

# Department of **Treasury and Finance**

Government of **Western Australia**

## Response to the Economic Regulation Authority Inquiry on Competition in the Water and Wastewater Services Sector

7 February 2008

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## INTRODUCTION

The Department of Treasury and Finance (DTF) is broadly supportive of all eighteen recommendations contained within the Economic Regulation Authority's (ERA) draft report into competition in the water and wastewater services sector. The DTF has therefore only responded to issues where further comment was believed to be required, in addition to comments previously provided to this inquiry<sup>1</sup>. Furthermore, clarification has been requested on some points where further detail would assist in a wider appreciation of the ERA's recommendations.

The focal point of the draft report was undoubtedly the introduction of an Independent Procurement Entity (IPE), with the responsibility of managing risk within the Integrated Water Supply Scheme (IWSS). This appears to be a both an innovative and practical approach to maintaining water security. The proposed mode of operation of the IPE would formalise an investment decision-making process commensurate with ensuring low-cost supplies at a socially acceptable level of risk, while promoting private sector investment in bulk water supply. The outcomes of which may be of economic benefit to Western Australia, and therefore warrant serious consideration.

Further additional recommendations related to water trading, the introduction of a third party access regime for the Water Corporation's (WC) infrastructure and scarcity pricing will assist in the creation of a competitive bulk water supply market. Again, the DTF believes that these proposals may be beneficial to both consumers and investors in Western Australia, and therefore require a more detailed analysis.

The DTF would like to note that a Steering Group on Water Charging has been developed, and is working on pricing principles for all jurisdictions, so that a nationally consistent water pricing and charging policy may be developed. The recommendations of this group may be of use to this Inquiry.

The DTF believes that it is important to note that in supporting the ERA's recommendations, it is not proposing either radical disaggregation or privatisation of the WC.

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<sup>1</sup> Available from <http://www.era.wa.gov.au/cproot/6094/2/Public%20Submission%20-%20Department%20of%20Treasury%20and%20Finance%20-%20Issues%20Paper.pdf>

## **BULK WATER PROCUREMENT**

### **ESTABLISHMENT**

The DTF supports the recommendation to establish an Independent Procurement Entity (IPE), and therefore the proposed approach to maintaining the supply and demand balance within the IWSS. It is important to note that the proposal to establish an IPE would not involve a major structural change to the water and wastewater industry, allowing the WC to largely maintain its present economies of scale and scope. It would, however, focus on delivering low cost water while maintaining a socially acceptable risk of a total sprinkler ban. As such, the manner in which investments are made, and what those investments are in, may significantly differ from the WC's current approach.

Further analysis of the cost and benefits of merging the role of the IPE with that of the Independent Market Operator (IMO) for electricity will need to be undertaken, although this may be outside the scope of the ERA's Inquiry. The DTF notes the intuitive appeal of the merger, primarily due to the economies of scale in regards to the maintenance of in-house expertise, particularly those associated with planning and procurement functions. There has been some suggestion that the WC could adopt the proposed framework for bulk water procurement, rather than the establishment of an independent body. While the WC could conceivably perform these functions, it is the *independence* of the procurement entity which provides confidence to the private sector, by ensuring that the largest provider of bulk water in Western Australia will not also be the regulator of investment decisions. This independence will also allow the WC to compete in bulk water supply tenders, therefore ensuring a least-cost approach to waters supply procurement.

### **OPERATION**

Four key points have been identified in regards to the operation of the IPE, which may benefit from further clarification or comment in the ERA's final report.

Firstly, under the proposed approach, it is suggested that the IPE would be responsible for the procurement and maintenance of a portfolio of bulk water supply options. Further guidance on the anticipated size, scale and management of this portfolio is required in order to determine the most appropriate method for funding the IPE's operations. Specifically, a more detailed discussion of possible source options would be appreciated, in order to guarantee a sufficient number of alternative sources or proposals are available, such that the viability of the IPE's operations is ensured. While this is not an immediate threshold issue, it will impact on both the ability of the IPE to attract and finance expertise, and the feasibility of a merger with the electricity sector's IMO.

