

# 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 – Further Consultation  
Report on the Establishment of an Independent  
Procurement Entity

23 May 2008

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## EXECUTIVE SUMMARY

The release of the Further Consultation Report on the Establishment of an Independent Procurement Entity (IPE) has been useful to better understand how the IPE would operate, and what the key differences are between the IPE, the current arrangement and the Water Corporation's proposal of an Independent Panel.

An examination by the ERA of the current arrangements to source additional bulk water supplies identified some concerns about the Department of Water's (DoW) role in the process. The Department of Treasury and Finance (DTF) shares these concerns, although it understands that most of the issues that have been identified will be addressed as part of the drafting of new water legislation.

While the Water Corporation's proposal of an Independent Panel is an improvement when compared to the current arrangements, particularly through greater transparency, there are still some issues in regard to the independence of the Water Corporation's proposed model.

The IPE, on the other hand, is likely to result in greater transparency and independence, although there are risks with this model as well which need to be considered. Furthermore, having the Independent Market Operator (IMO) performing the functions of the IPE warrants additional consideration if the proposed IPE model is adopted.

Comments on the proposed IPE model in this submission build on the DTF's previous submissions to the ERA's Inquiry on Competition in the Water and Wastewater Services Sector, where the DTF expressed concerns about how feasible the IPE role will be in practice. For example, the DTF encouraged a more detailed discussion of possible source options, in order to guarantee that a sufficient number of alternative sources exist to make the IPE's option procurement process feasible.

As these concerns have not been addressed in the ERA's latest consultation report, the DTF is still questioning the feasibility of an IPE in practice, although it is aware that some of the concerns that were raised are outside the scope of the ERA inquiry, as they are more implementation related issues. However, the DTF would again like to draw the ERA's attention to our previous submissions where further clarification was sought or matters for discussions were raised.

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## **BULK WATER SUPPLY**

In its recent report Towards Urban Water Reform, the Productivity Commission considered a range of issues, some of which have also been raised by the ERA during its Inquiry on Competition in the Water and Wastewater Services Sector. For example, the Productivity Commission examined demand management issues, scarcity pricing, third party access, as well as institutional and structural reforms.

Similarly to the ERA, the Productivity Commission suggested that facilitating efficient investment requires looking at more than just the per kilolitre cost, including factors such as that:

- small sources have the ability to delay the need for larger sources, and this may be beneficial due to significant savings from deferral of large projects, even if the result is a higher cost per kilolitre;
- sources which are climate independent (e.g. desalination) may have a higher cost, however a dollar value can be placed on the security benefit. Alternatively, non-climate independent sources need to have a risk-premium considered; and
- non-potable water is substitutable for potable water for particular uses.

While current policy settings may take these factors into account, formalising their consideration (for example through the proposed establishment of an IPE) may achieve improved outcomes according to the Productivity Commission.

In regard to the scope of the IPE, the DTF supports the ERA's view that the IPE should initially be responsible for the Integrated Water Supply Scheme (IWSS) only, although it may be possible to expand the scope of the IPE's operations at a later date.

## **CURRENT ARRANGEMENTS**

In examining the current arrangements for sourcing bulk water for use in the IWSS, the ERA discussed the involvement of the Minister for Water, the DoW, the Environmental Protection Agency, the Department of Planning and Infrastructure, the ERA, the Water Corporation and the private sector. One of the ERA's conclusions was that regardless of which procurement model is adopted in the future, the aspects of the DoW's role that might be unnecessary (or even restrict competition) must be addressed.

## **ROLES OF THE DEPARTMENT OF WATER**

In the ERA consultation report, it was recognised that as the new water legislation is being developed, it will be necessary to also address some of the current administrative functions of the DoW that restrict competition, and under National Competition Policy, could be viewed as anticompetitive.

The DTF shares the concerns raised by the ERA, and believes that any restrictions on competition need to be removed unless it is in the public interest not to. Western Australia's gatekeeping and legislation review arrangements will require identification and review of any restrictions on water markets to see whether they are in the public interest. For example, restrictions on water trading may continue in some instances, such as on the Gnangara mound, if such trading would have a significant negative impact on the mound.

It is understood that the DoW is addressing some of the issues that were raised by the ERA in the drafting of the new water legislation. In this regard, new legislation is likely to remove the ability of the DoW to recoup unused allocations.

