an overarching regulatory objective of protecting the long-term interests of customers, WSAA considers that best practice methodology and processes for economic regulation for a given industry should be those which best align the incentives of the regulated businesses with the long-term interests of customers.

While in theory there is a stark contrast between pure price regulation and the cost of service regulation, in practice, regulators across countries have avoided implementing these extremes and for the most part some form of hybrid has been adopted, where cost information and a building block model is a crucial piece of almost all regulatory frameworks.

While some of the criticisms of the current application of the building blocks model are valid (e.g. limited incentives for efficiency or innovation), there are many examples where the model has evolved to enhance incentives and reduce regulatory burden. There is a substantial literature and recent experience in reforms to economic regulation such as by the AER and by OfWat and OfGem in the UK which should be considered by the Review.

On the other hand there are few, if any, examples where completely divorcing price setting from costs has delivered good and sustainable outcomes for consumers. The scope for lumpy investment programs for compliance or supply capacity means that application of this approach would entail significant risk of regulated prices diverging significantly from the regulated entity's efficient cost, resulting in deferred investment and/or threat to water businesses' financial sustainability. In practice, there is likely to be a need to re-link regulated prices/revenues to costs periodically

to avoid either political concerns about excessive profits or businesses encountering financial difficulty.

The final report would benefit from considering these issues and how they would be addressed within the context of the Victorian water sector.

Customer consultation and transparency

Economic regulation in Australia and in other countries is moving towards strengthening the role of customer consultation within regulatory processes. The current Victorian framework has well-developed community consultation mechanisms and highly transparent decision-making and review processes. Most of these processes are integrated into the current framework for developing Water Plans. This is acknowledged in the independent reviewer's draft report.

It would be helpful if the Review identified how these features would be mirrored under the proposed review process. For example, in the absence of the Water Plan process how would the same level of customer consultation be maintained?

Integration with broader reform path

Experience with pro-competitive reform in other utility sectors suggests that a precondition for effective competition and a greater role for the private sector is the existence of a stable, predictable and independent regulatory framework.

In this regard there is a need for more detail on how the proposals for changes to the regulatory framework will provide the environment required to underpin pro-competitive reforms. Until an overall vision for the future reform environment and how the various elements of the institutional arrangements fit together is developed, there may be a risk that changes to the regulatory arrangements run counter to these reform objectives. There may also be a risk that diverting scarce government and industry resources into pursuing a major overhaul of the regulatory framework (when targeted improvements involving less effort, cost and time might instead have the desired effect) will detract from the pursuit of these broader reforms.

The next steps

A number of important aspects of the proposals are unclear or yet to be determined. This makes it difficult to provide informed comment on the proposals.

WSAA therefore suggests that before the Independent Reviewer finalises his recommendations, an additional round of consultation occur where the proposals are spelt out more clearly. In particular, further details should be provided on:

- the institutional arrangements for and precise functions of the water sector performance monitoring unit
- how the proposed methodology for reviewing efficiencies and setting prices would work in practice

- how the proposed review process would work in practice including what information will be required from the water businesses and how it would provide for transparency and customer consultation
- why it is necessary to establish a second economic regulator
- the institutional arrangements and the nature of the instruments governing the 'independent reviewer' including how its independence from government would be maintained and how it would be held accountable for its decisions
- how regulation of rural water businesses subject to the Commonwealth Water Act accreditation requirements would be accommodated
- how the proposed regulatory framework would promote the broader pro-competitive reform program.

Ideally, and consistent with RIS requirements for regulatory proposals, alternative options for achieving the underlying objectives or addressing the perceived problems should also be identified and canvassed.

1 Introduction

WSAA welcomes the opportunity to respond to the preliminary advice from the Independent Reviewer on economic regulation, governance and efficiency in the Victorian water sector.

WSAA supports periodic review of the arrangements for economic regulation and shares the goal of ensuring that regulation achieves its objectives in the most cost-effective manner. At present WSAA believes that the consistency, predictability and transparency of economic regulation of urban water across Australia needs to be addressed to ensure that it delivers outcomes that are in the long-term interests of customers.

To this end, WSAA has commissioned a major study from Frontier Economics benchmarking economic regulation across Australia against a best practice model. Our response draws from the research and emerging findings of this review.

WSAA support a number of the key findings of the Independent Reviewer, particularly in relation to transparency, role clarity and accountability of the current governance arrangements. While also supportive of pursuing opportunities for improving the current regulatory framework, WSAA considers that much more work is required to flesh out the details of how the proposed methodology and process for setting prices in the future will operate before the merits of the model can be properly evaluated.

It is also concerned that some aspects of the proposed arrangements, particularly the apparent move away from independent economic regulation to price setting within government, and the adoption of 'price-based' regulation, may undermine the underlying policy objectives.

The remainder of this submission provides our comments on:

- objectives and guiding principles for assessing institutional and regulatory arrangements
- the proposed governance arrangements
- the proposed methodology and process for economic regulation
- the proposed institutional arrangements for economic regulation
- integration of the proposals with broader reforms
- a suggested way forward

WSAA would be happy to further assist the review.

