SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY'S INQUIRY INTO COMPETITION IN THE WATER AND WASTEWATER SERVICES SECTOR

RESPONSE TO THE FURTHER CONSULTATION REPORT ON THE ESTABLISHMENT OF AN INDEPENDENT PROCUREMENT ENTITY

16 May 2008

Executive Summary

The Economic Regulation Authority (ERA) indicated in its *Draft Report for the Inquiry on Competition in the Water and Wastewater Services Sector* that it was looking at opportunities to increase competition by creating additional opportunities for private enterprise participation.

The Corporation supports this objective where it delivers value for money and improved customer service. Our business has benefited from the active pursuit of greater private sector participation over many years. The Corporation currently uses competitive processes that result in the private sector delivering 95% of our capital program and 50% of our operations. This contracting strategy has maximised service delivery outcomes for customers and controlled costs, delivering year on year measurable productivity gains. The Corporation has practical experience in designing and refining effective competitive processes that deliver services in an efficient and timely manner.

Preparing for the development of new sources is expensive, time consuming and uncertain. The challenge is to create circumstances where the private sector will be willing to invest in developing innovative and viable projects while ensuring that there are sources/reuse/demand reduction options ready to be developed when additional water is needed. To ensure supply security, private sector participation needs to be complimentary to the planning process, not a replacement for it.

While the water source procurement models developed by the Corporation and the presented by the ERA in its *Further Consultation Report on the Establishment of an Independent Procurement Entity* (Consultation Report) have many similar elements, the key differences appear to arise from the different starting points:

- The Corporation has developed its model with the objective of maximising the effective participation in the bidding process for new sources. We asked the question "will the private sector want to participate in this process and will they commit their best resources?"

- The ERA has taken a theoretical position based on the efficiency of markets and what may discourage participation in a perfect market rather than what will happen in practice.

The Corporation developed a model for the private sector to provide new water sources and wastewater treatment plants as part of an industry review undertaken in 2006/07. The model was developed with extensive industry consultation and involves the Corporation undertaking planning and gaining regulatory approvals for the most prospective new sources, followed by a bidding process where the private sector can either bid to build, operate and own one of the planned sources, or any other source option they choose to develop. This process ensures that there will be a viable private sector bid when a new source is required. As a result, the Corporation would not need to develop its own project proposal to ensure security of supply.

The ERA has recommended that procurement functions for new sources be transferred to an Independent Procurement Entity (IPE). Further, the ERA has recommended these functions be transferred to the existing electricity industry Independent Market Operator (IMO).

While the ERA model closely parallels the Corporation's, the triggering and assessment of new sources would be undertaken by an independent body. The ERA reasons that this will be more attractive to the private sector as it would avoid the perception of a conflict of interest and potential political interference that may occur if the Corporation were to undertake the procurement process. However, given the complexities and uncertainties associated with developing water sources, the Corporation would have to develop its own source proposal under the IPE model to ensure a viable source option was available when required.

The Corporation has argued that the model it has developed has a number of significant advantages over the proposed IPE model including:

- It eliminates the issue of conflict of the interest that must arise if the Corporation develops a source proposal. If the Corporation has to develop a source to ensure security of supply it will be both a competitor and a party to negotiating any water supply agreement with the private sector. This conflict of interest would discourage private sector participation and could lead to disputes that would require costly arbitration.

- Companies have indicated a willingness to participate and allocate their best teams under the Corporation's proposed prequalification process. The added uncertainty of the IPE process is likely to discourage participation. The Corporation's approach will ensure the optimum effective participation in the bidding process at the time a new source is required.

- It maintains a level of competition on the most prospective sources for a longer period of time as it allows the Corporation to maintain an association with more than one consortium and therefore competitive tension up to awarding the contract. Customers benefit from this more competitive outcome.

- The Corporation's negotiating position for the non-financial elements of the water supply agreement is not compromised by the winning source being pre-selected before negotiations are completed. The benefits are again passed onto customers either through lower prices or higher service levels.

- Source acquisition would normally only occur every 5 to 10 years. The ongoing cost of the Corporation's model would be considerably less than resourcing the IPE (IMO). Support skills would be productively retained, utilised and trained within the Corporation during the dormant periods between source developments. Under the ERA model, the higher cost of maintaining the IPE would be passed to customers. In addition, the IPE's capacity to attract highly skilled experts would be problematic, particularly in the current labour market.

The Consultation Report continues to misrepresent the outcomes of the Corporation's existing source planning processes. The ERA's conclusion about the greater cost effectiveness of the IPE model in balancing supply and demands depends on:

- an alleged bias of the Corporation for large sources which is clearly false. The ERA conclusion that the Corporation favours large sources is not correct and not consistent with the scale and variety of recent source developments for the IWSS; and

- the idea that an IPE would take a real options approach to source procurement. A real options approach is not exclusively available to the IPE and is in fact consistent with the Corporation's current considerations for source acquisition.