One area of concern with the new water legislation is that it will not be very specific on some matters, such as how any new access entitlements will be allocated. Instead, this issue will be a matter for determination by the DoW, to be specified in a policy document or perhaps in the various regional plans. In this case, it would be preferable if the legislation provided for an auctioning or tendering process of new access entitlements (in accord with the National Water Initiative), unless there are instances where it would clearly not be efficient to undertake such a process. For example, in a remote area where it has been identified that there is only one potential buyer of a new access entitlement, the administrative costs of running an auctioning or tendering process may not be warranted.

All of the issues in regard to the roles of the DoW that were raised by the ERA are outlined in Attachment 1, as are the DTF's comments on these matters, which are made in the context of Western Australia's responsibilities under the National Water Initiative and State commitments.

## **WATER CORPORATION'S PROPOSED APPROACH**

The Water Corporation's proposal for an Independent Panel to be established to take over responsibility for source development is an improvement on the current situation since it is a more transparent model. However, a number of existing issues with regard to source development are not addressed by this proposal, including the potential lack of independence.

For example, since the Water Corporation would provide advice to the Independent Panel on the need to acquire an additional source or demand management option, the ability of the Panel to reach decisions which are, and are seen to be, truly independent is questionable. If the members of the Independent Panel had the necessary expertise to analyse the information provided by the Water Corporation, or if this expertise could be sourced from a body independent from the Water Corporation, this potential risk could be ameliorated. However, it would probably be difficult to find members for the Independent Panel with the relevant expertise, and the ability to source independent advice from elsewhere could be limited (and costly).

Another concern is that the close involvement of the Water Corporation in the planning and development of new sources could reduce competition and innovation, since the private sector might perceive that the Water Corporation would favour particular types of water sources over others. However, the introduction of greater transparency during the planning and development of new sources might address this concern.

## **INDEPENDENT PROCUREMENT ENTITY**

The DTF continues to support the ERA's recommendation to establish an IPE, which will increase independence and transparency in bulk water procurement. An IPE is consistent with the DTF's view to introduce more competition into the provision of bulk water supplies, as the establishment of an IPE is a move towards a contestable bulk water market.

Centralised (independent) procurement through an IPE was raised in the Productivity Commission's discussion paper Towards Urban Water Reform. The Productivity Commission noted that there are benefits of a centralised procurement model, which allows for consideration of a broad range of investment opportunities in order to deliver cost effective supply at a predetermined level of risk. This would consider the benefits and costs of water saving technologies on equal terms with new (larger) investment decisions.

The suggested merger of the IPE with the IMO is appealing for a number of reasons, such as having an organisation with a viable number of employees and the ability to apply lessons learnt from the electricity market to water. Given the DTF's view that the IPE would be involved in the planning and development of new sources (including procurement), monitoring of markets, as well as having a lead role in demand management, it believes that there is justification for considering the establishment of a new organisation focusing on bulk water procurement. This may include the undertaking of a brief cost-benefit analysis of a potential merger, prior to making a decision to have the IMO performing the functions of the IPE as well.

## **RISKS TO THE GOVERNMENT**

There are some potential risks to the Government if an IPE is established, particularly since this is a new, unproven model. One risk in the IPE model is that the Water Corporation has to work closely with the IPE, in particular in developing the source-timing model. It is possible that there will be a tension between the Water Corporation and the IPE, which could impact the effectiveness of the IPE approach.

It was suggested in the draft report that an appointed governing body would lead the IPE with advice from its own secretariat. The independence of this secretariat is important, since whoever controls the secretariat will influence the IPE through the setting of agendas and provision of information. As with the Water Corporation's proposal of an Independent Panel, it might be difficult to find employees for the IPE that have the relevant expertise. This issue needs to be considered as part of the implementation process if the IPE model is adopted.

Another risk is the potential impact on the Water Corporation's performance, which is a risk for the Government in its capacity as a shareholder. The Water Corporation is operating at an arms length relationship from the Government and one of its objectives is to act on commercial principles. There is a risk that the IPE might have an impact on the Water Corporation acting on commercial principles as it sees fit. For example, the planning and procurement of additional bulk water sources is part of the Water Corporation's overall business planning model, and if there is uncertainty, or if the IPE decides to procure a bulk water source which is sub-optimal for the Water Corporation, its performance could be affected. However, ensuring good communication lines between the Water Corporation and the IPE could mitigate this risk.

