Economic Regulatory Authority's Draft Report on the Inquiry on Competition in the Water and Wastewater Services Sector

The Water Services Association of Australia (WSAA) welcomes the opportunity to provide comments to the Economic Regulation Authority's draft report on the Inquiry on Competition in the Water and Wastewater Services Sector and its further Consultation Report on the Establishment of an Independent Procurement Entity.

WSAA is the peak body of the Australian urban water industry. Its 30 members provide water and wastewater services to approximately 16 million people in Australia and New Zealand, and many of Australia's largest industrial and commercial enterprises.

WSAA was formed in 1995 to provide a forum for debate on issues of importance to the urban water industry, and to provide a focal point for communicating the industry's views to the public. WSAA provides a national focus for the provision of information on the urban water industry for all interested parties.

Full WSAA Membership is available to water businesses that provide water and/or sewerage services to 50,000 or more customers (i.e. service connections), either directly as retailers or indirectly as wholesalers.

The current interest in developing urban water markets in Australia is understandable. The provision of urban water services has all the features of a network industry and the establishment of wholesale and retail markets in other network industries naturally suggests that the costs and benefits of similar reforms in this industry should be researched and evaluated. In this regard, the ERA's generally cautious assessment as reflected in its recommendations is to be commended. It is important not to blindly follow an assumption that what model works well in the electricity industry will automatically work in the urban water industry. Although there are many similarities between the two industries there are also important differences. For instance, water is heavy and it is energy intensive and expensive to transport it large distances compared to electricity. Furthermore, water from different sources will have different qualities and it is essential to protect public health that water quality risks are managed. These risks do not exist in the electricity industry.

In this submission WSAA wishes to comment on only three matters raised by the ERA in its draft report on the on the Inquiry on Competition in the Water and Wastewater Services sector and its Further Consultation Report on the Establishment of an Independent Procurement Entity. The first issue is the proposed creation of an independent procurement entity.The second is the use of options analysis in the selection of the appropriate supply or demand management project(s) to meet the forecasted gap between demand and supply. The third issue is its recommendation regarding scarcity pricing. These are discussed briefly below.

Independent Procurement Entity (IPE)

The ERA has proposed the establishment of an independent and permanent body, the IPE, to undertake assessments regarding additional water source alternatives in an open competitive environment for the Integrated Water Supply Scheme. The advantages of this proposal over the traditional approach adopted everywhere else would, presumably, need to outweigh the additional costs of establishing such an entity.

WSAA, however, has some difficulty understanding the need to create a permanent entity that would only need to be active for short periods of time. This is particularly puzzling given the Water Corporation's stated willingness to:

- establish an independent panel of experts to review water supply augmentation proposals,
- undertake the planning and regulatory approval processes for the most prospective proposals (thereby taking these risks from the private sector proponents),
- undertaking not to develop its own project proposals (to remove the presumption that, in providing technical advice to the independent panel of experts, it would be biased towards its own proposal)
- have an open tender arrangement calling for private sector proposals for water supply augmentations,
- provide bidders with the choice of building, operate and own either one of the prospective sources investigated by the Corporation or their own alternative proposal
- purchasing contracts with capacity and volumetric components to get around the presumption of conflict of interest on the part of the Water Corporation favoring the water sources it owns,
- allow the panel the freedom to seek wider advice than that provided by the Water Corporation.

In the absence of established private water source providers who have demonstrated that they are willing to undertake the lengthy, expensive and uncertain process of developing new sources, there is the real possibility that there would be no private sector proposal sufficiently developed to deliver a new

source when it is required. If the Water Corporation has to develop a proposal to overcome this risk, there will be a real deterrent to the private sector due to the asymmetry of knowledge of distribution system capacity and operations and the potential conflict of interest associated with the negotiation of non-financial elements of the water supply agreement. In this regard, the Water Corporation's proposal is preferable to the proposed IPE.

WSAA considers that the Water Corporation's proposal has all the advantages of the IPE but none of the unnecessary costs; given that the panel need only be active for the duration of the consideration of water supply augmentation. So long as this process takes place in a transparent manner, the objectives of the ERA would be fully met at lower costs and this, surely, must be in the best interests of the community.