In addition to the technical arguments above, the Corporation questions the wisdom of changing accountability for source procurement from an organisation with a successful track record to a new entity. The Corporation's public accountability for supply security has provided the management focus to successfully deliver new sources and demand management initiatives over recent years, maintaining Perth's water supplies in a drying climate.

More fragmented accountability structures in place in the eastern states have resulted in slow supply responses resulting in the imposition of total sprinkler bans. These institutional arrangements have dramatically reduced customer service levels and failed to deliver value for money. Further, they have impacted more broadly on the economic activity levels in these States, stifling private and public investment.

Introduction

The Economic Regulation Authority indicated in its *Draft Report for the Inquiry on Competition in the Water and Wastewater Services Sector* that it was looking at opportunities to increase competition by creating additional opportunities for private enterprise participation.

The Corporation supports this objective where it delivers value for money and improved customer service. Our business has benefited from the active pursuit of greater private sector participation over many years. The Corporation currently uses competitive processes that result in the private sector delivering 95% of our capital program and 50% of our operations. This contracting strategy has maximised service delivery outcomes for customers and controlled costs, delivering year on year measurable productivity gains. The Corporation has practical experience in designing and refining effective competitive processes that deliver services in an efficient and timely manner.

At present, the private sector generally designs, constructs and operates projects to specifications developed by the Corporation. This includes large sources such as the Perth Seawater Desalination Plant and smaller projects such as the Kwinana Wastewater Reuse Plant, pump-back schemes and additional groundwater bores.

The planning process and public consultation that lie behind these projects result in potential sources which are well considered across a number of criteria and are ready to proceed when additional sources are required. Potential sources go through a process of:

- assessment as part of long-term planning that includes consideration of regional water resources and their potential use (Regional Water Plans) and long-term potable water requirements and source availability (Water Forever);
- recognition in statutory allocation plans and inclusion in the Corporation's indicative source timetable;
- undertaking investigation and obtaining approvals for the most prospective sources so that they are ready to be developed when required.

In its 2006 industry review, the Corporation recognised that there may be additional source/reuse/demand management opportunities that arise outside of this planning process (e.g. the Harvey Water trade) and potential benefits associated with private ownership that are not being achieved at present. There is an opportunity to reconfigure the procurement process to allow the private sector to deliver the required outcomes (e.g. meet potable water demand) by developing and owning their own projects.

Preparing for the development of new sources is expensive, time consuming and uncertain. The challenge is to create circumstances where the private sector will be willing to invest in developing innovative and viable projects while ensuring that there are sources/reuse/demand reduction options ready to be developed when additional water is needed. To ensure supply security, private sector participation needs to be complimentary to the planning process, not a replacement for it.

The Corporation developed a model for the private sector to provide new water sources and wastewater treatment plants. The model was developed with extensive industry consultation and involves the Corporation undertaking planning and gaining regulatory approvals for the most prospective new sources, followed by a bidding process where the private sector can either bid to build, operate and own one of the planned sources, or any other source option they choose to develop. This process ensures that there will be a viable private sector bid when a new source is required. As a result, the Corporation would not need to develop its own project proposal to ensure security of supply.

The ERA has recommended that procurement functions for new sources be transferred to an Independent Procurement Entity (IPE). Further, the ERA has recommended these functions be transferred to the existing electricity industry Independent Market Operator (IMO).

While the ERA model closely parallels the Corporation's, the triggering and assessment of new sources would be undertaken by an independent body. The ERA reasons that this will be more attractive to the private sector as it would avoid the perception of a conflict of interest and potential political interference that may occur if the Corporation were to undertake the procurement process. However, given the complexities and uncertainties associated with developing water sources, the Corporation would have to develop its own source proposal under the IPE model to ensure a viable source option was available when required.

The Corporation's public accountability for supply security has provided the management focus to successfully deliver new sources and demand management initiatives over recent years, maintaining Perth's water supplies in a drying climate. More fragmented accountability structures in place in the eastern states have resulted in slow supply responses resulting in the imposition of total sprinkler bans. These institutional arrangements have dramatically reduced customer service levels and failed to deliver value for money. Further, they have impacted more broadly on the economic activity levels in these States, stifling private and public investment.

The model developed by the Corporation was in response to extensive engagement with stakeholders with significant capital, construction, design and customer interests. There are a number of significant advantages over the proposed IPE model including:

- It eliminates the issue of conflict of the interest that must arise if the Corporation develops a source proposal. If the Corporation has to develop a source to ensure security of supply it will be both a competitor and a party to negotiating any water supply agreement with the private sector. This conflict of interest would discourage private sector participation and could lead to disputes that would require costly arbitration.

- Companies have indicated a willingness to participate and allocate their best teams under the Corporation's proposed prequalification process. The added uncertainty of the IPE process is likely to discourage participation. The Corporation's approach will ensure the optimum effective participation in the bidding process at the time a new source is required.