2 Objectives and guiding principles

Economic regulation aims to promote effective competition where this is possible, and to reproduce the disciplines otherwise provided by competition, where it is not feasible to introduce competition. WSAA concurs with the Independent Reviewer that the natural monopoly characteristics of the industry provide a rationale for economic regulation. While the profit motive that might drive private monopolies to exploit customers may not apply to publicly owned utilities, the monopoly position of a publicly owned utility may nevertheless blunt its incentives to maximise efficiency. In the case of government-owned water businesses, concerns may be about under-pricing rather than over-pricing, whereby political intervention has in the past led to prices at levels well below cost recovery levels, resulting in underinvestment and deferred maintenance.

WSAA supports the position that, consistent with other regulatory regimes, the primary objective of economic regulators should be framed as being to promote the long-term interests of customers. This is broadly consistent with the Independent Reviewer's view that economic efficiency should be the primary objective of economic regulation of Victoria's water corporations.

Critically, however, economic efficiency should not be equated with minimising short-term costs – it should be about providing the services that customers want at the lowest long-term cost. This in turn requires appropriate maintenance and investment in long-lived assets. A regulatory framework that fails to encourage efficient and appropriate investment in maintenance and investment in essential assets and infrastructure (e.g. by providing for recovery of efficient costs) would not be in the long-term interests of customers.

The principles set out to guide the review also appear broadly appropriate. In our own work on best practice economic regulation we think an additional principle is also important: that of consistency and predictability. This is particularly important for an industry with very long-lived assets, where long-term planning and maintenance is critical. It is also critical to the encouragement of competition and greater private sector involvement. This principle would require that the framework for economic regulation should:

- provide a stable and objective environment (e.g. well-defined decision making criteria and clear timetables) enabling all those affected to anticipate the context for future decisions and to make long-term investment decisions with confidence
- not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets
- ensure consistency of treatment of participants across service sectors, over time and across jurisdictions.

WSAA also supports the observation in the Review report that the regulatory framework can only be properly considered in the context of the wider institutional arrangements, and in light of how different regulators and agencies work together.

In this context, considerable care is required in attributing perceived failings in the current arrangements to particular elements of the overall framework. In particular, while WSAA concurs on the need for reinvigorating the role of the shareholder (see discussion below) and related governance arrangements, it is not clear to WSAA that the current arrangements for economic regulation are similarly deficient. In fact, the national study commissioned by WSAA suggests that the current model for economic regulation in Victoria ranks relatively well against a best practice model.

A key point here is that in diagnosing problems with the current institutional arrangements, and in proposing solutions, it is important to clearly differentiate the nature and purpose of the shareholder, policy and economic regulatory functions respectively. While there may be particular challenges associated with doing so for government-owned businesses, in our view the Review conflates these roles and associated issues.

Further elaboration of these issues and our detailed comments on the proposals in the Review is provided below.

3 Governance arrangements

3.1 Governance principles

The setting of appropriate functioning governance arrangements that provide for efficient service provision and allow for water businesses to meet their statutory obligations is central to any proposed model. Getting these arrangements right is fundamental to ensuring that Victoria is serviced by a viable and effective water sector. The original corporatisation model established in 1995 was based on the following principles:

- clear specification of roles
- clear specification of accountabilities
- separation of policy, operational and regulatory functions
- avoidance of unnecessary duplication.

WSAA therefore fully supports the principle espoused in the Review that the role and objectives of government, water corporations and regulators should be clear, and that the Government should set clear and consistent objectives for water corporations which are aligned with government policy and clearly defines their purpose and establishes clear accountabilities for Boards.

3.2 Achieving good governance in practice

As noted by the Review, the current institutional arrangements are complex, with important roles being undertaken by a relatively large number of participants. However, the Review ultimately recommends establishing a number of new participants:

- a ‘water sector performance unit’ within Government;
- an ‘Independent Reviewer’ to undertake periodic assessments of efficiency in order to set prices (while still retaining a role for the current economic regulator (the ESC));
- an ‘active’ shareholder (although the institutional arrangements for this ‘active shareholder’ are not clear).

These proposals underline the need for very clearly defining the role and responsibilities of these new entities and establishing institutional arrangements for them which do not give rise to conflicts. For example, it would seem appropriate that the water sector performance unit reside within the Treasury portfolio rather than the line department/agency.

As part of reforms designed to better reflect these principles, WSAA supports the thrust of the Reviewer’s proposals to reinvigorate the role of the shareholder through the establishment of a ‘water sector performance unit’.

In WSAA’s view some aspects of the proposed governance arrangements may run counter to the principles of clear roles and accountabilities. For example, in addition to setting targets and reviewing and challenging the corporations’ strategic planning, the Review paper suggests that the water sector performance unit could also “encourage and broker synergies between corporations, such as in the area of shared services”. There is a risk that if the role of the unit becomes too ‘activist’, accountability for performance will in fact become blurred as the unit has effectively become part of the business decision-making process. This ‘line’ will need to be defined very carefully.

In addition, in our view conferring a role on the independent economic regulator, who oversees whether price and service quality plans have been delivered, as an ‘advisor’ to the shareholder (p.43 of the preliminary advice) would be inappropriate. Conferring an advisory role on the economic regulator to the owner of the businesses it is overseeing would raise major conflicts of interest. Further issues relating to the proposed independent reviewer/regulator are discussed below.