Secondly, further discussion is needed around the approach to the procurement of options by the IPE. It is recognised that the decision to procure an option will be made primarily on the basis of the additional security and cost that option would bring to the IWSS if exercised. Given that the cost of exercising an option will likely exceed the cost of procuring the option, the focus should therefore be on the former. While this point is implied within the draft report, a clear recognition of the fact is beneficial to a wider understanding of the proposed approach. Placing an overarching emphasis on option procurement costs will lead to the creation of a sub-optimal portfolio, to the detriment of the integrated system. This should not preclude the IPE from making best endeavours to minimise option procurement costs. The DTF believes that it may be necessary to categorically state that the portfolio held by the IPE may contain options which were of relatively high cost to procure, while options which were less expensive were not chosen. This would not be mismanagement on the IPE's part, but recognition that the majority of the total costs will be associated with exercising the options rather than the procurement of the option.

Thirdly, the approach proposed for the IPE could include options for bulk water sources which may never be exercised. The price of developing and sustaining each option is effectively the cost of mitigating the uncertainty associated with future climatic conditions, as opposed to the cost of exercising the option. As this approach to water source procurement has not been attempted before in Western Australia, it may be necessary to explain why options that are never exercised are not 'bad' investment decisions. In explaining the need to procure a portfolio of options, it may be appropriate to compare the procurement of the options with purchasing insurance against possible (adverse) climatic conditions and unanticipated changes in demand. This can be viewed as a more cost effective alternative to the present approach, where risk is minimised through investment/overinvestment in large bulk water sources. The DTF believes that a more thorough discussion of this point in plain English will assist in avoiding contention on the issue at a later date.

Lastly, the ERA has suggested that the private sector may wish to instigate the development of a bulk water source outside the procurement framework provided by the IPE. For example, a private sector firm may wish to build, own and operate a new water source, with the decision to invest being made independently from the IPE exercising a call option. Given the need to attract private sector participation, it is questionable as to whether the WC would also have scope to source new bulk water supplies from outside the IPE's procurement framework.

One argument against allowing the WC to invest independently of the IPE would be that this may act as a disincentive for private sector participation. Independent procurement by the WC may effectively short circuit the security offered by the IPE's regulated procurement process. However, the DTF considers that competitive neutrality implies that the WC should not be restricted from investing in new water infrastructure, if it is in WC's commercial interests to do so. Nevertheless, in order to effectively perform its role of managing the risk associated with bulk water supply, the IPE may need to have the capability to veto the introduction of new bulk water supplies to the IWSS, where to do so would be detrimental to the integrated network. This proposal is not designed to place a limit on competition between sources, or prevent the demise of uneconomic sources, but provide some reassurance to potential investors. This must also take into consideration that the decisions of the IPE may not be (or not believed to be) in the commercial interests of the WC. Legislative change may be necessary in order to acknowledge the additional risk taken on by the WC in accepting the investment decisions of an independent entity. The DTF would welcome the ERA's consideration of this matter.

#### **BENEFITS OF INVESTMENT FLEXIBILITY**

The DTF concurs with the ERA's assertion that the proposed approach would likely result in the development of sources which are substantially different from those which have been historically utilised in Western Australia. This change would be independent from the effect of external factors, such as climate change, community expectations and technological innovation. The analysis carried out by ACIL Tasman<sup>2</sup> on behalf of the ERA illustrates how the options-based procurement process explicitly recognises the benefits of avoiding overinvestment in bulk water supply infrastructure. This approach may contribute to the development of smaller sources (with a higher per-kilo litre costs) as they are less costly from a system-wide perspective than larger source types (with a lower per-kilo litre costs). A simplified example of why investment in small, relatively high cost sources is both economically and commercially rationale is included in Box 1. The central tenet of this approach is recognition of the fact that the option to avoid an irreversible investment (either permanently or temporarily) has an implicit value, commensurate with the size of the investment. While the ACIL Tasman report examines the benefits of the proposed approach in some detail, the DTF believes that a clear and concise discussion of these points in the final report would contribute to a greater understanding of the costs of suboptimal investment decisions.

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<sup>2</sup> Acil Tasman. 2007. *Frameworks for Water Source Procurement in WA*. Available from: <http://www.era.wa.gov.au/cproot/6225/2/ACIL%20Tasman%20%20Frameworks%20for%20Water%20Source%20Procurement.pdf>

One further point of contention could arise regarding the decision to delay an investment is that it may be misinterpreted as an attempt to avoid expenditure by placing additional pressure on existing bulk water supply sources. As it relates to water infrastructure, there is a fear that the deferral of an investment would lead to increased pressure on existing sources over the deferral period, which may not be able to meet demand at the required level of security. This is clearly not the intention, and would not be the outcome of any well-planned procurement process. Planning by the IPE would consider the risks associated with deferral, such that any delay is not 'gambling' with water security, but a calculated decision to avoid unnecessary overinvestment in infrastructure, as previously discussed. There would be the potential to provide lower cost water with similar risk management to the present approach, which has historically avoided the risk of undersupply through large, irreversible and capital-intensive projects. Recognition of this point will be an important aspect in the public acceptance of an options approach to water source procurement, and therefore the effectiveness of the IPE.