- It maintains a level of competition on the most prospective sources for a longer period of time as it allows the Corporation to maintain an association with more than one consortium and therefore competitive tension up to awarding the contract. Customers benefit from this more competitive outcome.

- The Corporation's negotiating position for the non-financial elements of the water supply agreement is not compromised by the winning source being pre-selected before negotiations are completed. The benefits are again passed onto customers either through lower prices or higher service levels.

- Source acquisition would normally only occur every 5 to 10 years. The ongoing cost of the Corporation's model would be considerably less than resourcing the IPE (IMO). Support skills would be productively retained, utilised and trained within the Corporation during the dormant periods between source developments. Under the ERA model, the higher cost of maintaining the IPE would be passed to customers.

Direction of Water Reform

The Corporation believes the ERA has developed its model from a theoretical position on the efficiency of markets rather than analysing what is required to attract companies to develop viable projects for the water industry. A simple extrapolation of experience in electricity, gas and communication is not sufficient justification. While the elements that make up the water industry are superficially similar to electricity, there are many fundamental differences.

Globally, energy and telecommunications utilities continue to evolve from public sector authorities to disaggregated, competitive private sector companies in industrialised nations. This experience has not been transferred to water utilities in any part of the world.

The ERA has commenced each of its papers for their competition inquiry with a statement of their philosophical position in respect to the efficiency of markets and how markets are superior to other ways of allocating resources to their highest value use. Alternative non-market solutions are described as "second best".

As a result, the ERA expresses the view that markets are the best way to determine water values for both consumption and production. This view is at odds with the current practice where considerable long-term planning and public consultation is undertaken to determine values.

The ERA's Draft Report also recognises that there are many examples where markets are not efficient. In these circumstances there is a need for planning and regulation. This is described as "second best" relative to their theoretical ideal. In practice markets and market failure can clearly be a second best (or even worse) outcome, and a well planned water supply can be the "first" best outcome, even when a market based outcome is possible.

Perth's individual water sources do not operate in isolation. The benefit each source contributes to the system yield, the source operating strategy required to optimise the system yield/security trade-off and the cost and constraints imposed by integration assets mean that a water source can only be efficiently managed in combination with other sources and the distribution system. Any new source also needs to be assessed for its contribution to system yield and integration costs, including any real option value it may create or destroy.

There are no examples in the world where this has been left to the market. Commencing such reforms in the water sector in a sparsely populated, arid, vast land area such as Western Australia is highly unlikely to succeed. Customer service is likely to suffer as a result. Any reforms should explicitly identify projected benefits to customers and protect customers from bearing the cost of policy experimentation.

A vague belief that a decentralised market is a natural and ultimate direction for water reform because "that's what happened in electricity" is insufficient to justify starting reform off in that direction with a "let's see what will happen" approach. While this approach has been advocated in the Productivity Commission's research paper *"Towards Urban Water Reform – A Discussion Paper (March 2008)"* it has subsequently been criticised by the Water Services Association of Australia (WSAA) as not being prudent. WSAA has called for further research and modelling, particularly as there is the potential for water markets to fail disastrously at a time of crisis, and crisis conditions may not emerge for many years. WSAA is not taking a position that opposes reform, but rather questioning the assumed direction of reform.

The burden of proof clearly lies with the advocates of water reform that contemplate moving toward a decentralised market. Such reform proposals would need to be supported with proper analysis of how the market would function, with robust modelling of the likely outcomes for different water source configurations. With the large variety of water source configurations for different utilities (single dams, multiple dams, borefields, desalination plants, and water trading) it should be recognised that one model will not fit all situations.

The Corporation's procurement model is based on the realistic assumption that central source management will continue in Western Australia. As a result, water supply agreements for private sector owned sources will include both fixed capacity payments and variable volume payments. This form of contract eliminates any potential conflict of interest for the Corporation in developing the annual source operating strategy, allowing this strategy to be developed and optimised by the organisation with the best skill base and system knowledge to undertake the task.

Competition vs Markets

A clear distinction needs to be made between obtaining the benefits of competition and the need to set up a competitive market for water. Fortunately, competition in water source supply does not need a decentralised water market. The benefits of competitive procurement are available to a well planned water supply system.

Companies are willing to bid to build, operate and own new water sources on the basis that they will be managed centrally and procurement processes can be designed to encourage and reward innovation.

A key attraction of a central procurement and management model is the commercial certainty associated with water supply contracts with the water utility. The advantage of a contract with fixed capacity payments is that it is bankable for the private sector, and will encourage more participation and competition than with less certain market outcomes. This model will attract more private sector interest and therefore result in greater competition.

The ERA has not provided analysis of the likely level of participation under each model and therefore which is the most effective for competition. The Corporation's industry consultation suggests a strong preference for contracts with fixed payments to create bankable contracts.

Market vs Planned Approach to water allocation

The ERA's faith in a market based approach again appears problematic where they advocate exclusively using a neutral auction process for planning and issuing water allocations.