As part of the proposed revisions to governance arrangements, the Review also proposes that the Government should issue binding ‘Letters of Expectations’ to the water corporations, setting out the Government’s policy objectives and performance expectations for each corporation. These would encompass the “economic, social and environmental performance expectations, including service standards”. It suggests that the setting of these expectations should be coordinated

across Government and its regulatory agencies to ensure they are consistent with the Government's overarching objectives for the sector. WSAA supports the clear specification of expectations for the businesses. It is not readily apparent, however, how this would differ from the existing instrument (i.e. the Statement of Obligations).

4 Methodology and process for economic regulation

4.1 Introduction

Consistent with an overarching regulatory objective of protecting the long-term interests of customers, WSAA considers that best practice methodology and processes for economic regulation for a given industry should be that which best aligns the incentives of the regulated businesses with the long-term interests of customers. In doing so, it should seek to:

- prevent excessive pricing due to monopoly power
- encourage efficient and timely investment and innovation
- incentivise operating efficiencies
- minimise the regulatory burden; and
- provide a predictable and stable regulatory framework.

A key finding of the Review is that the current building blocks methodology to setting prices should be replaced with a 'price-based' methodology. It finds that the current building block approach is "complex, inflexible and burdensome". It suggests instead that a "price-based incentive approach would best support efficiency improvement".

WSAA supports the exploration of alternative regulatory approaches which will better achieve the underlying objectives of economic regulation in a cost-effective manner. However, it also considers that changes to economic regulatory frameworks should not be made lightly and new models adopted only where there is clear and compelling evidence that they will represent substantial improvements. In WSAA's view the Review report has not yet made this case. Our key issues relate to:

- the characterisation and assessment of the current building blocks approach
- the need to also consider improvements within the building block model to improve its incentives and reduce regulatory burden, drawing on recent experience in other sectors and jurisdictions, rather than replacing the building block approach altogether

- the need for much more detail on the proposed ‘price-based’ model to properly evaluate it
- the risk to long-term investment and other regulatory objectives under a model that completely divorces prices from costs.

4.2 The characterisation and assessment of the current building blocks approach

As noted in the Review, the building block approach is currently used by the ESC in regulating prices of water corporations in Victoria. It is also the most common approach used by regulators in a range of utility sectors in Australia, New Zealand and the U.K.

While WSAA shares the view that the building block model has some deficiencies, it does not consider that the assessment of this approach by the Independent Reviewer is fully justified. In particular:

- While in theory there is a stark contrast between pure price regulation and cost of service regulation, in practice, regulators across countries have avoided implementing these extremes and for the most part some form of hybrid has been adopted, where cost information and a building block model is a crucial part of almost all regulatory frameworks.
- The Reviewer’s characterisation of building blocks as being a ‘cost-based’ regime with incentives to cost pad is misleading. It is widely seen (including by the AER) as a form of incentive-based regulation, as the ESC (and other regulators applying the building block model) do not set prices or revenues based on a firm’s actual costs. Rather regulated prices or revenues are based on assessments of the revenue/prices that an efficient firm would need to deliver the specified services at the required standards. Once set, firms with commercial drivers have incentives to reduce their costs, as they will retain the financial benefits from doing so, at least for a period. This is quite distinct from rate of return regulation as practised in some sectors in North America.
- The Review suggests that the building block approach encourages water corporations to grow their asset base and adopt capital rather than operating solutions. The report provides no evidence to demonstrate that this has been a major driver of high costs in practice. In fact, key drivers of capital expenditure in the industry relate to bulk supply decisions (made by central government) and compliance with environmental and public health standards- both of which are outside the direct control of water businesses and the economic regulator. Moreover, the Review ignores the fact that regulators that employ a building block model, including the Australian Energy Regulator (AER), have adapted their frameworks to tackle this issue (e.g. by rebalancing the incentives to

pursue operating expenditure and non-network solutions, rather than undertaking capital investments).

- The extent of the “challenges” in estimating the regulatory asset base, WACC, and efficiency of capital and operating expenditure are overstated and/or not unique to the building block model. For example, the RABs have been set based on a ‘line in the sand’ and are not a matter for ongoing attention or debate. Further, the Review understates or ignores the complexities and controversies that are likely to arise under the alternative ‘price-cap’ approach proposed.
- The Reviewer suggests that the building block model “has many complexities and these often lead to highly detailed and technical debates about the appropriateness of the model and its application”. In WSAA’s view, the desire for ‘simplicity’ should not override the need for the regulatory model to produce sound regulatory outcomes. Adoption of ‘simple’ approaches which do not allow for any debate on the appropriate level of prices will not necessarily result in better outcomes. For example, the simplest possible approach to price-setting would be to freeze prices at current levels in perpetuity. That would eliminate all complexity. However, such an approach would also be extremely undesirable as it would not allow adaption to changing economic and environmental circumstances. A sensible regulatory framework should aim to reduce complexity to the minimal level necessary in order to ensure the long-term interests of customers. This would not necessitate the current building block approach to be replaced altogether.
- The intrusiveness, complexity and cost of the building block model are also overstated. Rather than ‘duplicating’ the corporate planning process, the preparation of a Water Plan covers very similar ground which would need to be addressed anyway by a well-managed business.
- The Review states that the length of the regulatory period can also undermine incentives for efficiency (e.g. if the regulator sets relatively short periods between regulatory resets , say one to three years). WSAA notes that the ESC price determinations are now set for a period of 5 years.

