

Water Services Association of Australia

**Submission to the inquiry by the Senate
Standing Committee on Economics:
*Privatisation of state and territory
assets and new infrastructure***



WATER SERVICES
ASSOCIATION OF AUSTRALIA

Key messages

1. The Water Services Association of Australia represents public and private water utilities.
2. Decisions on privatisation are matters for government shareholders and as such WSAA does not support nor oppose privatisation.
3. However, WSAA wants to create a platform for good decision making which includes discussing the preconditions for privatisation that would ensure it is in the long term interest of customers.
4. Regardless of ownership there is a strong role for Commonwealth Government involvement in the urban water industry through COAG.
5. WSAA is seeking a national voice for urban water that focuses on:
 - Improving economic regulation to ensure that water utilities can continue to meet the long term interests of their customers
 - resolving the appropriate role for competition in urban water
 - ensuring the industry retains sufficient flexibility to meet future challenges.
6. Current economic regulation of urban water
 - Like utilities, needs to be more customer-centric
 - Does not provide sufficient incentives for innovation and productivity
 - Is not sufficiently predictable, transparent and consistent to enable greater private investment in the future.
7. WSAA recommends expanding the National Water Initiative through COAG to put in place minimum standards for economic regulation to be met by all jurisdictions. Minimum standards should be developed around
 - Establishing regulation which is independent from Governments
 - Setting a clear objective for regulators to act in the long term interests of customers
 - Establishing incentives for productivity and innovation
 - Assessment of financial viability as a cross check on that revenue is sufficient revenue to cover efficiently incurred costs over time.
 - Strong and transparent customer engagement within the regulatory framework
 - Merits review and appeal mechanisms for water businesses and other stakeholders.

1.0 Introduction

The Water Services Association of Australian (WSAA) is the peak body representing the urban water utilities in Australia and New Zealand. Our members provide water services for over 20 million people. The industry manages assets with a value of over \$120 billion and has annual revenue of around \$15 billion.

While the urban water industry has always worked closely with the private sector, it remains that most urban water infrastructure is government owned. However, there is growing interest from within the industry and from policy makers in new forms of private involvement and WSAA's private utility membership is growing. Interest in private involvement includes:

- Extending outsourcing and alliancing models
- New forms of private financing of water infrastructure
- New private entrants to service different parts of the water market
- Sale of existing assets or businesses

WSAA does not take a position either in favour or against privatisation. These decisions are properly a matter for Governments as shareholders. However, WSAA is well placed to provide information and analysis on the complex issues that private involvement raises. Our aim is to create a platform for good decision making by us and our governments. In previous public submissions, including those to the National Water Commission and the Harper review of competition policy, WSAA argued that private involvement must be assessed against a benchmark of whether it preserves and enhances the public and private value generated by the urban water industry. This is still our position.

In this context, WSAA welcomes the opportunity to respond to the Senate Inquiry: Privatisation of state and territory assets and new infrastructure. WSAA notes the terms of reference for the inquiry and our submission specifically comments on parts a, b and c of the terms of reference. These are:

(a) the role of the Commonwealth in working with states and territories to fund nation-building infrastructure, including:

- (i) the appropriateness of the Commonwealth providing funding, and
- (ii) the capacity of the Commonwealth to contribute an additional 15 per cent, or alternative amounts, of reinvested sale proceeds;

(b) the economics of incentives to privatise assets;

(c) what safeguards would be necessary to ensure any privatisations were in the interests of the state or territory, the Commonwealth and the public;

2.0 Role of the Commonwealth

Urban water is and will remain primarily as state responsibility. However, over the last year WSAA has been advocating for a greater leadership role by the Commonwealth Government through the Council of Australian Governments (COAG) to drive urban water reform. To a large extent the reforms necessary in the urban water industry are necessary regardless of ownership in the industry. However, it remains the case that without reform further privatisation will be constrained, or would not create additional value for customers and the community.

In essence a national approach is desirable for three reasons:

- to improve regulation of the industry, particularly economic regulation, to ensure it meets the long term interests of consumers
- to establish the preconditions necessary to ensure that greater private participation in the industry delivers net benefits to consumers and the community
- to resolve the scope for competition in the industry.

These issues are explored further under b and c of the Inquiry's terms of reference.

Therefore in relation to part (a) of the terms of reference, WSAA supports a national voice for urban water, noting that the need for national action extends beyond privatisation. As discussed below, WSAA recommends a national urban water agreement through the COAG to further the reform process. There is an opportunity to build on the existing National Water Initiative and put in place clear minimum and agreed standards for economic regulation to be met by all jurisdictions.

While we consider consistency across the State-Based regulators is important via a national agreement, at present we do not think a clear case has been made for a national regulator, however it is something to consider in the future.

Appropriateness of Commonwealth funding

The terms of reference asks about the appropriateness of the Commonwealth providing funding. The Australian urban water industry led the world in putting in place user charging, and particularly consumption based charging for water. It is appropriate that water and wastewater users fund the infrastructure they rely on every day.