"The risk the DoW faces by using methods other than neutral auctioning processes is that it may inadvertently allocate water to those who do not value it most, resulting in the inefficient use of water.

Current practices that may be counterproductive to the promotion of competition include:

- *the 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 (although other users may be able to use a proportion of the water on a temporary basis until it is required for drinking water purposes, provided that use does not compromise the quality of the resource)."*

"the DoW is attempting to ensure that the water resources of the State are used in the most efficient manner. The efficient use of any given product is generally best assured by leaving the allocation of the product to market mechanisms." (Consultation Paper Page 17, 18)

The ERA's position reflects an assumption of the possibility of efficient markets for long-term water allocation. These markets do not currently exist and there are a number of issues such as environmental and social externalities and capturing future values that would need to be addressed before such a market could be considered

efficient. A statement such as "*the efficient use of any given product is generally best assured by leaving the allocation of the product to market mechanisms*" needs to be supported with more analysis before it is used as the basis for recommendations.

Auctions tend to reflect current and near-term private values rather than longer-term and community values. They do a good job of balancing the supply and demand for (say) fresh produce today (for example bananas). However, to suggest substituting planning with an auction process requires demonstration that the market will properly value future water uses and that externalities such as environmental and social impacts will be properly accounted for.

The benefit of long-term planning underlying water resource allocations needs to be properly considered. Potable water supply needs safe, protected sources, and if these resources are not reserved for future use, sub-optimal use in the short-term may result in the need to develop alternative higher cost sources in the long-term. Protection of public drinking water supplies is a paramount customer and community accountability of water utilities.

Under the Australian Constitution, water resources are a responsibility of the States. Western Australian statutes clearly recognise the ownership of surface and groundwater resources by the State at all times. The State can grant licenses to use water, but ownership cannot be divested. This constitutional and legislative framework gives explicit recognition to the unique characteristics of water. As a result, the intention of federal and State statutes is to manage water resources closely, in the long term interests of the State. Administration of licensing arrangements is not anti-competitive, but necessary to achieve legislative intent.

Current legislative arrangements regarding water licensing were supported by the competition policy review of water legislation initiated in 1995.

While the temporary use of resources should be facilitated when practical, future market transactions cannot be relied on to transfer resources to their highest value long-term use in the future. It is financially and socially costly to reverse poor long-term allocation decisions once significant investments have been made to utilise resources. The sunk costs invested in utilising resources form a barrier to shifting them to what would have been a higher long-term use.

For example, investment sunk in irrigation infrastructure and farms, and the supporting business and community infrastructure is a barrier to shifting irrigation allocations to alternative uses. A longer term planning horizon may save the sinking of inefficient costs.

If the use of a resource is to be temporary, the associated allocations should also be temporarily, and the long-term higher value use clearly identified and protected.

Long-term planning also provides benefits through coordinating the provision of multiple services. Water source planning does not stand alone. It needs to be coordinated with customer service requirements, land planning requirements, demand

management and reuse, wastewater disposal, distribution planning and the integrated management of sources.

Over the past fifteen years, the Water Corporation has completed several strategic infrastructure-planning documents that have formed the basis for ongoing investment in new programs and infrastructure:

- Perth's Water Future: A water supply strategy for Perth and Mandurah, 1995;
- Wastewater 2040, Strategy for the Perth Region, 1995; and the
- Integrated Water Supply Scheme, Source Development Plan, 2005.

The Source Development Plan adopted an integrated resource planning approach as recommended in the State Water Strategy released in 2003. Integrated resource planning ensures that options to reduce demand on water supplies (such as water use efficiency initiatives) are compared on an equal basis with options that increase supply (such as new water sources). This framework has been developed by urban water utilities across Australia to evaluate a range of options.

The direction provided in the above mentioned planning reports have helped the Corporation to keep pace with land development and climate change. We have been able to meet customers' water service needs by implementing a range of water use efficiency and service initiatives, coupled with detailed asset planning and development of existing or new water resources.

The Corporation is currently undertaking *Water Forever,* focusing on the future needs of our customers – residents, businesses and organisations connected to our schemes. Where possible, consideration will be given to enhancing the environment and provide services to other water users where there is a need.

Water Forever will be examining a range of water source and water use efficiency initiatives that could help to meet demand over the next 50 years. *Water Forever* is developing a long-term plan for Perth, integrating water, wastewater and drainage services with land planning. The plan will outline actions to support water service delivery in three horizons:

- 10 years to 2020;
- 20 years to 2030; and
- 50 years to 2060.

Water Forever will create a framework for the delivery of conservation initiatives and infrastructure to support our water future. The plan will need to be comprehensive and flexible to adapt to our changing environment.

Private sector participation will form a part of the plan, but it cannot be a substitute for the plan itself.

Extracts and Commentary on the Consultation Paper

Clarification of the ERA's discussion of the Water Corporation "proposal"

The Corporation wrote to the ERA on 11 March 2008 explaining a variation of our model that could achieve the ERA's objective of making decisions on sources independent from the Government through making the review panel independent and giving it decision making powers on the source triggers and selection. The ERA has presented this as the Corporation's proposal rather than a variant to meet the ERA's objective of independence from Government.