4.3 The need to also consider improvements within the building block model

Given the costs and risks in dismantling the current model of economic regulation and replacing it with an unproven alternative, WSAA suggests that more detailed consideration be given to potential improvements in economic regulation within the current broad arrangements, including in the context of a strengthened shareholder function as proposed in the Review. For example, a much more ‘light-handed’ approach to economic regulation may be feasible where water businesses’ submissions to the regulator have already been subject to detailed critical scrutiny by the shareholder.

The study by Frontier Economics commissioned by WSAA has identified a number of potential improvements designed to improve the incentive properties and/or reduce the costs of the building block approach. There is a substantial literature and recent experience in reforms adopted by economic regulators such as the AER and OfWat and OfGem in the UK which should be considered by the Review.

One set of options is to incorporate more incentive and risk-sharing mechanisms in the regulatory controls such as longer regulatory periods, efficiency benefit sharing schemes, and service efficiency mechanisms:

- For example, OfGem, the economic regulator of the gas and electricity sectors in the UK undertook a major review of its regulatory framework between 2008 and 2010. This review, which gave rise to the RIIO (**R**egulation = **I**ncentives + **I**nnovation + **O**utputs), represented a major shift in regulatory thinking in the UK. Among other things, RIIO seeks to provide much stronger incentives for efficiency and better performance through a number of mechanisms involving rewards and penalties to regulated businesses. For example, it increased the length of the regulatory period from five years to eight years to provide stronger incentives for regulated businesses to pursue efficiency improvements by being able to retain them for a longer period of time.
- Other regulators, such as OfWat, have since adapted their own schemes based on insights from the RIIO framework. For example, OfWat has also introduced in the current review a shift towards a risk-based assessment, where the extent of regulatory scrutiny varies according to the assessed quality of the companies' business plan submissions.
- The AER, under its Better Regulation reform package, has recently introduced several efficiency incentive mechanisms including:
 - Efficiency Benefit Sharing Scheme (EBSS) — The EBSS works by allowing network businesses to retain underspends for a total of six years, regardless of the year in which they underspend. Consumers then benefit from lower forecast opex in future regulatory periods, which leads to lower prices.
 - Capital Expenditure Sharing Scheme (CESS) — The CESS provides a network business with the same reward for an efficiency saving and a corresponding penalty for an efficiency loss regardless of which year the saving or loss is incurred. When the CESS is implemented, a business will retain 30 per cent of an underspend or overspend, while consumers will receive 70 per cent of the benefit. In addition, if a business' capex exceeds the forecast, the AER will examine their spending. If AER determines that all or some of the overspending was inefficient, the business may not be allowed to add the excess spending to its RAB, so that consumers will not fund that expenditure. This is referred to as an ex-post review.
 - Another potential way of improving the incentive properties is to adopt 'menu regulation'. The objective of menu regulation is to address directly

the asymmetry of information between regulators and regulated businesses, by incentivising the businesses to reveal information truthfully. This, at least in principle, reduces greatly the need for the regulator to engage in costly and perhaps futile information gathering efforts in an attempt to overcome the information asymmetry.

Another potential way of streamlining the current building block approach would be to reduce the regulatory burden by standardising some of the elements. One example of such an approach is the default versus customised price/quality path regimes for electricity distribution businesses (EDBs), administered by the New Zealand Commerce Commission (the Commission). The current regulatory approach in New Zealand was the result of a conscious move away from the type of regulatory regime recommended by the Independent Reviewer.

Finally, there are several potential adjustments to methodologies adopted in applying the building blocks model (which would also address specific issues identified by the Independent Reviewer) including:

- Setting a WACC allowance based on a longer-term view:
 - The allowed revenues within a building blocks model are typically highly sensitive to WACC, because the return of capital is derived by multiplying the WACC by the firm’s capital base, which is typically very large. This means that if the WACC is volatile over time, the revenue allowance and prices to customers will also be volatile. The interests of creating a stable environment for planning future investments and price stability augur for an approach for determining WACC which does not lead to undue volatility. One option would be to adopt the approach followed by economic regulators in the UK, which have given greater weight to long-run evidence than to short-term movements in market parameters over time. IPART has recently moved in this direction.
- Using totex rather than capex and opex:
 - In the UK, OfWat and OfGem have adopted the total expenditure (totex) approach. Under this approach, expenditure allowances are assessed on a totex basis (as opposed to opex and capex separately) and the incentive rates on opex and capex have been harmonised (to minimise any skew in preferences towards capex solutions over potentially more efficient opex solutions). A significant proportion of totex is capitalised in the RAB (and is therefore remunerated as “slow money”), whilst the residual proportion of totex is paid as immediate cash (i.e. “fast money”). This is an explicit attempt to avoid distortions in preferences for one type of expenditure over another, arising from the way the businesses are allowed to recover these expenditures.
 - The AER’s recent Better Regulation reforms also seek to balance the incentives for pursuing opex and capex solutions. In particular, the AER will

approve a total quantum of expenditure (akin to the totex concept applied in Great Britain), and then allow networks to find and use the most optimal 'mix' of capex and opex to manage overall service performance. In order to effect this, the AER has now equalised the incentives and penalties applied to all types of expenditure.

