



Department of Water
Government of Western Australia

Submission to the Economic Regulation Authority

Draft report - Inquiry on competition in the
water and wastewater services sector

January 2008

About the Department of Water

The Department of Water is the lead agency in the Government of Western Australia for the management of the state's water resources and lead adviser to the Minister for Water Resources on water policy and governance. These responsibilities include:

- water resource management and planning;
- water source protection;
- water governance and legislation;
- water services policy, including Indigenous water services; and
- water reform, including the National Water Initiative and State Water Plan.

The department operates throughout Western Australia with offices in eight regional areas.

Head office

168 St Georges Terrace
Perth WA 6000

Postal address

PO Box K882
Perth WA 6842

Telephone: 08 6364 7600

Facsimile: 08 6364 7601

www.water.wa.gov.au

Disclaimer

The views expressed in this submission are those of the Department of Water and should not be taken to reflect the views of the Minister for Water Resources or the Government of Western Australia.

Introduction

This submission is made in response to the draft report of the *Inquiry on Competition in the Water and Wastewater Services Sector*, released by the Economic Regulation Authority (the Authority) on 3 December 2007.

The draft report makes a number of recommendations and findings, including:

- the establishment of a new independent and centralised bulk water procurement entity, with responsibilities for water supply planning and demand management in addition to identifying sources of potable water for development and use by service providers;
- no fundamental change to the structure or operations of Water Corporation;
- the promotion of water trading;
- the introduction of a third-party access regime;
- retail contestability for large water customers;
- no retail contestability for smaller customers;
- support for the introduction of scarcity-based pricing;
- support for the establishment of a multi-utility service provider for regional areas, based on the Horizon Power model;
- merit in the reconfiguration of the structure of the water and wastewater services sector in the Bunbury and Busselton regions; and
- extension of eligibility for community service obligation payments to all service providers.

With the exception of the recommended operations and perceived outcomes of the proposed central bulk water procurement entity, the Department of Water (DoW) is in broad agreement with the recommendations and findings of the draft report.

Bulk water procurement

Authority's draft recommendations and findings

- 1 There are synergies between the Water Corporation's bulk water operations and distribution functions which indicate that it may not be appropriate at this time to separate these functions.
- 2 An independent procurement entity (IPE) should be established with responsibility for ensuring least expected cost of balancing supply and demand subject to the constraint of maintaining security of supply at a level set by the government.

Department of Water's comments

When considering any changes to the operation of bulk water procurement in Western Australia, the DoW considers that it is important for the past successes of the state's investments in bulk water, which have led to the avoidance of total sprinkler bans, to be recognised as a successful model.

The DoW would not want to see, under any amended model for bulk water procurement, the loss of incentives to a service provider to adequately plan its operations and ensure ongoing security of supply for its customers. Similarly, the DoW would not like to see any confusion to emerge over the respective roles between service providers and government agencies.

That said, the DoW is supportive of the perceived objectives underlying an IPE model where it adds to the sustainable growth of the Western Australian water industry and ensures ongoing security of supply. Specifically, the DoW supports:

- maximum cost-effectiveness in achieving security of supply;
- water supply planning that sustains consideration of a wider range of options to more advanced stages;
- increased transparency and independence in the examination of the major augmentations of water providers;
- improved opportunities for competition and innovation and improved public and business perception of the degree of opportunity; and
- improved skills and capacity to independently review capital projects, options and risk management associated with water procurement.

DoW would need to be convinced that any change to the current service model, such as that now proposed through the establishment of an IPE, would effectively and efficiently deliver these objectives. So far we are unable to support the proposal in its current form.

As the DoW understands the proposal, an IPE would seek to achieve cost savings in source development through a competitive process without

compromising the level of water security. Fundamental to achieving this outcome is the development of alternative sources of water supply and the creation of a water trading market. With this understanding, the DoW raises the following matters for consideration by the Authority in its ongoing deliberations.

Role of the Department of Water and transitional issues

It is important for the Authority to understand that the DoW's role has evolved from that of simply a resource manager as the Water and Rivers Commission to one that has responsibilities in every stage of the water cycle. This role is being established in the government's forthcoming reforms to water resources management and water services legislation and includes:

- water source identification and evaluation;
- establishment of water entitlements and water allocation licence requirements;
- local and regional water planning;
- defining ecological water requirements and environmental water provisions;
- ongoing evaluation of water source availability, use and resource management; and
- water service licensing policy requirements.

The strategic water planning function in the DoW will strengthen water planning capacity. Regional water plans have a 25-year outlook across all areas of water management planning. The emerging water resources development planning function seeks to broadly match potential water sources against projected demand and provide options for water source development consistent with a fit-for-purpose approach.