**ECONOMIC REGULATION AUTHORITY’S COMMENTS ON THE DEPARTMENT OF WATER’S (DOW’S) LEGISLATIVE REFORM PROCESS**

ERA VIEWS ON THE (DoW) POSITION	NATIONAL WATER INITIATIVE (NWI)	BLUEPRINT FOR WATER REFORM IN WESTERN AUSTRALIA	GOVERNMENT RESPONSE TO THE BLUEPRINT FOR WATER REFORM	DTF COMMENT
<p>In cases where a water resource is close to fully allocated, the DoW has stated that it will allocate water via expressions of interest, auctions, or merit.</p>	<p>Paragraph 64(vi). Provide appropriate mechanisms for the release of unallocated water.</p> <p>Paragraph 70. Any release of unallocated water should be managed in the context of encouraging the sustainable and efficient use of scarce water resources.</p> <p>Paragraph 72. To the extent practicable, releases should occur through market-based mechanisms.</p>	<p>Recommendation 8. That the future release of reserved water be made through market mechanisms, such as auctions or tenders, at the discretion of the Minister, with the resultant revenue being directed to water resource management.</p> <p>Recommendation 56. As a prerequisite to achieving water use efficiency and where conditions conducive to water trading exist, that water be controlled in a manner that assists water to achieve an economic value and facilitates the operation of water markets, for example by...releasing new water by auction or tender.</p>	<p>Unless otherwise defined in a statutory water management plan, water will be released through consideration of a water licence to facilitate productive economic use. Alternate mechanisms to release water may include tenders. Any revenue generated through tenders would be returned to the consolidated fund for water resource management.</p>	<p>Specifying an auction mechanism would be preferable, in order to meet NWI requirement 72. This would also ensure that the State meets paragraph 70.</p> <p>In regards to the Government response, water should be released in a manner commensurate with allocative efficiency, rather than the ambiguous “productive economic use” requirement.</p>



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<p>Reservation of water for future public water suppliers, rather than maintenance of a certain amount of water at a standard that is suitable for potable supply. For example, the South West groundwater areas water allocation management plan proposes to set aside water for public water suppliers, excluding other users from seeking an entitlement to the resource.</p>	<p>Paragraph 70. Any release of unallocated water should be managed in the context of encouraging the sustainable and efficient use of scarce water resources.</p>	<p>Recommendation 7. That to address uncertainty inherent in the establishment of the consumptive pool, shares in a pool may be transparently allocated to the Crown for reservation for future release, including for public water supply. <i>These shares could be released into the market on a temporary basis.</i></p>	<p>The Department of Water has the ability to reserve water for future public water supply and other high value uses.</p>	<p>Water should not be reserved unless there is a clear rationale for preventing consumption.</p> <p>Unless DoW adopts a market-based mechanism for allocating additional water, it is unclear how DoW can allocate water to “high value uses”.</p>
<p>The unequal treatment of existing water users. For example, in the draft Gnanagara groundwater areas management plan, the DoW is proposing to require the Corporation to reduce its abstraction from the Gnanagara and Jandakot systems while not imposing similar restrictions on other users.</p>	<p>Paragraph 79(ii). Where it is necessary to recover water to achieve modified environmental and other public benefit outcomes, to adopt the following principles for determining the most effective and efficient mix of water recovery measures: purchase of water on the market, by tender or other market based mechanisms.</p>	<p>Recommendation 10. That when assessing options for returning over allocated or overused systems to sustainable levels, due consideration be given to ecological, economic and social implications and further that implementation of the preferred option takes place at a rate that allows orderly adjustment to occur.</p>	<p>The Government supported recommendation 10.</p>	<p>Without a reverse auction/tender buyback process occurring (as required by paragraph 79(ii), those who value water highly may be forced to reduce consumption under DoW’s proposal, while low value consumption continues unabated. This methodology reinforces allocative inefficiency.</p>

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<p>There is a clear role for the DoW to ensure water resources are not over allocated, and are not being used in a way that compromises water quality and are not being used in an environmentally unsustainable manner. Restrictions on trades may be appropriate in these circumstances. However, in all other circumstances, trades should be permitted. This includes in circumstances where the DoW currently requires a licence holder to demonstrate they have used their entitlement before allowing a trade. While this may be considered fair because it prevents windfall profits, reallocating this water administratively will be less efficient than having it reallocated on a commercial basis.</p>	<p>Schedule G – Principles for trading rules</p> <p>3. Restrictions on extraction, diversion or use of water resulting from a trade can only be used to manage:</p> <ul style="list-style-type: none"> <li>i) environmental impacts, including impacts on ecosystems that depend on underground water;</li> <li>ii) hydrological, water quality and hydrogeological impacts;</li> <li>iii) delivery constraints;</li> <li>iv) impacts on geographical features (such as river and aquifer integrity); or</li> <li>v) features of major indigenous, cultural heritage or spiritual significance.</li> </ul>	<p>Recommendation 48. That, guided by Schedule G (pages 50-51 of this report) of the National Water Initiative, statutory water management plans actively support water trading, with any restrictions e.g. those needed to address or allow for:</p> <ul style="list-style-type: none"> <li>i) Environmental impacts, including impacts on ecosystems that depend on underground water;</li> <li>ii) Hydrological, water quality and hydrogeological impacts;</li> <li>iii) Delivery constraints;</li> <li>iv) Impacts on geographical features (such as river and aquifer integrity);</li> <li>v) Features of major indigenous, cultural heritage or spiritual significance</li> <li>vi) Other social impacts.</li> </ul>	<p>The Government supported recommendation 48.</p>	<p>The DTF supports the ERA recommendation subject to item vi being applied in only restricted circumstances.</p>