- A greater focus on material issues
 - Another way in which the regulatory burden could be reduced is by focusing resources on the issue which matter the most.

In summary, WSAA considers that there is a range of potential options for improving the operation of the building blocks methodology which should be fully examined and assessed as a viable alternative to the Independent Reviewer's proposals for adopting an entirely new methodology.

4.4 The need for more detail on the proposed 'price-based' model to properly evaluate it

WSAA supports the consideration of alternative approaches to economic regulation. However, as it stands it is difficult to fully evaluate the model proposed by the Independent Reviewer as key details of how it would work are lacking.

The draft advice states that in future the Independent Reviewer should adopt a methodology that:

... should follow a similar process to that used in this review to determine the efficiency factor applied to prices. This involves benchmarking costs between water corporations to achieve near best practice within the Victorian water sector, identifying productivity improvements and involving water corporations in reaching a proposed outcome. The methodology should avoid complex technical benchmarking approaches. The approach recommended is based broadly on what is commonly described as 'CPI-X' principles. However, that concept is capable of several interpretations in regulatory analysis that causes us not to use that expression in this report and thus avoid any misunderstanding of the approach adopted in this review.

The process for the recent efficiency review under *Fairer Water Bills* is described as follows:

- water corporations and the Independent Reviewer working with Third Horizon, a firm with specialist expertise and experience in utilising benchmarking, to identify for each water corporation cost efficiency and revenue opportunities against industry benchmarks
- water corporations' submission of over 300 efficiency proposals for consideration
- scrutiny and due diligence by the Independent Reviewer, assisted by Deloitte, to examine the robustness, risks, quality and ability to implement the water

corporations' submissions, and to provide advice regarding additional efficiencies beyond those initially proposed by the water corporations

- ongoing close engagement with water corporations, including with Chairs, boards, managing directors and other managers across the sector
- through the efficiency review, water corporations analysed closely the efficiency of their operations and sought to identify improvements.

It appears that this type of process and methodology is being proposed as the long-term regulatory framework. However, the details of precisely how this methodology would work are somewhat unclear:

- While it appears that the process is designed to generate an 'X' factor for the price path to be applied to the water businesses, in the interest of promoting greater certainty and transparency it would be helpful to clearly articulate how this X factor, or set of X factors, would be determined. It appears that the X factors may be based on the subjective views of the Independent Reviewer (conventional, but complex benchmarking tools such as econometric analyses, Total Factor Productivity analysis, or Data Envelopment Analysis appear to have been ruled out) drawing on material submitted by the businesses on opportunities for incremental efficiencies, which would then be vetted in a very constrained timeframe.
- It is not clear that in practice the distinction between the proposed approach as being 'price based' and the current 'cost-based' approach is as marked as implied. As WSAA understands it, there was a baseline set of prices (set on the basis of the building block cost model) which were the starting point for the review. It is not clear how this baseline will be established at the next review given there would not be a prior ESC building blocks determination to draw on. In any event, the efficiency savings are themselves based on cost concepts (i.e. they are valued on the basis of costs that would be avoided).
- Although not stated in the draft advice report, at one of the briefing sessions on the preliminary advice it was stated by one of the Review members that significant changes in capital expenditure programs would be taken into account in the review and price setting process. Whilst WSAA agrees with the need to consider the individual capital programs and state of the investment cycle in regulating prices for water businesses, it is not clear how such assessments could be undertaken in any meaningful way without a process akin to the one currently used by the ESC for examining and approving expenditure. Furthermore, it is unclear how 'step-changes' in expenditure (particularly in long-lived assets) can be translated into a smoothed change in prices over time (allowing for recovery of those costs) in the absence of a building block model.
- It would be helpful to outline what information businesses would be required to submit in the next review and how customers would be involved in the process. Economic regulation in Australia and in other countries is moving towards

strengthening the role of customer consultation within regulatory processes. The review should consider in more detail how these features would be mirrored under the proposed review process.

In summary, it would assist us to provide meaningful feedback on the proposed methodology and process for setting price in the future if the details of the proposal were more clearly articulated.