Aspects of these functions both complement and overlap with the existing bulk water functions of Water Corporation. To that end, the DoW has held discussions with Water Corporation to clarify roles, reduce overlap and ensure greater effectiveness. The proposal to transfer the bulk water supply planning and demand management functions to a new agency could duplicate roles and introduce ambiguities in planning responsibilities. In this regard, the Authority needs to consider the need for clearly defined roles in water source planning while recognising:

- the commercial aspects of water development must respect and have regard to broader water management and sustainability objectives;
- the need for functionality and a high degree of collaboration and cooperation between planning, procurement, regulation resource management and water service functions;

- the inter-relationships of water resources management involving both water services and self-supply users; and
- the complexity of commercial, resources and service functions that operate on broad geographic scales and across institutional structures.

Given these aspects there is benefit in strengthening the transparency of commercial aspects of water services while recognising the DoW's role in managing non-commercial public interest aspects of water service planning and demand management.

The transfer of responsibility for these non-commercial, public interest aspects of water supply planning and demand management to an independent body could lead to increased operational risk in planning for service provision and confusing governance responsibilities in government agencies.

Clarification of water source options

While the DoW agrees that there is scope for increased use of smaller sources, it wishes to provide clarification around some of the discussion contained in the draft report, that in some instances, is used to support the perceived benefits of an IPE model in the short term.

Additional transfers from Bunbury-Busselton region

The draft report mentions the possibility of water transfers from the Bunbury–Busselton region as a potential water supply option for the Perth Integrated Water Supply Scheme (IWSS). The source of this water is the Yarragadee aquifer and any transfer of water reserved for public water supply requires an assessment and approval by the DoW, which would involve a detailed proposal involving all stakeholders.

There are also infrastructure requirements to be considered given that there is currently no physical way to transport the water from the region to Perth.

Trading with Harvey Water

The report identifies an additional trade opportunity of 5 GL per year from Logue Brook Dam. However, this amount is already part of the existing 17.1 GL per year trade between Harvey Water and Water Corporation.

The report also identifies a 19 GL per year trade opportunity between Harvey Water and Water Corporation in the Collie Irrigation District. However, this is non-potable water from Wellington Dam and could not be used as potable water in the short term, without substantial new treatment facilities.

Wellington Dam

The report indicates that the surplus water in the Wellington Dam is not used for drinking water purposes because the dam is used for recreation. The dam is used as a source of irrigation water and was originally used as a drinking water source but had to be abandoned in favour of Harris Dam due to rising

salinity levels. The salinity is not expected to return to drinking water levels until 2015.

Dewatering in the Collie coalfields

This source is estimated to deliver 6 GL per year for at least five years from the dewatering activities of mining companies and would require the construction of a 10 km pipeline from the coalfields to Harris Dam. However, transfers would not be able to commence before May 2009 at the earliest, due to major upgrades currently underway at Stirling Dam.

Transferring surplus water from Harris Dam to Stirling Dam

This source is estimated to deliver 5 GL per year for two years. However, transfers would not be able to commence before May 2009 at the earliest, due to major upgrades currently underway at Stirling Dam.

Additional bores at Jandakot and Neerabup

These three bores draw on the deep artesian aquifers. As mentioned by Water Corporation, the DoW would not agree to use these bores as additional sources outside of the groundwater abstraction rule.

Gnangara abstraction

The draft report states the government does not have a direct role in determining the rule that Water Corporation applies when abstracting water from the Gnangara Mound. It is important for the Authority to note that this is not the case and the rules for abstraction were developed jointly between Water Corporation and the WRC/DoW in 2004 as part of the licensing process for the IWSS.

The DoW is involved in negotiations with Water Corporation in October–November each year to develop a pumping strategy based on minimising the environmental impact of abstraction. The intention of the abstraction rule is for an average usage of 135 GL per year by Water Corporation, over time but lately the average has been much higher than this. As a result, the DoW is proposing to review the abstraction rule to reduce the level of impact on the Gnangara Mound.

Outstanding issues for the establishment of an IPE

Given the broader role of the DoW as outlined above, and following an examination of the proposed model, the Authority is requested to consider and provide further advice on the following matters, with regard to the proposed operation of an IPE and its perceived benefits:

- How the IPE could complement the DoW's responsibilities to ensure appropriate and sustainable long-term planning of potable water supplies in Western Australia.