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<p>The DoW recoups unused allocations. It does this to address concerns that licensees may be granted access to large volumes of water without having the intention of using their water entitlements within a reasonable timeframe and be given windfall gains should they later trade their unused entitlements.</p>	<p>No comment on the applicability of Part IV of the <i>Trade Practices Act 1974</i> to “water hoarding”.</p>	<p>Recommendation 52. That no provision be made for anti-speculative regulation aimed at preventing the holding of water, provided that future releases of reserved water are made through either auction or tender.</p> <p>Recommendation 53. That monopoly abuse that may arise from the deliberate holding of water to prevent competing development be managed through existing fair trading and trade practices legislation.</p>	<p>The Government supports the emergence of active water trading markets, and the release of water will be done as outlined in the response to Recommendations 6, 7 and 8.</p> <p>To inform future water resources legislation, the Government will review existing legal mechanisms to determine whether these provide sufficient protection against anticompetitive behaviour.</p>	<p>Part IV of the <i>Trade Practices Act 1974</i> should be sufficient to prevent anticompetitive behaviour.</p> <p>It must be recognised that speculation is not the problem, anticompetitive behaviour is. In a maturing water market, many players may benefit from water entitlement capital gain just as they may benefit from capital gain of their land. Only the irrational, or incapacitated, will not put their unused allocation on the market.</p>

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<p>Reducing the <i>inefficient</i> use of water is a legitimate way in which to ensure the supply/demand balance is maintained. However, interference in source development by requiring administratively-determined efficiency targets, or by any other means, is potentially counterproductive to the promotion of competition because it will impact on commercial decision making and the efficient use of water.</p> <p>While it is efficient to invest in cheap ways of reducing water use, there is a point at which the cost of achieving water savings becomes greater than the cost of accessing the next available source.</p>	<p>Paragraph 91. Implementation of demand management measures, including:</p> <ul style="list-style-type: none"> <li>i) implementation and compliance monitoring of WELS, including mandatory labelling and minimum standards for agreed appliances;</li> <li>ii) develop and implement ‘Smart Water Mark’ for garden activities;</li> <li>iii) review effectiveness of temporary water restricts and associated public education strategies, and consider extending low level restrictions to standard practice; and</li> <li>iv) implement management responses to water supply and discharge system losses including leakage, excess pressure, overflows and other maintenance needs</li> </ul>	<p>Recommendation 56. As a prerequisite to achieving water use efficiency and where conditions conducive to water trading exist that water be controlled in a manner that assists water to achieve an economic value and facilitates the operation of water markets ...The Government should continue to encourage adoption by all sectors of practical initiatives to improve the efficiency of water use. These can help develop a lasting culture and practice within the wider community that ensures water is valued appropriately and used wisely.</p> <p>Recommendation 57. That water use efficiency be supported through initiatives such as:</p> <ul style="list-style-type: none"> <li>i) Waterwise Rebate Program</li> <li>ii) Waterwise on the Farm</li> <li>iii) Demand management</li> <li>iv) Water conservation plans</li> </ul> <p>The application of regulations and specific licence conditions.</p>	<p>The Government notes that water markets support the efficient allocation and use of water. The recommendation is supported with regard to controlling the release of new water, minimising transaction costs and establishing appropriate pricing mechanisms.</p> <p>New water may be released through consideration of a water licence or entitlement application or, in some circumstances, through market mechanisms including tenders.</p> <p>The Government will develop and implement a State Water Recycling Strategy and review water usage for households and industry to identify opportunities for further water use efficiency including the development of industry benchmarks and recommendations for best practice.</p>	<p>Important to ensure that conservation and recycling measures are economically efficient (including any avoided costs) and not adopted unless they are competitive with supply costs.</p>