Real Options Analysis

WSAA has undertaken a project in the use of real options analysis in the financial evaluation of urban water resource planning. The findings of this project, which was undertaken by a consortium of Farrier Swier Consulting and Stratelytics LLC, have just been published in WSAA's Occasional Paper No 20 (please see the attached report).

WSAA agrees with the ERA that real options analysis can potentially provide extremely valuable information to, and insights for, decision makers. As the WSAA Occasional Paper notes real options analysis ".. can be seen as an extension of discounted cash flow analysis and in the urban water sector appears to be most appropriate in situations where:

- the benefits of one project over others is uncertain,
- information can be gathered in future that helps make better decisions,
- there is flexibility in a project, in some of its components or in a portfolio of projects – for example the ability to delay, or to choose a staged or modular design,
- there are adjustment costs in reversing the project or its components."

WSAA notes that there are several techniques that come under the heading of real options analysis. The WSAA project suggests that risk-adjusted decision trees is the most appropriate technique from both a technical and a transparency perspective.

While WSAA commends the use of real options analysis as a useful tool for the financial evaluation of alternative supply sources and demand management projects, WSAA notes that no tool can ever be a substitute for professional judgment and taking responsibility for decisions. WSAA also notes that decisions in the urban water industry will not always be taken purely on a financial basis. Environmental, social and technical considerations must all come into play.

Urban water utilities around Australia have been involved in the real options project. It is unclear to WSAA how the real options analysis presented in the Draft Report relates to the establishment of the proposed Independent Procurement Entity. It appears clear that the benefits of a real options approach is equally available for source planning undertaken by an integrated water utility such as the Water Corporation, as it is to a separate source procurement entity.

Scarcity Pricing

WSAA notes the ERA's cautious recommendation to explore scarcity pricing for water. The ERA's wish to explore the use of scarcity pricing is understandable (and WSAA supports further research in this area). Nevertheless, WSAA feels compelled to make a number of observations regarding this topic.

First and foremost, WSAA agrees with the ERA's approach of exploring the topic. The customers' demand for water is estimated to be inelastic (particularly compared to the services of other network industries such as electricity). Just as importantly, the existing estimates of the demand elasticity for water are either dated or based on stated (rather than revealed) preferences. With most Australian cities facing significant real price increases over the coming years, WSAA believes that this is an opportune time to evaluate the price sensitivity (both in the short and medium terms) of the customers' demand for water. Accordingly, WSAA suggests that such research be undertaken.

The issue of price responsiveness is equally valid on the supply side. Scarcity pricing in the electricity market was introduced at a time when there was spare capacity such that additional supply could be brought on and off as the market required. In most Australian cities this condition does not currently apply. Accordingly, short term price supply responsiveness is non-existent and additional capacity can take years before it can be brought to the market.

As a brief side remark, WSAA would also note the unfortunate experience in the USA where political interference led to price suppression and, as one would expect, no additional electricity production was brought to the market despite rapid growth in its demand for electricity. If one proceeds down this road, the policy makers need to understand quite clearly that prices need to be allowed to rise and fall (and in the case of water, the span of price increases and decreases will be larger than other more price responsive industries) according to market forces rather than political convenience.

The last observation WSAA would make regarding scarcity pricing is where it is likely to be applied. A number of public commentators argue in favour of introducing the electricity competition model and scarcity pricing in the urban water industry on the basis that only in such an environment households would make appropriate decisions regarding their water consumption. In the electricity model scarcity pricing plays an extremely useful role. However, it must be

pointed out that it is applied at the wholesale market not at the retail market level. Even more importantly, it must be noted that electricity retail entities are allowed to have direct medium term contract with individual wholesalers. As a result, the exposure to end users to scarcity pricing is somewhat muted. WSAA acknowledges that what happens at the wholesale market level cannot (indeed, should not) entirely be divorced from the retail market, but some of the public commentary in this area is, at best, simplistic.

Concluding Remarks

WSAA supports the ERA's recommendations to:

- include real options analysis as an additional financial evaluation tool to provide better information to decision makers regarding the development of an optimal strategy to fill any forecasted gap between demand and supply, and
- explore the likely impact that scarcity pricing might have in an appropriate use in the urban water sector.

If you have any questions regarding this submission please do not hesitate to give me a call on 03 9606 0678.

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