- How an IPE would give effect to a service provider's responsibility to ensure ongoing potable supplies to its customers in the circumstance where the licensed service provider was reluctant or unable to develop the source in a timely manner.
- The extent to which the perceived benefits of an IPE rely on the immature trading market in Western Australia and the expected quantity of those benefits in the short to medium term given the likely delays in the establishment of a mature, fully operational trading market. A further discussion on the water trading is included below for the consideration of the Authority.
- Can the IPE still operate effectively and deliver the proposed levels of confidence to a market for the provision of bulk water supplies when the supply limits of the state's natural water sources are subject to a number of dynamic variables including public preference for sustainable abstraction¹?
- A significant barrier to private sector participation in the water industry has been the timing of decisions by government to proceed with future sources. Will the proposed operation of an IPE remove those barriers completely or, if not, to what extent can the IPE improve the process already undertaken by Water Corporation?

¹ Water markets depend upon the establishment of consumptive pools and/or clear extraction rules. Where consumptive pools and extractive limits are not yet defined, conservative interim extraction rules can minimise the risk of environmental damage in a transparent manner. However the impacts on consumers of a conservative interim approach may outweigh gains. For example, the variable groundwater abstraction rule that defines the maximum amount of Gngangara groundwater in any one year relative to dam storage levels is intended to minimise the need for severe water restrictions during dry periods. It was not intended to promote an unsustainable level of groundwater abstraction.

Water trading

Authority's draft recommendations and findings

- 3 There are potentially considerable additional sources of bulk water available from Harvey Water, the Gnangara Mound and Wellington Dam.
- 4 Pricing arrangements within irrigation cooperatives should be adjusted to allow for the trade of water out of cooperative areas by individual members should they choose to do so. A recent decision by the Australian Competition and Consumer Commission provides guidance on a possible approach.
- 5 To facilitate an effective water trading regime, all significant users within a catchment, including pine plantations, should be taken into account when developing statutory water management plans and water allocations.
- 6 On Gnangara Mound, finalisation of the statutory water management plan and Gnangara Mound sustainability strategy is critical. In the meantime, an effective water trading market should be developed despite a degree of environmental uncertainty.
- 7 The concerns regarding water hoarding appear to be limited. However, there is the potential for a single individual or entity to obtain a significant share of water allocations and thereby be in a position to exert a degree of market power. While the Authority considers that the *Trade Practices Act 1974*, would be sufficient to deal with such potential anti-competitive behaviour, the Authority will consider the matter further.

Department of Water's comment

The DoW is in general agreement with the recommendations. However, there is limited evidence of significant water trading in Western Australia and it is doubtful if an effective trading system will be operable before 2009.

As noted by the Authority, in the event of a low rainfall winter in 2008, the trading opportunities identified may not offer the necessary supply of water to justify the deferral of other water source developments and provide the ongoing security of supply.

Furthermore, trading involving groundwater is subject to an impact assessment and usually involves the establishment of new source treatment and delivery infrastructure that would require a significant lead time and additional capital resources.

Beyond the prescriptive provisions of the legislation, trade in water will be facilitated by factors such as participants having sufficient information on the water commodity to be traded and there being well understood rules to guide vendors and purchasers.

Availability of 'additional' bulk sources

While there may appear to be considerable additional sources of bulk water available from Harvey Water, the Gngangara Mound and the Wellington Dam, consideration needs to be given to a number of factors before any trading is to occur from these areas. Such matters to consider include:

- the overall strategic plan for the area in question and the associated sustainable limit of supply;
- the location of associated infrastructure to enable access to the water and if not available, the cost of developing the infrastructure; and
- the competing demands for the water, such as for environmental purposes.

External trade by irrigation cooperative members

The trade of water out of irrigation cooperative areas is a licensing matter and the DoW is currently investigating the issue as a part of its legislative reform program. The Authority is directed to the State's National Water Initiative (NWI) Implementation Plan for the latest discussion on this matter:

'An issue given priority under the NWI is removing barriers to trade within irrigation districts. Irrigation cooperatives currently dominate the delivery of surface water for irrigation purposes in Western Australia. Water irrigation licences are currently issued at the cooperative level, with individual irrigators holding shares in the cooperative in proportion to their entitlements of water. In addition, the current arrangements, in combination with the memorandum and articles of association of the irrigation cooperatives, allow the irrigation cooperatives to restrict sales of water by individual irrigators to external parties.

The government has initiated a dialogue with the irrigation cooperatives to develop a mutually beneficial trading framework, taking account of social and regional development requirements.'

Plantation forestry

The availability of water and, therefore, water markets will be relevant in areas where plantations use significant amounts of water.

The DoW is working on an approach to incorporating plantations into water management decisions. This process will need to address the complex issues of a drying climate, comparison with the water use of original vegetation and the benefits of trees.

Gngangara groundwater system

The Gngangara groundwater allocation water management plan will be released in 2008. A new groundwater allocation management plan will be developed in line with proposed water resources legislation and a statutory

water management plan is scheduled for completion by 2011. The Gnangara Sustainability Strategy will be finalised by 2009.