The letter states clearly that:

> "The Water Corporation has presented a robust model for private sector participation in our 1 February 2008 response to the Draft Report. The model was developed with extensive consultation with potential industry participants, and we believe that it will ensure a competitive outcome at the time that tenders are called for supplying a new source.
>
> Our proposed model has been developed with our understanding of the Government's desire to be a participant in the decision making process. We have now considered the best way this model could be adjusted to achieve the Authority's objective of ensuring decisions on new water sources are made independently of Government."

The model in the letter is referred to as the Independent Panel model.

The following section provides extracts from the Consultation Paper followed by the Corporation's comments. It has been arranged under the general headings used throughout the Consultation Paper.

- **a lack of transparency and independence in the assessment of alternative sources**

"There is a lack of transparency in the process used to assess alternative options. It is not clear on what grounds the Corporation assesses alternative proposals developed by the private sector.

While the Corporation argues that there is no actual conflict of interest in it undertaking the assessment or developing annual operating plans, merely the perception that it may have a vested interest in developing and operating its preferred sources may be sufficient to deter the private sector from offering alternative sources.

Moreover, the lack of transparency and potential perceptions of a conflict of interest may be exacerbated by the role of the Minister in the supply source decision. In order for the private sector to invest in identifying and proving-up a source it needs to have confidence that decisions will be made on a commercial basis. Any ambiguity regarding the role of the Minister can create uncertainty for the private sector and

will reduce the likelihood that the private sector will invest time and money in developing alternative options." (Page 16)

The Corporation disagrees with the conclusion that a lack of transparency is discouraging private sector proposals and is the cause of alternative projects not being developed.

There have been two serious private sector water supply proposals for the IWSS, the Harvey Water trade and the United Utilities Australia (UUA) proposal for a desalination plant in Esperance and a pipeline to Kalgoorlie.

The Harvey Water trade was successful and followed a process of consultation and then negotiation with the Corporation and approval by Government. The process used to assess the viability of the project was transparent to both Harvey Water and the Government and the process was clearly no barrier to Harvey Water's participation.

The Harvey Water trade was assessed on its merits and not against competing private sector alternatives. A bidding process would not have improved the outcome in these circumstances. One of the catalysts for the Corporation developing its own private participation model was the recognition that if competition was to be increased a process had to be developed so that private participants with alternative sources were ready to submit viable bids at the time a new source was required. This is the key gap in the current process and has been dealt with through negotiation to date.

While the UUA proposal appears to have not been successful, UUA has not put a firm proposal to the Corporation for assessment. During a period of extensive consultation, the Corporation indicated to UUA the price targets that would need to be achieved for the project to be viable, including providing extensive information on the basis for these calculations. These price targets were subsequently confirmed by the ERA in an independent public inquiry.

While the Corporation has expressed the view that it thought the UUA project was not commercially viable based on the costs provided by UUA (and necessarily proceeded to plan for other water sources for the IWSS on that basis), the project would still be favourably considered by the Corporation if UUA could supply water at a competitive price.

The establishment of an IPE would not change the economics of the UUA proposal. Additionally, the IPE would be incapable of making an independent assessment of the UUA proposal as a key element in the economics of this proposal is the capital and operating cost savings in the Goldfield and Agricultural Water Supply (G&AWS) scheme, a clear example where the integration assets and their operation dominate the economic evaluation. Similarly any private project proponent and the IPE would have to continue to rely on the Corporation for this type of information

It should be noted that the UUA project would be quite complicated to assess in a bid process as it relies on the cost saving to the Corporation from substituting existing supply arrangements. The assessment of these benefits would have to be made clear in

any bidding process. This would also provide a clear conflict of interest to the Corporation if it had to bid an alternative source in competition with UUA.

Potable water for the public water supply scheme is only part of the output of the UUA proposal. It also provides water directly to mining companies. Under these circumstances a better outcome may be achieved through negotiation rather than a bidding process. This raises a significant question – are the benefits of competitive procurement likely to be greater than those from negotiated acquisition? Similar considerations are required for projects such as Managed Aquifer Recharge, and for very small sources which will only have a minor but cumulative impact on system capacity. Consideration needs to be given as to whether the benefit of giving the private sector certainty of process by sourcing all water through a bidding process outweighs the benefits of allowing negotiated outcomes. The answer depends on the types and volume of alternative water supply that are likely to be proposed.

The ERA claim the uncertainty of the existing process is deterring the private sector from offering alternative sources. A contrary view is to ask why the private sector has not developed viable proposals at a time when there is essentially no competition. The Corporation has clearly been searching for as many viable water source options as possible to compensate for our drying climate. An alternative conclusion is that viable innovative alternatives to the Corporation's options are rare and the current process is not a deterrent.