**Box 1: FINANCIAL BENEFITS OF INVESTMENT FLEXIBILITY**

The IPE recognises that with current rainfall and demand levels, a new water source will be required. The IPE presently has two bulk water source options which it can exercise:

- a large bulk water supply source, delivering 100GL/year. Capital cost of \$1 billion, and an operating cost of \$100 million/year. Will reduce the probability of a total sprinkler ban below the required threshold for the next 30 years; or
- a small bulk water supply source, delivering 5GL/year. Capital cost of \$100 million, and an operating cost of \$10 million/year. Will reduce the probability of a total sprinkler ban below the required threshold for the next 2 years.

For simplicity, a discount rate of 6% is assumed over a 50-year timeframe.

***Financial benefit of deferral***

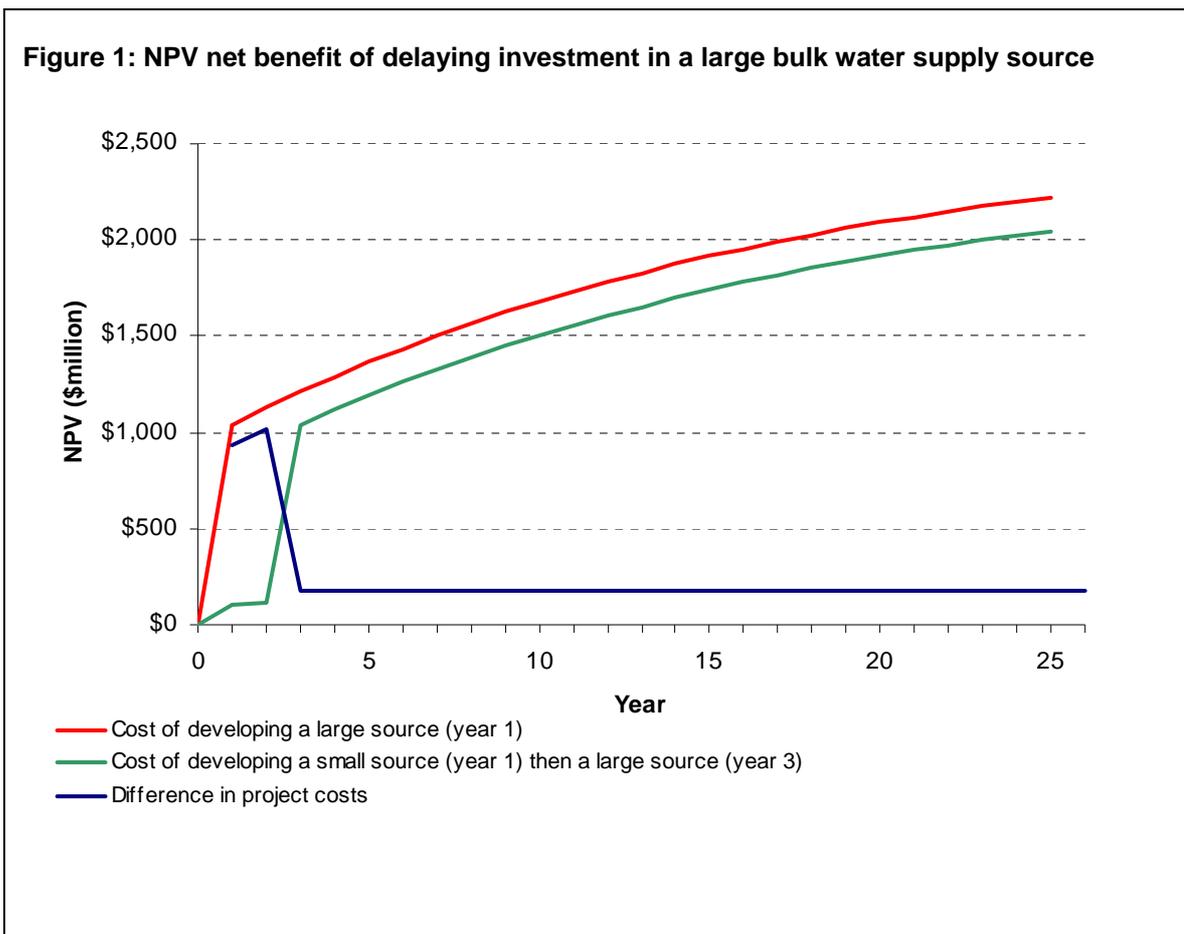
By deferring investment in the large source for two years, the IPE can avoid placing additional costs of \$287 million (in present value) on the IWSS, which in turn would need to be recouped from consumers.