While the existing *Rights in Water and Irrigation Act 1914* does not prevent trade, it is recognised that trading is restricted due in part to the lack of a water access entitlement regime that separates land and water titles. The DoW's legislative reform program is working towards the introduction of legislation that will separate land and water titles and enable a more efficient water trading market.

Water hoarding

The DoW has considered the issue of hoarding through its legislative reform program and has formed a preliminary view that the provisions in the *Trade Practices Act 1974* are likely to be sufficient to protect against the risks.

It is further considered that hoarding would generally not be a commercially attractive activity as the cost of the water needed to manipulate a market would be prohibitive, especially while it was not being put to profitable use.

Nevertheless, the DoW invites the Authority to investigate this matter further and looks forward to reviewing its final advice.

Third party access

Authority's draft recommendations and findings

- 8 A state-based third-party access regime should be implemented in Western Australia.
- 9 A state-based third-party access regime should be based on the principles of the competition policy agreement, including provisions for negotiated access between the infrastructure owner and the access seeker, independent dispute resolution and appeals mechanism.
- 10 Further consideration should be given to prices under the state-based third-party access regime being based on a 'retail minus avoidable cost' approach.
- 11 Any state-based third party access regime should be supported by sound and transparent regulation to ensure that access arrangements are safe, efficient and achieved at minimum cost.

Department of Water's comment

The DoW is generally supportive of the recommendations and notes the proposed adoption of the 'retail minus' access pricing regime in the services Sydney decision, in order to discourage 'cherry picking' of profitable operational areas.

The DoW recognises that there is no practical alternative to the use of the 'retail minus' approach for the encouragement of third-party access in Western Australia but encourages the Authority to examine the effectiveness of the approach.

Retail

Authority's draft recommendations and findings

- 12 There are likely to be minimal gains from the disaggregation of Water Corporation's Perth operations at this time.
- 13 Retail contestability is premature for small customers at this time. However, to facilitate third-party access and the potential use of recycled water, contestability should be considered on a case-by-case basis.
- 14 Retail contestability should be introduced for large customers.
- 15 There is merit in exploring the introduction of scarcity-based pricing to improve signals for customers regarding the true cost of their consumption and producers regarding potential investment opportunities.

Department of Water's comment

Disaggregation

The DoW has reviewed the Authority's rationale in this instance and agrees with its findings.

Retail contestability

The DoW is generally supportive of the recommendations and encourages further detailed examination of retail contestability. Generally, the DoW would not favour an inflexible approach to competition and would like to see the competition framework be able to accommodate genuine approaches by service providers to contest markets.

Scarcity pricing

As the Authority is aware, demand for internal domestic potable water is generally price inelastic. Subsequently, it is uncertain whether scarcity pricing would adequately replace the need for long run marginal cost pricing and well-timed augmentation of sources. However the potential role of scarcity pricing in addressing short term fluctuations could be examined in further detail.

In further considering the appropriateness of scarcity pricing, the Authority is requested to ensure that any proposal does not lead to the earning of monopoly rents, thereby giving service providers an incentive to avoid investment in augmentation.

Regional and remote operations

Authority's draft recommendations and findings

- 16 There may be potential significant cost savings from the creation of a multi-utility by transferring Water Corporation's water and wastewater assets to Horizon Power in its area of operation. However, further investigation prior to the release of the final report is required before any definitive conclusions can be made.
- 17 There may be potential significant cost savings from the reconfiguration of water and wastewater services in the Bunbury and Busselton areas. However, further investigation prior to the release of the final report is required before any definitive conclusions can be made.
- 18 Proposed legislative reforms being undertaken by the DoW will enable the payment of community service obligations (CSO) to all licensed service providers. The Department of Treasury, the agency responsible for the payment of CSOs, should develop a policy perhaps similar to that in operation in Queensland to explicitly allow for the payment of CSOs to non-government entities.

Department of Water's comment

Regional multi-utility

The DoW encourages further development of the proposal and understands that Water Corporation and Horizon Power have been involved in talks and intend to further advise the Authority.

Bunbury and Busselton water boards

Proposed legislative reforms will allow both the Bunbury and Busselton water boards to expand their respective water service activities.

The DoW would see an outcome such as that proposed by the Authority as best derived from market dynamics rather than through government policy.

Community service obligations

As noted, the proposed legislative reform will enable the payment of CSOs to all service providers, including licensed private providers. As part of the policy development for the legislative program, the DoW is evaluating alternative policy approaches, including the Queensland approach suggested in the draft report.

The DoW will work closely with the Department of Treasury and Finance to ensure that the operation of the new CSO regime will seek to encourage the maximum benefits available from the participation of the private sector in the industry, while also seeking maximum value for money from the CSOs themselves.