4.5 The risk to long-term investment and other regulatory objectives

While the desire for a 'simpler' methodology with higher-powered incentives is understandable, it is not clear that the proposed model will deliver on the regulatory objectives:

- A number of conditions need to be satisfied for a benchmarking approach to work properly and promote efficient regulatory decisions. Key requirements include the availability of robust data from a sufficient number of comparator businesses, the comparability of businesses within the industry, and the ability to control properly for intrinsic differences between firms that do not influence their relative efficiency to one another.
- Benchmarking approaches to direct price-setting are likely to be most appropriate when a range of suitable comparators is available and the industry is in a 'steady state'. It is not well-suited to an industry where there may be significant bow-waves of required capital investment which will need to be remunerated. The scope for lumpy investment programs for compliance or supply capacity means that application of this approach would entail significant risk of regulated prices diverging significantly from the regulated entity's efficient cost, resulting in deferred investment and/or threat to water businesses' financial sustainability. In practice, there is likely to be a need to re-link regulated prices/revenues to costs periodically to avoid either political concerns about excessive profits or businesses encountering financial difficulty.
- It is not clear that the proposed model would meet the principles espoused by the Review report. For example, in relation to transparency the report by Deloitte for the recent efficiency review process has not been publicly released. This makes it difficult for stakeholders to make their own judgements on the achievability of the cited cost savings and/or any risks associated with them. As noted above, it is also not clear how customers would input into the process.
- The observation (p.41) that effective price-based regulation should build in a "margin for error - regulation should not be so tight that failure is a reasonable prospect" – suggests that this model would also not achieve the "optimal level of efficiency".

- The proposal appears to rely on subjective benchmarking and imprecise price setting methodologies which may not address, and may even exacerbate, the problems of regulatory gaming and information asymmetry identified by the Independent Reviewer as problems with the current arrangements.

The track record of approaches which divorce prices completely from costs is not good. The Review could usefully examine experience with similar models elsewhere. Whilst many aspects of the alternative, price-cap form of regulation recommended by the Independent Reviewer are unclear, similar forms of regulation have been trialled overseas (e.g. to regulate electricity networks in Great Britain and New Zealand). However, the trend in those countries has been to move away from that system of regulation (in large part due to the disconnect between efficient costs and revenues), and towards the building block form of regulation that the Independent Reviewer suggests should be abandoned. WSAA is unaware of any other jurisdiction that has begun with a building block approach and replaced that with a system of regulation similar to the one proposed by the Review.

In summary, it is not clear that the proposed model better meets any of the review principles identified in the preliminary advice than the current arrangements.

4.6 Regulatory methodology - overall assessment

One of the most prominent findings of the Independent Reviewer is that the current institutional and regulatory arrangements do not ensure ‘optimum’ efficiency. Whilst WSAA agrees that the current regulatory arrangements can be improved, it cautions against applying an unrealistic benchmark to the current - and any proposed alternative - arrangements. In practice, there is likely to be a choice between imperfect alternatives. As has been previously observed by Stephen King, “the regulatory problem is just too hard” and “we have learnt that good regulation is hard and perfect regulation is impossible”. He states:

In simple terms, there are a variety of complex objectives and the regulator simply does not have enough tools to achieve all of these economic efficiency objectives. Even if the regulator had perfect information it could not achieve all of these objective with the small number of tools that it has at its command.....As a consequence, regulators both here and around the world implement a third-best solution...They make sure the regulated firm doesn’t go bankrupt. And, to the degree possible, they provide the regulated firm with some modest incentives to be efficient. In Australia we call this building block regulation. And it is about as good as we can get...

We need to recognise that we have insufficient information and insufficient regulatory tools to achieve economic efficiency or to design a market that will be optimal for customers¹...

¹ Stephen King, ‘The future of infrastructure regulation in Australia’, Speech to ACCC Regulatory Conference, July 2012

In this context care is needed in comparing current imperfect arrangements which apply workably well in practice and idealised theoretical but untested alternatives. A key conclusion from Frontier's analysis of alternative regulatory methodologies is that there is no 'silver bullet' regulatory approach to achieve the underlying objectives of economic regulation while simultaneously minimising compliance and other costs.

More specifically, different approaches to economic regulation may differ in the extent to which they prevent excessive pricing due to monopoly power; encourage efficient and timely investment and innovation; incentivise operating efficiencies; minimise the regulatory burden; and provide a predictable and stable regulatory framework. In addition, the impacts of these approaches will vary depending on precisely how they are applied in practice.

Developing an appropriate regulatory framework for a particular industry requires careful consideration of these trade-offs in the context of the key features of the industry in question. For example, while there may be some situations in the urban water sector in Australia where the conditions may allow for more 'light-handed' approaches (e.g. price monitoring), the industry is still largely characterised by entrenched natural monopolies providing services to numerous, generally small customers with limited ability or motivation to engage directly on water pricing issues. These conditions are generally seen as justifying direct ex ante price regulation:

- As a generalisation, ex ante direct price control approaches with a direct link to costs (e.g. the building block model) are generally seen as providing greater constraint on the ability of the regulated business to earn monopoly returns, but are often seen as imposing a significant regulatory burden. They are also sometimes seen as providing muted incentives for efficiency improvements. However, the evolution of these regimes in a number of sectors suggests that there is scope to improve their cost-effectiveness and their incentive properties through careful design of the arrangements.
- Setting prices instead by reference to external benchmarks is seen by some as providing greater incentives for efficiency and lowering compliance costs relative to a building blocks approach. However, successfully applying this approach in practice may be problematic, particularly where a robust database is not available and where there is scope for costs and prices to diverge significantly, giving rise to concerns about monopoly pricing or financial viability and incentives for investment.
- More indirect or 'light-handed' approaches have a mixed track record. In broad terms they are typically seen as less effective in ensuring that the regulated business is not charging excessive prices through the exercise of market power, and therefore more suited when the scope for market power is constrained through potential for competition or through countervailing power. While they

are often seen as less resource-intensive this is not necessarily the case in practice, particularly if they rely on the threat of more direct price regulation.