The assumption that there are innovative private sector alternatives waiting to be developed is essential to the benefits of the ERA's model. If the successful sources are likely to be those that are already coming out of the Corporation's planning processes, the Corporation's model, which costs less, is more closely aligned with the natural skill set and knowledge of the system and maximises the competitive tension in developing these options, will also maximise the benefits of competition.

The Corporation's proposed model does not address the potential conflict of interest related to the Corporation being responsible for the development of the annual source operating strategy, where the character of that operating strategy has implications for the need for additional sources and the relative value of different forms of new supply. (Page 24)

The ERA has not recognised that the water supply contract with any private sector service provider would almost certainly have a fixed capital payment and a variable volumetric payment. This form of contract would eliminate any conflict of interest when developing the annual operating strategy. The focus on this issue is the result of an unrealistic expectation that a water market would develop without the need to guarantee recovery of capital costs.

Neither the Harvey Water trade or UUA project involved a potential conflict of interest in developing the annual operating strategy for the IWSS sources nor was this an issue for either proponent. The ERA should demonstrate where and how this conflict may realistically rather than theoretically occur.

In addition, the Independent Panel would rely heavily on advice from the Corporation (although it may have the ability to seek wider advice if considered necessary). As such, the Independent Panel, which would only convene as necessary, may lack the ability to develop and maintain the necessary expertise to undertake an appropriately independent and rigorous investigation of additional water source issues. (Page 24)

This point is not overcome with the ERA's IPE proposal. The IPE would still be heavily reliant on the Corporation's advice, their workload would be intermittent, there would be difficulty retaining any expertise and there would be the additional cost of maintaining a full time body.

- ***an uneven playing field for the private sector***

The private sector does not have access to the same detailed information as the Corporation. While the Corporation does release long term supply/demand projections, a lack of access to the detailed modelling complicates the task of the private sector in developing business plans for alternative options. (Page 16)

Under the Corporation's proposal, the private sector continues to lack access to the same detailed modelling information as the Corporation, in turn reducing the ability of the private sector to develop detailed business plans for alternative sources. (Page 24)

The ERA has failed to recognise that the information asymmetry between the Corporation and the private sector and the IPE lies in the underlying knowledge and understanding of the distribution system and its constraints, not the supply/demand projections. This asymmetry cannot be overcome by the creation of an IPE and therefore remains a problem to be addressed by the IPE model. The Corporation's procurement model overcomes this problem by removing the Corporation as a competitor. This is not a solution that is prudently available to the IPE model.

The UUA proposal is an example of the reliance on an assessment of its impact on the costs of the existing G&AWS scheme. The impact of integration into the IWSS can also be demonstrated through an assessment of the integration of the Southern Seawater Desalination Plant (SSDP).

Augmentation of integration assets is not always progressive. It is not possible to progressively duplicate a pipe that connects two places. Often, significant changes in capacity are required to provide the required level of augmentation to integrate the next step change in source availability with assets sized for optimal long-term capacity, not simply for the next source.

A decision was made to initially install 50GL per annum of capacity at the SSDP rather than 45GL as the integration assets could handle 50GL without additional augmentation. The additional 5GL of desalination capacity could therefore be installed at an incremental cost of $14 million, a capacity cost of around 20c/kL. However, a step increase is required for any increase in capacity above 50GL per annum, and these could occur in discrete steps.

Integration for an additional source up to a further 10GL per annum will cost $180 million (a minimum integration cost of $1.10/kL for a 10GL source using the full increment in capacity), up to another 10GL will require a further $200 million ($1.30/kL). Once these works are in place, subsequent sources could be integrated at around 10c/kL. The average cost for the full 50GL increment is around 50c/kL.

It is interesting to note that rather than being a large source option, the progressive augmentation of the SSDP is likely to become a possible small source option under a future real options analysis, something even the ERA would be hard pressed to argue that the Corporation would be biased against.

However, if the private sector does decide to invest in an alternative option with the intention of entering into negotiations with the Corporation, it is at a competitive disadvantage as it has to spend its own time and money proving up the option and gaining the necessary approvals. (Page 16)

This disadvantage remains with the ERA's IPE model as they are proposing to provide similar funding through option payments to prove up some options.

This has to be accepted as one of the costs of ensuring security of supply. No adjustment should be made to bids to compensate for these payments as they will be a sunk cost.

Additionally, this will only be an issue for private companies who either are unwilling to participate in the planning process (and therefore receive the payments) or have been rejected by either the IPE or the Corporation in the initial assessment of their scheme.

The ERA claims that under the Panel model the Corporation would be biased towards the source options it had pre-selected for investigation funding. If this were the case (and it is not), the ERA doesn't explain why the same bias would not be present in the IPE as they would have also pre-selected some sources for investigation funding through their options process.