However, in order to maintain the required level of water security, the IPE still needs to increase available supply capacity. By investing in a small supply source, the IPE can effectively delay the need for investment in a large supply source for a period of two years. The question is whether or not it is economically rational to do so.

Figure 1 compares the cost of investing immediately in a large source with the costs of investing in a small source, and then a large source after a two-year delay.

The NPV of investing in a small source, and running it for only two years is \$113 million. As this cost is less than the \$287 million in savings accrued by a two-year delay in the large source, it becomes economically viable to consider this course of action. Put simply, the \$113 million has been 'spent' in order to procure the \$287 million in 'savings'.

By undertaking the delay outlined in this example, there is a net benefit of \$174 million in present terms.



**OTHER APPLICATIONS OF THE PROPOSED APPROACH**

It is important to note that while this is an innovative approach, it is not unique to Western Australia. For example, an options based procurement process is similar to the adaptive management approach implemented by the New South Wales (NSW) Government. In developing a framework for natural resource management, the NSW Government has adopted a desalination and groundwater readiness approach, whereby planning for sources was undertaken, but not implemented until triggered by particular climatic conditions. The adaptive management approach to water source procurement will be employed by the IPE in regards to how and when options are exercised for development. Box 2 highlights the key benefits of adaptive management over traditional approaches to investment in bulk water sources, as identified in the NSW report “Review of the metropolitan water plan” (2006), which are equally applicable to the ERA’s proposed approach. It is also standard practice within the private sector to use an options approach to determine the appropriate time to invest in irreversible, capital-intensive projects, as it allows recognition of the value of investment flexibility in order to minimise both costs and risk.

**Box 2: BENEFITS OF AN ADAPTIVE MANAGEMENT APPROACH TO BULK WATER SOURCE PROCUREMENT<sup>1</sup>**

- Pursuing any single solution is likely to incur unreasonably high costs.
- Confidence in any one solution is not high enough to guarantee that it will stand the test of time and not require further fine-tuning at high cost. This is because of uncertainty regarding a number of factors including:
  - trends in per capita demand;
  - future climate and hydrology;
  - future changes in technology; and
  - community attitudes, public health concerns and pricing policy.
- The analysis required to achieve least cost, safe strategies for the system is significant in terms of the time, resources and skills required. Unavoidably, this analysis is iterative, however a large up-front investment in capital works is likely to be less cost-effective than investments made in smaller initiatives over time.

<sup>1</sup> NSW Government. 2006. *Review of the metropolitan water plan*. p.39. Available from [http://www.waterforlife.nsw.gov.au/\\_\\_data/assets/pdf\\_file/0016/1483/isf\\_acil\\_review\\_april06\\_final\\_1.pdf](http://www.waterforlife.nsw.gov.au/__data/assets/pdf_file/0016/1483/isf_acil_review_april06_final_1.pdf)

## **WATER TRADING**

### **TRADING OF NON-POTABLE AND RECYCLED WATER**

In addition to the issues raised in the draft report, the DTF considers that the trading of non-potable or recycled water will require further consideration. For many uses, non-potable or recycled water will be a substitutable product for potable water, for example, for garden watering or industrial applications. However, as noted by Harvey Water, there are presently restrictions placed on the use of non-potable water within urban settings. While the DTF understands that the Department of Health is currently reviewing the associated guidelines, there is benefit in investigating whether these restrictions are acting as a significant barrier to the trading and use of non-potable water, which is in the public interest. Furthermore, this is not just a limit on trading, but also a limit on how a business or household can recycle its water.

### **COOPERATIVE EXIT FEES**

In addition to comments already raised regarding the optimal approach to exit fees for water cooperatives, the DTF suggests that it is important to recognise that any exit fees on irrigators will effectively act as a tax on irrigators, and hence be a disincentive to trade, therefore imposing a dead weight loss to the Western Australian economy. Furthermore, consideration of equity issues surrounding any requirement for an irrigator who chooses to leave a cooperative to subsidise the future costs of maintaining the distribution system they will no longer utilise is required. In regards to economic costs of exit fees, the DTF draws attention to the report *Exit fees and interregional water trade*<sup>3</sup>, which suggests that “exit fees distort interregional trade and generate a net economic loss compared with free trade”. Commensurate with these findings, the DTF would question the need to levy exit fees on individual farmers whom chose to trade out of irrigation cooperatives.