In WSAA's view, the frameworks within which economic regulators operate should not preclude the adoption of alternative approaches that would better achieve the underlying regulatory objectives. WSAA therefore supports the suggestions by the Independent Reviewer that the existing Water Industry Regulatory Order (WIRO) is too prescriptive. Equally, however, by mandating that the future Independent Reviewer must adopt its proposed methodology, the Independent Reviewer may also be imposing excessive prescription on the future regulator and unnecessarily constrain its ability to evolve its approach to regulation in line with emerging best practice.

As noted above, WSAA considers that changes to economic regulatory frameworks should not be made lightly and new models adopted only where there is clear and compelling evidence that they will represent substantial improvements. WSAA considers that there are a number of improvements which could be made to the current building block methodology to address the concerns raised by the Independent Reviewer, while progressing further analysis and other work (e.g. establishing a robust benchmarking dataset) which could allow other regulatory models to be considered in the future.

5 Institutional arrangements for economic regulation

The review states as a guiding principle that "prices should continue to be set independently of Government". WSAA strongly supports this principle. We note that the current framework has a number of institutional and legislative arrangements that go a long way to both supporting independence and to maintaining it over time. It is not clear, however, that the proposed model for setting prices is in fact consistent with these principles.

The following discussion:

- briefly examines why independent economic regulation is desirable
- assesses the extent to which the Review proposal is likely to meet the requirements for independence.

5.1 The importance of independent economic regulation

The introduction of independent economic regulation of utility businesses was a key plank of a major pro-competitive microeconomic reform program in Australia commencing in the 1990s.

This was also reflected in the 1994 COAG Water Reform Framework which obliged States to ensure that “as far as possible, the roles of water resource management, standard setting and regulatory enforcement and service provision are to be separated institutionally”. The rationale for this separation centred around clarifying and simplifying roles and responsibilities, enhanced transparency and accountability, minimising conflicts of interest (e.g. where prices were set by the owner/shareholder), improving regulation by effective and professional regulators, and the determination of prices in a transparent and independent manner.

The OECD (2012) suggests that independent regulatory decision-making, at arm’s length from the political process, is likely to be appropriate where:

- there is a need for the regulator to be seen as independent, to maintain public confidence in the objectivity and impartiality of decisions;
- both government and non-government entities are regulated under the same framework and competitive neutrality is therefore required; or
- the decisions of the regulator can have a significant impact on particular interests and there is a need to protect its impartiality.

At the same time, the OECD notes that all regulators should operate within the power delegated by the legislature and remain subject to long-term national policy.

This highlights the importance placed on the economic regulator being able to make independent decisions. This is a crucial component in the ability of an independent economic regulation regime being able to achieve its underlying objectives, namely the long-term interests of customers. Unless independence is assured, these long-term objectives might be undermined by short-term political goals.

5.2 The proposal for an ‘independent reviewer’ to set prices

The preliminary advice report states (p.45) that “prices should continue to be set independently of Government”. It proposes the establishment of an independent reviewer who would be responsible for the periodic assessment of efficiencies and the resetting of prices at the commencement of each regulatory period. However, it, is unclear what entity/institution would undertake this role.

The nature and identity of this entity is in fact critical to how “independent” it is. Any new arrangements need to ensure that the decisions of the economic regulator are not influenced unduly by government by providing for a clear separation between regulatory decision-making and government policy-making. Without clarity on the nature of this entity, it is difficult to assess the merits of the proposed model. For example, it is not clear from the draft paper how the independence of the regulator would be assured and how it would be held accountable for its decisions.

WSAA has identified the existence of a right of review of regulatory decisions as a key feature of best practice economic regulation.

WSAA is also concerned that periodic and temporary appointment of a reviewer may undermine the consistency of approach from one regulatory period to another. This latter risk may be particularly significant if the independent reviewer is an individual rather than a regulatory office (such as the ESC) that establishes precedent and institutional experience over time.

While the review report is unclear, it appears that it is not intended that this 'independent review' role be assumed by the existing independent economic regulator, the ESC, as this would not require the creation of new instruments as cited in the paper.

This then gives rise to the question as to what other existing body would be suitable to house the 'independent' reviewer. Clearly, location of the independent reviewer within an existing government department or agency with policy formation roles (e.g. the OLV) would give rise to conflicts of interest and breach the principle espoused in the Review paper itself that there should be a clear delineation of the policy, shareholder and regulatory roles. This principle is also enshrined in the National Water Initiative, and reflects long-standing tenets of competition policy reform.