- ***uncertainty about factors that impact on commercial decision-making;***

The extent of rebates on water efficient technologies and levels of restrictions on water use influence the demand for water and therefore the potential market for options the private sector may be considering developing. Greater certainty over the rebate and restrictions policies would provide greater certainty for proponents of alternative water supply options and demand management solutions. (Page 17)

While this issue is relevant, its impact on reducing the overall uncertainty for a private sector proponent would be minor compared with the uncertainties of climate. Additionally, the IPE model is not a prerequisite for resolving this issue, and it could equally be dealt with through alternative options.

The real issue is whether government wishes to lock into a policy for the benefit of private sector certainty or retain policy flexibility to meet other objectives.

- ***ERA's concluding comments***

> *The nature of the Independent Panel is that of a review board for decisions taken by the Corporation regarding additional sources. As such, the panel is likely to focus on the procurement of additional large sources of supply to the detriment of smaller source options or alternative ways of ensuring the supply/demand balance is maintained such as demand management solutions. The effectiveness of the Independent Panel in establishing a market aimed at ensuring the supply/demand balance is met in the most cost effective manner would be limited. (Page 25)*

This is a completely unsubstantiated conclusion. As discussed above, the ERA's position that there will be a market established aimed at ensuring supply/demand balance is entirely theoretical. The IPE model actually presented is almost identical to the Corporation's centralised procurement model in how it would go about procuring new sources.

The conclusion about the greater cost effectiveness of the IPE model in balancing supply and demands hangs on:

- the alleged bias of the Corporation for large sources which is clearly false; and

- the idea that an IPE would take a real options approach to source procurement. However, the real options approach is not exclusively available to the IPE and is in fact consistent with the Corporation's current approach to source acquisition.

Information was presented to the ERA explaining their conclusion that the Corporation favours large sources is not correct and not consistent with recent source developments. In recent years we have developed additional capacity through the Stirling/Harvey Redevelopment (29GL), the Mirrabooka borefield expansion (6GL), 3 separate additional Yarragadee bores (3 x 5GL), Samson Pipehead Dam (8GL), Wokolup Creek Pumpback (10GL), the Kwinana Wastewater Reuse Project (6GL), Perth Seawater Desalination Plant (45GL), the Harvey Water trade (17GL), and demand management (45GL) made up of multiple initiatives.

In addition to preparing for an additional 50GL desalination capacity at the SSDP, the Corporation is pursuing Security through Diversity, including investigating catchment management (20GL), Collie mine dewatering (6GL), Managed Aquifer Recharge (up to 100GL) and the second stage of Kwinana Wastewater Reuse Project (3.6GL).

Clearly this track record demonstrates that the Corporation is interested in developing sources of all scales, and the ERA's assertion that we have a bias towards large sources has no basis.

There is no discussion by the ERA as to the advantages the Panel model has over the IPE model in encouraging private sector participation. The Corporation's conclusion

is that there would be a greater level of participation and competition if the Corporation was not a project proponent. This has not been addressed by the ERA other than to suggest that we do not have to be a project proponent if we do not want to.

ERA's discussion on the Independent Procurement Entity

> *The IPE model described is the same as that presented in the Draft Report except for one aspect regarding the requirement for the Corporation to submit a bid to the IPE on its preferred source. Following the submission from the Corporation on the Draft Report, the Authority no longer considers that the Corporation should be required to submit a bid (although the Corporation would provide a proposal on possible source options so as to ensure that the approvals process was progressed). As such, the Corporation would be able to assist the IPE on an impartial basis in assessing the various bids and negotiating supply contracts. This is consistent with the Corporation's preference for not owning new sources and is discussed in greater detail in the following section. (Page 28)*

The ERA has chosen to ignore the Corporation's advice that we would develop a source proposal under the IPE model to ensure security of supply and that this would necessarily result in a genuine conflict of interest that would discourage private participation.

> *Once the IPE had concluded that an additional source(s) or demand management option might need to be commissioned within reasonable planning times, it would seek proposals from the Corporation and the private sector for ways in which to address the supply shortfall. The IPE would conduct a degree of due diligence on the potential options offered by the Corporation and the private sector, and would fund the investigation and approvals for the most promising options, potentially excluding the Corporation's option if other more cost effective viable alternatives were proposed. (Page 28)*

The ERA has attempted to merge the Corporation's model with the IPE model to suggest that we wouldn't need to bid. The problem with this approach is that if the IPE selects the Corporation's option to be developed then there is no difference between the IPE model and the Independent Panel model, and if the IPE doesn't select the Corporation's option at any stage, the Corporation will still have to develop an option to ensure security of supply and there will be a conflict of interest.

Sustainability

The ERA has attempted to address sustainability issues.

> *It is expected that the assessment process undertaken by the IPE would be consistent with the State Sustainability Strategy (2003), as the IPE would base its decisions on the project that has greatest total net benefit to the community. The total net benefit of a project to the community is the sum of net private benefits and net public benefits. Private benefits and costs accrue to parties directly engaged in the project (such as*

potential suppliers, shareholders, employees, or customers). Public benefits and costs accrue to the wider community, for example from environmental impacts or the provision of public amenities.