### **IMPEDIMENTS TO WATER TRADING**

Establishment of an effective water-trading regime in Western Australia requires that all who have a licence, entitlement or de-facto entitlement to water can participate in trading. This is necessary for the efficient allocation of water, as an entity with an entitlement to use water but not to trade it may mean that the water is locked up in a low value use, when trading would be of material benefit. Trading should therefore be allowed on a permanent and short-term basis.

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<sup>3</sup> Goesch, T., Hafi, A., Heaney, A. and Szakiel, S. 2006. *Exit fees and interregional water trade: An analysis of the efficiency impacts of exit fees*, ABARE Research Report 06.5.

Excluding particular consumers, such as horticulturalists or plantations will lead to a suboptimal outcome for Western Australia, as it would lead to locking up of a water resource. This prevents the high value use of the water achieved through a mutually beneficial trade. Consumers who do not have the ability to trade their entitlement as they see appropriate are provided with a perverse incentive to continue utilising water in a socially inefficient manner. The DTF is therefore supportive of the ERA's draft recommendation that all major users of groundwater should be included in a trading regime.

### **THIRD PARTY ACCESS TO INFRASTRUCTURE**

#### **CHARACTERISTICS OF A THIRD PARTY ACCESS REGIME**

As noted in the DTF's previous submission to the inquiry, State based access regimes will need to be developed to meet the criteria set out in section 44M of the *Trade Practices Act 1974* (TPA), the Competition Principles Agreement (CPA) 1995, and the Competition and Infrastructure Reform Agreement (CIRA) 2006.

Consideration must also be made for the type of infrastructure the access regime will cover, in keeping with the theory that it should be only the services provided by natural monopoly infrastructure. As the WC's existing distribution infrastructure will undoubtedly be able to service all levels of foreseeable demand at a lower cost than any competing infrastructure, it would be apparent that the distribution infrastructure forms the basis of any access regime. However, access to other infrastructure, such as dams or wastewater treatment facilities may encourage competition through private sector participation.

In regards to access pricing, the DTF would suggest that the recent determination by the Australian Competition and Consumer Commission (ACCC) in regards to the Sydney Water access dispute provides guidance for a possible approach<sup>4</sup>. The ACCC has recommended the adoption of a retail-minus approach, with the inclusion of *avoidable* costs rather than *avoided* costs to calculate the access price, which has been discussed in greater detail in Appendix 6 of the ERA's draft report. While the DTF recognises that the ACCC's methodology may be more complex than alternative approaches, it intuitively will provide a more efficient outcome than could be otherwise achieved. Nevertheless, a more detailed analysis of this approach by both the DTF and other stakeholders will be required.

The DTF understands that there has been some discussion of a national third party access regime for water infrastructure. The DTF would cautiously welcome such a proposal, but would need to consider the issue in more detail before providing further comment.

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<sup>4</sup> <http://www.accc.gov.au/content/index.phtml/itemId/793017>

## **IMPLEMENTATION OPTIONS**

To date, third party access to water and wastewater infrastructure in Western Australia has not been sought, either on commercial terms or through the TPA. Whether an access regime should be developed as soon as possible, or whether development could be delayed until interested parties identify the need for access is an issue for policy makers. The costs and benefits of both approaches must be considered.

The DTF recognises that the development of a third party access regime is not without both cost and risk. The key benefit of delay includes the ability to consider potential access seeker's view of a proposed regime. This will allow policy makers to ensure that the proposed regime is not fundamentally unworkable from the perspective of an access seeker.

Alternatively, having an access regime in place will provide a service which does not presently exist, thereby reducing the regulatory uncertainty for access seekers. Uncertainty surrounding the terms and conditions of access will reduce the probability of private sector participation, as investors consider the risk of an unfavourable regulatory landscape eventuating. While this approach may reduce the opportunity for feedback from potential access seekers, there is still the opportunity to seek stakeholder feedback on the development of the regime as:

- regime be submitted for certification to the National Competition Council, who will also conduct a further consultation process; and
- feedback can be sought from (potential) access seekers in other states.

On balance, the DTF would suggest that an access regime should be developed in concert with wider legislative reforms to the water and wastewater services sector.