In this context for most urban water infrastructure there is little role for the Commonwealth to fund infrastructure. However, there are exceptions. The key exceptions are likely to be in regional areas, where the difficulty of funding capital infrastructure is often acute. These problems can be compounded in areas where communities have a particular environmental impact on sensitive water ways yet lack the revenue base to fund the capital necessary to address these impacts. The Commonwealth may also consider that it has special responsibility to fund water infrastructure for indigenous communities in line with its broad indigenous role.

Commonwealth contribution to encourage capital recycling

Part (a)ii of the terms of reference asks about the capacity of the Commonwealth to contribute an additional 15 per cent, or alternative, amounts, of reinvested sale proceeds.

While this may be viewed as a form of Commonwealth contribution to infrastructure to encourage privatisation, WSAA considers that it is important to distinguish the role and rationale for such a payment. Such payments may be viewed as overcoming an impediment to privatisation by the national tax equivalent regime.

Capital recycling and the national tax equivalent regime.

Most corporatised government owned businesses, including water utilities, operate under the National Tax Equivalent Regime (NTER). The primary objective of the NTER is to promote competitive neutrality¹, through a uniform application of income tax laws, between the NTER entities and their privately held counterparts. The NTER is a successful element of the corporatisation model. It is an administrative arrangement under which relevant Commonwealth taxation laws are applied notionally as if they were subject to those laws.

Corporatised water utilities are assessed annually as to their income tax equivalent liability and pay the liability to the state government treasury instead of the Commonwealth Government.

As a result a state government receives two revenue streams from their businesses. It receives dividends as the shareholder and they receive the income tax on profits that an equivalent private company would pay to the Commonwealth Government.

If assets belonging to a corporatised entity are sold to the private sector, the income tax liabilities would then be paid by the private company to the Commonwealth. The state government potentially loses part of the revenue stream associated with the assets. There is no loss of value associated with the transfer

¹ Competitive neutrality between public and private water utilities is affected by a range of factors including operating licence conditions and rate of return requirements, as well as taxation.

— what the state government loses the Commonwealth Government gains. However, the loss of the tax stream to the state government weakens the incentives to undertake such transactions.

A number of state governments have suggested that the Commonwealth and states should reach agreement on sharing of the tax revenue stream to overcome this potential impediment.

3.0 Economic Incentives

Part (b) of the terms of reference asks about the economics of incentives to privatise assets.

Just as the incentives in the capital recycling legislation are intended to overcome impediments within tax system to privatise assets, WSAA considers that the Commonwealth's role should focus on removing impediments to reform. As a general public policy principle it is better to first remove impediments to reform before considering whether additional incentives are necessary.

Urban water invests for the long term in assets with very long lives. For privatisation to deliver benefits to customers, the industry needs to be able to access long term low cost capital. If Commonwealth and State Governments wish to create an attractive environment for private investment it is necessary to provide greater predictability, consistency and transparency in the urban water policy environment. Two aspects of that environment are critical:

- improving economic regulation -- over the last year WSAA has identified the economic regulation of urban water as a key impediment to reform.
- defining the market structure, including the scope for competition and contestability.

Improving economic regulation

Over the last year WSAA has drawn attention to the need for better economic regulation of urban water. Since its first submission to the Competition Policy Review it has released a flagship report on *Improving economic regulation of urban water in Australia*.

Water utilities occupy a privileged place as the suppliers of essential services with the need to balance commercial, social and environmental drivers while having many monopolistic characteristics. Economic regulation provides protection and assurance to customers and discipline on utilities to demonstrate that they are efficient.

Economic regulation has played an important role in the industry's development and it needs to continue to evolve to meet future challenges. These challenges include adapting to climate change, providing for significant population growth in cities, and maintaining and renewing ageing assets while maintaining the affordability of services. This will require greater flexibility in the regulatory framework to manage uncertainty while keeping costs down.

WSAA commissioned Frontier Economics to review the economic regulation of the urban water industry in Australia and identify improvements that would be in the long term interests of customers and stakeholders.

Governments and local governments, typically the shareholders of utilities, can be conflicted in their role as owners, policy setters and having a quasi arms-length role in economic regulation.

WSAA considers that current economic regulation:

- Can be improved to support utilities to move from a compliance culture to a customer focus
- Does not provide sufficient incentives for innovation and productivity

- Needs focus more explicitly on ensuring that that utilities have the long term financial viability to renew and maintain assets without imposing unexpected price increases on customers
- Is not sufficiently predictable, transparent and consistent to enable private investment in the future.