- *Private benefits and costs associated with each project would obviously be reflected in the value of the bid.*
- *Public benefits and costs that relate to the environment would be taken into account through the involvement of the EPA in undertaking Environmental Impact Assessments and the DoW in granting licences and monitoring usage. The costs associated with meeting EPA and DOW requirements would be reflected in the value of the bid as would costs incurred to comply with meeting the requirements of the Department of Health.*
- *To the extent that other benefits and costs (often referred to as social benefits and costs) outside of those identified above exist, these would need to be identified by the proponent through appropriate consultation processes and included as part of its bid. The IPE could be given the power to undertake further consultation to ensure the assessment process incorporates all public benefits and costs. (Page 29)*

The ERA appears to believe a private sector proponent would be in a position to identify social benefits and costs of their project and would also be motivated to identify the social costs, a negative element that would be against their proposal.

What is also missing is an acknowledgement by the ERA that the proponent will not be able to assess the non-private net system benefit of their source, only their particular project yield.

This section identifies that the IPE would assess options for meeting a supply shortfall in line with the *State Sustainability Strategy* (SSS) and its philosophy that decisions on projects be based on what has the greatest total net benefit to the community.

It should be noted that the status of the sustainability assessment process for use by Government departments like the proposed IPE is unknown. Therefore, basing the assessment process on a statement in the SSS does not appear to be robust.

There is also concerned that an IPE buried in the IMO would not have the public face required to undertake a truly comprehensive and meaningful sustainability assessment. Additionally, electricity does not currently have the same level of public policy development as water. Any claim that the IMO has a similar skill set to carry out the proposed functions of the IPE clearly misunderstands the profile and skill sets required to successfully carry out public consultation and sustainability assessments.

Once the IPE determined that there was a need to commit to an additional source and therefore select the preferred option, it would oversee negotiations between the Corporation and the successful bidder(s) regarding the relevant supply contracts to ensure they are consistent with the bid. In the event of a dispute, the IPE would act as an arbitrator. (Page 29)

This model would leave the Corporation in a much weaker negotiating position as the winning bidder would have been selected before the water supply agreement had been negotiated. The Corporation's customers would bear the costs and level of service impacts of this weaker bargaining position.

Conclusion

The ERA's Consultation Paper contains many logical short-comings that overstate the benefits of an IPE. Many of the issues used by the ERA to criticise the Corporation's Panel model apply equally to the proposed IPE model. These include:

- The information asymmetry between the Corporation and the private sector (and the IPE).

  The key asymmetry is the cost of source integration and system operation. Both the IPE and the Panel would inevitably have to rely heavily on information provided by the Corporation. The Panel model overcomes the conflict associated with this asymmetry by ensuring the Corporation is not a competitor. The IPE cannot provide this assurance and cannot overcome the information asymmetry.

- The ERA claims the Corporation's funding for proving up of the most prospective source options gives these sources an advantage over a private sector proposal. The IPE will also fund the most prospective sources, giving them the same advantage. This is a necessary element of insuring there are sources capable of being developed when needed.

- The IPE and Panel model can give equal clarity on the future level of rebates and restrictions. This requires a Government decision to delegate these powers. This is not an advantage of the IPE over the Panel model.

- The ERA claims the Corporation will have a bias to develop the sources that are proven up through its short-listing process. If there were a bias created through this process, the bias would apply equally to the IPE as their proposed process is the same.

- The assertion that the Corporation (and therefore the Panel model) has a bias towards large sources is unsubstantiated and contrary to recent experience. There is no reason to assume a difference between the IPE and Panel model.

In contrast to the above, the Panel model has significant advantages over the IPE model.

- It eliminates the issue of conflict of the interest that must arise if the Corporation develops a source proposal. If the Corporation has to develop a source to ensure security of supply it will be both a competitor and a party to negotiating any water supply agreement with the private sector. This conflict of interest would discourage private sector participation and could lead to disputes that would require costly arbitration.

- Companies have indicated a willingness to participate and allocate their best teams under the Corporation's proposed prequalification process. The added uncertainty of the IPE process is likely to discourage participation. The Corporation's approach will ensure the optimal effective participation in the bidding process at the time a new source is required.

- It maintains a level of competition on the most prospective sources for a longer period of time as it allows the Corporation to maintain an association with more than one consortium and therefore competitive tension up to awarding the contract. Customers benefit from this more competitive outcome.

- The Corporation's negotiating position for the non-financial elements of the water supply agreement is not compromised by the winning source being pre-selected before negotiations are completed. The benefits are again passed onto customers either through lower prices or higher service levels.

- Source acquisition would normally only occur every 5 to 10 years. The ongoing cost of the Corporation's model would be considerably less than resourcing the IPE (IMO). Support skills would be productively retained, utilised and trained within the Corporation during the dormant periods between source developments. Under the ERA model, the higher cost of maintaining the IPE would be passed to customers.