## **RETAIL**

### **CONTESTABILITY OF RETAIL SERVICES**

The DTF is supportive of the ERA's draft recommendation, wherein retail contestability is introduced only for large customers at this time. However, the synergies between the retail functions of the water sector and other private firms indicate that residential consumers may benefit from contestability at some time in the future. As such, the DTF would suggest that full retail contestability is not precluded from occurring following the introduction of contestability for large consumers.

## SCARCITY PRICING

The introduction of scarcity pricing would encourage consumers to reduce consumption in periods of drought while simultaneously encouraging private investment in bulk water supply sources. The present approach to achieving reduced consumption is the imposition of water use restrictions on consumers. However, scarcity pricing is considered to be a more efficient approach to allocating water during periods of reduced inflow than can be achieved through non-price means. An examination of the costs and benefits of scarcity pricing versus alternative approaches (such as restrictions) is included in the report "Water Scarcity: Does it exist and can price help solve the problem?"<sup>5</sup>, and would be of use when considering how such an approach would be implemented in Western Australia. Also in regards to implementation, the DTF would suggest that as the IPE would have a role in modelling supply and demand requirements, there may be scope for the entity to additionally determine the scarcity value of water.

Practical issues surround the implementation of a scarcity based pricing method at this time. For example, frequency of meter reading would need to be increased in order to accurately reflect the temporal availability of water. Though this could be achieved through the adoption of remote reading technology, it may not be economically viable to implement for all customers at this time. A phased roll-out, similar to the introduction of retail contestability may be practicable. As such, further consideration is required to determine whether scarcity pricing is practical to implement for all consumers at this time.

There is definite appeal to the proposal to offer consumers various consumption plans, as outlined in the draft report. Such plans would allow consumers to signal whether they are willing to accept a fluctuating price based on the present scarcity price of water, or have a preference for avoiding future price fluctuations by setting a predetermined price and/or volume on a per-annum basis. However, the DTF believes that decision on this matter is best left to the commercial interests of retail entities.

## REGIONAL AND REMOTE OPERATIONS

### MULTI-UTILITY

The DTF recognises that there are some benefits from economies of scale that may emerge from the formation of a multi-utility via a merger of the WC and Horizon Power's (Horizon) operations in regional and remote areas.

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<sup>5</sup> O'Dea, G. & Cooper, J. 2008. *Water Scarcity: Does it exist and can price help solve the problem?* Independent Pricing and Regulatory Tribunal Working Paper. Available from: <http://www.ipart.nsw.gov.au/files/Water%20scarcity%20-%20Does%20it%20exist%20and%20can%20price%20help%20solve%20the%20problem%20-%20Working%20Paper%20January%202008.PDF>

The opportunities that a merger between the WC and Horizon would create, depends on the current overlap of operations and synergies between the two businesses. The regional objectives of both organisations are similar, where the focus is on delivering and maintaining adequate services to remote communities. Similar functions exist in terms of billing operations, some staff functions, and fixed costs such as regional depots and offices. There is also the opportunity to coordinate operations and package services together for a more efficient delivery, particularly in terms of developing underground water and electricity infrastructure concurrently.

Further specialisation in the knowledge of regional matters would also be an advantage of merging the two organisations. Currently, the WC focuses on both metropolitan and regional services, with some offices located in regional areas including Karratha. However, some services are still provided by the Perth office, such as scheme planning, engineering design, asset management, system control, and customer billing. In contrast, Horizon's operations cover regional areas external to the South West Interconnected System (SWIS), with its Head Office located in Karratha. Establishing water operations in a regional area such as Karratha may minimise the costs associated with managing some operations remotely from the Perth office.

The most significant obstacle to a merger is the financial cost of merging the WC and Horizon's operations. The DTF agrees with ACIL Tasman's reasoning that the main test is whether the costs of merging and establishing a separate entity for water and power operations exceeds the financial benefit provided by a merger of regional functions. It is expected that the costs of merging the two businesses would be significant. Restructuring the WC's operations also has the potential for the WC to lose some economies of scale compared to its current structure.

Further, if the WC operations are divided into metropolitan and regional operations, potential difficulties may arise with regard to responsibility and accountability, particularly along the boundaries of responsibility where there are connections between the Integrated Water Supply Scheme and the SWIS and regional areas. The formation of a large multi-utility could act as a further barrier to competition from other service providers. However, it is expected that due to the current barriers that exist in terms of the high costs involved in the provision of water and electricity in regional areas, and the current unavailability of Community Service Obligation (CSO) payments to private providers, that any additional the effects of this would be minor.