Key findings

The Improving Economic Regulation Report identifies significant gaps in the regulatory frameworks across Australia compared to best practice, the key priorities for reform are:

Establishing regulation which is independent from Governments	This is necessary to ensure regulators are free from undue influence that could compromise regulatory outcomes. It is also important that regulators can determine prices rather than just recommend.
Setting clear objectives for regulators to act in the long term interests of customers	Lack of clarity in objectives leads to inconsistency in decision making and lack of accountability.
Establishing incentives for productivity and innovation	Productivity and innovation are necessary for utilities to drive further efficiency gains. In addition, future efficiency and innovation will be driven in part by greater private involvement in the water industry and by adopting new business models.
Assessment of financial viability to protect the long term interests of customers	The sector needs to be financially sustainable to maintain service levels over the longer term. Regulators need to incorporate financial viability metrics into the price determination process.
Strong and transparent customer engagement within the regulatory framework	Utilities need to better understand customer needs and what drives customer value. It is critical that this understanding is part of the regulatory process.
Merits review and appeal mechanisms for utilities and other stakeholders	These are essential to ensure accountability of regulators for their decisions and are a precondition for further private involvement.

The findings are not surprising, nor controversial, and highlight that no one jurisdiction has it completely right. Some jurisdictions meet most elements of a best practice model, but no jurisdiction meets them all. For example, of the eight regulatory jurisdictions:

- Only four have clear objectives
- None has well developed incentives for productivity and innovation
- Only two have (recently) begun to consider financial viability of utilities
- Only two jurisdictions have merits appeal processes.

WSAA recommends a national urban water agreement through the Council of Australian Governments to further the reform process. There is an opportunity to build on the existing National Water Initiative and put in place clear minimum and agreed standards for economic regulation to be met by all jurisdictions.

Further WSAA recommends that minimum standards be developed around:

- Establishing regulation which is independent from Governments
- Setting clear objectives for regulators to act in the long term interests of customers

- Establishing incentives for productivity and innovation
- Assessment of financial viability to protect the long term interests of customers and stakeholders
- Strong and transparent customer engagement within the regulatory framework
- Merits review and appeal mechanisms for water businesses and other stakeholders.

3.1 Competition and Contestability

Part of identifying future private involvement in urban water is considering the scope for competition. Private investors will need certainty about the market structure and scope for competition in each jurisdiction before committing funds. WSAA has previously identified the key steps that need to happen, most recently in our submission to the Competition Policy Review (Harper Review), and these still ring true.

A national approach is also necessary to resolve the appropriate role for competition in urban water. State action to date has been piecemeal. The Water Industry Competition Act in NSW is most advanced but still lacks a vision for the market structure. From an efficiency perspective, it is necessary to pool resources and expertise to progress these complex issues.

The Productivity Commission (PC) examined the role of competition in urban water in its 2011 Report, concentrating on the bulk water sector. WSAA considers that the PC reached a balanced view. The PC saw a case to 'introduce greater competition and promote innovation where cost effective' and considered the gains could be substantial, particularly for bulk water supply. However, it noted:

The potential gains in urban water are likely to be more modest [than other utility industries] because:

- limited forms of competition have already been introduced through contracting out and build, own and operate arrangements
- compared with other utility sectors, a greater proportion of costs are in natural monopoly elements of the supply chain (for which competition in the market would be inefficient) (p. 245).

The PC reached the conclusion that competition is unlikely to 'naturally' develop in urban water. It also questioned whether the benefits of established competition via administered markets outweighed the costs at this time.

WSAA was pleased that the PC recognised the complexities of the water industry. A significant proportion of the services in the water industry are subject to competitive tendering (competition for the market), and the industry has shown a preparedness to work with new players. However, competition in the market in its traditional form is more difficult to introduce in the water industry than in most industry sectors and is challenging even by infrastructure sector standards. The UK is introducing retail competition for non-residential customers. Retail competition in Scotland illustrates that competition can co-exist with public ownership of utilities. However WSAA notes that in Australia, the retail segment is a very small proportion of the total value chain and comprise less than 5% of the total bill. This means that bill reductions are unlikely in a retail-only competition model.

Contestability of service provision (competition for the market) in new growth or infill areas is the most likely form of competition in the short term.

The NSW Independent Pricing and Regulatory Tribunal has also recognised that national consistent principles should guide the development of competition in urban water.

This is significant as by virtue of the Water Industry Competition Act, NSW and IPART are the most advanced in considering competition in urban water, yet recognise there are still benefits in a national approach.

4.0 Safeguards

The urban water industry is entering a new era of greater engagement with, and focus on, meeting our customers' needs. This is possible due to the solid foundations that have been built over many years to ensure the urban areas of Australia have resilient, diversified and high quality water supply.

However there is always scope for improving customer value.

As set out the key preconditions for privatisation is improved economic regulation. WSAA has always accepted the key role that economic regulation plays in protecting customers and promoting better outcomes.

The objective of economic regulation should be to protect the long term interest of customers. Likewise, environment regulation and protection of public health should operate seamlessly with economic regulation to deliver value to the wider community.

In considering safeguards we reiterate our earlier statement that the changes that need to happen in the urban water industry need to happen regardless of whether ownership changes. Better economic regulation and more clearly defined markets are necessary to ensure that customers continue to get the best possible services from their water and wastewater industry. It is also these changes that are necessary to create a stable climate to encourage further private involvement.

Contact details

WSAA welcomes the opportunity to provide a submission to the Inquiry on this matter. If there are any details you wish to follow up on please contact:

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