It would also seem to be inappropriate that the independent reviewer be a Ministerial appointee, along the lines of the arrangements of the Independent Reviewer for the current review. The Independent Reviewer (for the current review) is explicitly tasked with providing advice to the Government. As noted in the review report itself (in the context of the water sector performance unit), an advisory role is inherently at odds with independence. An 'independent reviewer' answerable to the Minister would not pass any reasonable test as to what is meant by 'independent economic regulation'.

The Review partly acknowledges this when it refers to the need to establish the Independent Reviewer through appropriate instruments. This in turn raises the question as to why the need to create a second 'independent' economic regulator when one already exists, with well-established legislation and a reputation for independence. The creation of another economic regulator would require legislative change and would add cost and complexity to the regulatory framework. The proposal as it currently stands could potentially introduce significant duplication in regulatory roles and accountabilities through the introduction of the Independent Economic Reviewer, in addition to the ESC undertaking a regulatory monitoring role. The reasoning behind the introduction of a second economic regulator is not clearly stated in the draft decision.

Moreover, the Review does not spell out why the objectives underpinning the creation of the independent reviewer could not be achieved within the current institutional structure. Refining the existing structure, to the extent necessary, would likely be the lowest-cost option for improvement, without the risk of

regulatory independence being undermined. For example, if the key problem perceived by the Independent Reviewer with the current regulatory framework relates to the building block methodology, rather than the institution of the ESC itself, it is not clear why the Independent Reviewer did not simply propose to change the WIRO to require the ESC to adopt its alternative methodology, rather than incur the effort and cost establishing another independent economic regulator. Alternatively, the ESC could be tasked to undertake a 'root and branch' review of its current framework to identify weaknesses and potential improvements.

A further complication relates to the institutional arrangements for economic regulation of the rural water businesses in relation to the Murray-Darling Basin. The preliminary advice is not explicit as to whether it is proposed that in the future prices for these services also be regulated by the Independent Reviewer. At present these services are regulated by the ESC as an accredited regulator under the *Commonwealth Water Act 2007* in order to ensure consistency in charging across the Basin. Accreditation under the Act requires the regulator meet the following three criteria:

- that the accredited regulator undertakes approvals or determinations in accordance with the Water Charge (Infrastructure) Rules 2010 (including the associated pricing principles)
- that the regulator must not be subject to the direction or control of a minister in implementing approvals or determinations
- that the regulator must be independent of the rural water businesses.

WSAA has concerns regarding the ability of the proposed regulatory framework to comply with the first two of these criteria. In particular, it would appear that the regulation of these services by the Independent Reviewer using the alternative methodology suggested in the report would be unlikely to be accredited by the ACCC, as the pricing principles in effect require the application of a building blocks methodology. This in turn would mean that these services would need to be excised from the Independent Reviewer's jurisdiction, and regulated by the ACCC or by the ESC in a manner consistent with the pricing principles. Alternatively, the Independent Reviewer would need to seek accreditation from the ACCC (which would seem to require adopting a different methodology than that proposed in the preliminary advice). The final recommendation should clarify which of these options is being proposed. Either way, the outcome would seem to be a disjointed set of arrangements for regulating water businesses across the State.

6 Reform path

The preliminary advice refers to the 'reform path' envisaged over the coming four to five years involving pro-competitive reforms to the sector.

Experience with pro-competitive reform in other utility sectors suggests that a precondition for effective competition and a greater role for the private sector is the existence of a stable, predictable and independent regulatory framework.

In this regard there is a need for more detail on how the proposals for changes to the regulatory framework will provide the environment required to underpin pro-competitive reforms. Until an overall vision for the future reform environment and how the various elements of the institutional arrangements fit together is developed, there may be a risk that changes to the regulatory arrangement may run counter to these reform objectives. There may also be a risk that diverting scarce government and industry resources into pursuing a major overhaul of the regulatory framework (when targeted improvements involving less effort, cost and time might instead have the desired effect) will detract from the pursuit of these broader reforms.

7 Next steps

WSAA submits that institutional and regulatory frameworks should only be changed after detailed analysis that provides confidence that new arrangements will result in material improvements.

It is evident from our submission and feedback from the public briefings on the preliminary advice that a number of important aspects of the proposals are unclear or yet to be determined. This makes it difficult to provide informed comment on the proposals.

WSAA therefore suggests that before the Independent Reviewer finalises his recommendations, an additional round of consultation occur where the proposals are spelt out more clearly. In particular, further details should be provided on:

- the institutional arrangements for and precise functions of the water sector performance monitoring unit.
- how the proposed methodology for reviewing efficiencies and setting prices would work in practice
- how the proposed review process would work in practice including what information will be required from the water businesses and how it would provide for transparency and customer consultation
- why it is necessary to establish a second economic regulator
- the institutional arrangements and the nature of the instruments governing the 'independent reviewer' including how its independence from government would be maintained and how it would be held accountable for its decisions
- how regulation of rural water businesses subject to the Commonwealth Water Act accreditation requirements would be accommodated

- how the proposed regulatory framework would promote the broader pro-competitive reform program.

This would provide a much better basis for informed consultation on the costs and benefits of the proposals. Ideally, and consistent with RIS requirements for regulatory proposals, alternative options for achieving the underlying objectives or addressing the perceived problems should also be identified and canvassed.

WSAA is keen to further assist the review.