If such a merger were to occur, the ERA should consider whether it is possible to maintain the synergies that exist now between the metropolitan and regional operations of the WC. It may prove to be unnecessary to divide the WC's operations completely into metropolitan and regional operations, and could also result in negative externalities.

The Northern Territory's Power and Water Corporation (PWC) is a good example of a multi-utility operating successfully. It provides electricity and water services to the major and minor centres in the Northern Territory, including remote Aboriginal communities. PWC operations are successful in providing these essential services as a combined unit to the Northern Territory, and have Essential Service Operators working in the community to monitor water and electricity services. Some functions in remote locations are also controlled remotely from PWC's urban offices.

The Department of Water (DoW) has suggested that the establishment of a multi-utility would introduce the opportunity for competition in the provision of CSO payments. While the amalgamation of the WC and Horizon in regional areas in itself would not introduce competition in CSO payments, the current policy does not allow payments to be available for any non-government business. For contestability in CSO payments to occur, the State Government would be first required to modify its policy to allow contestability (see further discussion on page 16).

The DTF concurs with the ERA's conclusion that further analysis is necessary of how a merger would transpire and the financial implications, including a cost benefit analysis, before a determination can be made in the final report.

#### **REMOTE INDIGENOUS COMMUNITIES**

It should be noted that in July 2007, the State Government established a taskforce to investigate and report on "*The Delivery of Essential Services to Town Based and Remote Indigenous Communities*". This matter is still under consideration and may have a flow on impact on the provision of essential services in regional areas.

#### **COMMUNITY SERVICE OBLIGATION PAYMENTS**

The DTF is supportive of the draft recommendation and finding that the current CSO policy should be changed to allow payment to non-government entities.

The introduction of contestable CSO payments would provide opportunity for potential competitors in the water industry to compete with the WC to provide services and infrastructure, particularly in regional areas where it is not commercially beneficial to do so. This would reduce the current barriers to entry that exist for non-government entities in regional areas and could increase efficiency. The WC has argued that there is competition in the procurement of construction, operations and maintenance, energy and chemicals in providing services that attract a CSO payment from Government. While competition does exist in these parts of the process, there is no competition at a whole project level. Allowing competition in all steps of the process has the potential for greater efficiency gains than exist under the current arrangements.

The DoW has indicated that the proposed legislation under its water law reform project will specifically recognise CSO and enable these to be provided to all licensed service providers. However, to affect such a change, the Western Australian Government must change its CSO policy to allow contestable CSO payments across the board for all Government Trading Enterprises and private providers, rather than make changes for the water sector alone. If Government endorsement were granted, the DTF would likely base a new CSO policy, allowing contestable CSO on the Queensland system.

In Queensland, for a product or service to incur a CSO payment, it is considered by Government on a case-by-case basis and must be consistent with the Queensland CSO policy guidelines. The CSO arrangements between the Government and a private sector supplier can vary. A CSO-type arrangement can exist, where the product or service to be acquired by Government comprises only part of the supplier's business. Alternatively, the service being provided by the private sector can be the primary activity of the supplier. The determination of whether a CSO arrangement is to be made between the Government and a private supplier is determined as part of the Budget process.

The process employed by the Queensland Government to select a service supplier can be an exclusive arrangement between the Government and supplier or a competitive tender process, depending on the nature of the service required. If Western Australia were to adopt a CSO policy similar to Queensland, a competitive tender process would be the preferred method of selecting a service provider. All service providers competing for a contract would submit to Government costings and required CSO payments to the Government. The Government would then choose the provider that required the smallest CSO payment.

The Community and Public Sector Union has argued that in the past private suppliers of water services did not provide adequate services to regional and remote areas. The DTF would ensure that reviews of CSO funding, perhaps on an annual basis would be undertaken, similar to that which occurs in Queensland, to ensure that the outcomes agreed by Government are being achieved and adequate services are being delivered.

It should be noted that the mechanism for a competitive tendering process to occur does exist, and has occurred in the past. The then Office of Water Regulation attempted to introduce competition in the water industry by establishing a tendering process for the licence to supply water and wastewater services to a 3,400 lot community in Dalyellup in the State's south west. The winning bid was received from the WC, who outbid the other contenders and provided the cheapest option. The project required the WC to construct supply bores, a water treatment plant and storage tank, water and sewer mains and pumping stations. This process was considered to be unsuccessful due to the economies of scale of the WC that enabled it to offer a lower bid compared to the other competitors, as well there was a lack of competitors bidding for the licence.

**DRAFT RECOMMENDATIONS AND RESPONSE**

RECOMMENDATION OR FINDING		DTF RESPONSE
<b>BULK WATER PROCUREMENT</b>		
1.	There are synergies between the WC's bulk water operations and distribution functions which indicate it may not be appropriate at this time to separate these functions.	The DTF reiterates its view that the full vertical disaggregation of the WC should not be undertaken at this time. Creation of the IPE and the innovative practices it would undertake should be considered by Government.
2.	An 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 government.	There is considerable merit in this proposal, as it would facilitate private sector participation and competition in bulk water procurement and encourage the adoption of innovative solutions to meeting demand for water. The method proposed offers prospects of achieving secure water supplies at lower cost. Further consideration is required. Synergies between the proposed IPE and the IMO in the electricity industry may deliver cost savings by merging the two.

<b>WATER TRADING</b>		
3.	There are potentially considerable additional sources of bulk water available from Harvey Water, the Gngangara Mound and Wellington Dam.	The DTF believes that potential water sources should be considered on the basis of the economic merit of each proposal, including consideration for any externalities associated with extraction.
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.	Allowing individuals to trade out of cooperatives will allow for the socially optimal allocation of water, as individuals will only trade out if they believe it is in their best interests. It is recognised that Community perspectives may be different. Any exit fees levied on individuals would effectively be a tax, and potentially distort resource allocation as it would be a disincentive to trading.
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.	The DTF supports this recommendation.
6.	On the Gngangara Mound, finalisation of the Statutory Water Management Plan and Gngangara Mound Sustainability Strategy is critical. In the meantime, an effective water trading market should be developed, despite a degree of environmental uncertainty.	The DTF supports this recommendation regarding the finalisation of the Statutory Water management plan. Development of a trading market prior to finalisation of the plan is supported provided that an appropriate precautionary approach is taken to the extent of allocation and trading.

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 <i>Trade Practices Act 1974</i> , would be sufficient to deal with such potential anti-competitive behaviour, the Authority will consider the matter further.	The DTF believes that provisions within the TPA are sufficient to protect against anti-competitive behaviour. Furthermore, care should be taken not to confuse anticompetitive behaviour with the legitimate commercial interests of market players. It is important to ensure that perceived or real anti-competitive behaviour should not result in limiting the beneficial functionality of the market.
<b>THIRD PARTY ACCESS</b>		
8.	A State-based third party access regime should be implemented in Western Australia.	The DTF supports the recommendation to develop a third party access regime for water and wastewater infrastructure that has natural monopoly characteristics.
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 an appeals mechanism.	The DTF supports this recommendation. The proposed access regime should be capable of certification under part IIIA of the <i>Trade Practices Act 1974</i> . This would include obligations set out in the Competition Principles Agreement (1995) and the Competition and Infrastructure Reform Agreement (2006).
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.	The DTF supports the adoption of a retail minus approach to the pricing of third party access to distribution infrastructure

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 a minimum cost.	The DTF believes that the ERA should have a central role in the regulation of any third party access regime for water and wastewater distribution infrastructure
<b>RETAIL</b>		
12.	There are likely to be minimal gains from any disaggregation of the WC's Perth operations at this time.	The DTF recognises the synergies between the WC's existing functions which preclude disaggregation 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.	The DTF is supportive of this recommendation. However, the introduction of contestability for residential consumers should be examined at a later date.
14.	Retail contestability should be introduced for large customers.	The DTF supports this proposal.
15.	There is merit in exploring the introduction of scarcity based pricing to improve price signals for customers regarding the true cost of their consumption and producers regarding potential investment opportunities.	The benefits of scarcity based pricing should be examined further, recognising the additional costs of such an approach.

<b>REGIONAL AND REMOTE OPERATIONS</b>		
16.	There may be potential for significant cost savings from the creation of a multi-utility by transferring the WC's water and wastewater assets to Horizon 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.	The DTF recognises that there may be some synergies from a multi-utility in regional areas. However, further analysis of how a merger would transpire and the financial implications before a determination 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.	The DTF has no comment on this recommendation.
18.	Proposed legislative reforms being undertaken by the Department of Water will enable the payment of CSO to all licensed service providers. The Department of Treasury, the agency responsible for the payment of CSO, should develop a policy perhaps similar to that in operation in Queensland to explicitly allow for the payment of CSO to non-government entities.	The DTF is supportive of introducing contestability in CSO. However, for such a change to occur the Government would have to change its CSO policy for general consistency between all Government Trading Enterprises.