

## **Regulation and Reform: IPART after 20 years**

### **Urban Water the Future – price mentoring or regulation?**

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On the 20<sup>th</sup> anniversary of IPART, I thought it appropriate to begin with some of my own reflections on the circumstances surrounding the genesis of the Government Pricing Tribunal, as it was first known.

Although not a Sydney or NSW resident at the time, I was a frequent visitor from my then home in London.

My consulting work in those days was focused on advice to the England and Wales water utilities, which had just been privatised under the reforms of the Thatcher era.

So, when the corporatisation of the then Water Board was first mooted by the Greiner government, the then CEO Bob Wilson sought out me and my NERA colleagues in London to advise him during the NSW corporatisation process.

The creation of the Government Pricing Tribunal took place during the early part of this period and, through my work for the Water Board, I was drawn into the early policy design process for the organisation that is now IPART.

Although this was 1992, we heard from Gary Sturgess and Percy Allen last night that the idea of independent economic regulation of government-owned infrastructure service providers had been under development inside the NSW government for some time, and in fact as far back as 1988, when Nick Greiner was in opposition.

But there was one element of the process not mentioned, but which has stuck clearly in my mind ever since.

In 1992 NSW had a minority government; the then opposition introduced a bill on utility pricing – the essence of which was to lock-in annual increases in prices for utility services at no more than CPI, indefinitely.

This apparently seductive proposal presented the Greiner government with both a challenge and an opportunity.

And so the legislation establishing the Government Pricing Tribunal was in fact introduced as a means of heading off a political initiative from the opposition that clear thinking people could see was economically crazy.

At the time, the Government Pricing Tribunal was the first example in the world of arms' length economic regulation of publicly owned utilities.

There was no question in my mind that, at the time, a fresh, independent, analytical perspective was needed for NSW utility pricing.

In those days the Water Board had major pricing problems.

Notwithstanding that meters were installed, and read each quarter, property value was the dominant basis for collecting Water Board revenue; the idea of paying according to what the meter read was heresy.

I also recall observing during my frequent visits to Sydney the widespread but strange habit of citizens using hoses instead of brooms to clean driveways, streets and so on – as if water was a free good with unlimited availability, which of course to end users, it was!

The Water Board had a major section of people focused on trying to clean up the mess that was water pricing, but it was clear that all the decisions were simply made by the politicians, with the usual unhealthy mix of objectives.

It remains the case today that Australia has a very distinct position globally in terms of its institutional framework, whereby economic regulators run open, transparent, and independent processes for setting tariffs for utility services, irrespective of whether they are provided under public or private ownership.

These arrangements are supported by the 1994 Competition Principles Agreement, and particularly its requirements for competitive neutrality in the way GTEs are regulated in product markets.

Regulation applies, irrespective of ownership, and so we have, for example:

- the AER regulating government owned as well as privately owned energy networks;

- a combination of the ACCC and state regulators setting terms and conditions for access to rail network infrastructure (again, some government owned, some not);
- some state regulators (ESC, ESCOSA, QCA), although not IPART, operating regulatory regimes for ports, and some port terminal infrastructure; and
- state regulators setting water service charges.

Nevertheless, the Productivity Commission's (PC) review of urban water sector has raised the question of whether we need price's control of urban water that is under government ownership (as it all is), recommending that:

“Regulatory price setting should be replaced with *price monitoring*”

The PC cites the success of the airports price monitoring regimes as a case in point, but does not mention that a typical airport has a handful of paying customers (airlines), whereas a typical water utility has hundreds of thousands.

The PC also recognises that there is significant room for further reform of the urban water sector in general, suggesting that:

“the early policy priority should therefore be on establishing clear roles and objectives, improving institutional performance and governance, competitive procurement of supply and pricing reform...” (Banks, 2012)

These are undoubtedly worthy reform objectives, and sound very much like the agenda that was behind the corporatisation reform of the late 1980s in New Zealand and which moved to NSW in the early 1990s.

But there is one very important distinction, in that the PC also recommended that the role of the economic regulator of urban water services should be replaced with (and I quote):

“...a charter between the government and the utility that includes a number of principles, and open and transparent processes and procedures, which are similar to those applied under economic regulation.”

The PC's reasoning for this recommendation is uncharacteristically thin, but goes along the lines of:

“economic regulation is about prevention of the misuse of market power”

“formal price setting controls are costly and can inhibit innovation”

Whereas:

“government ownership “(which the PC recommends should continue)

in combination with:

“a charter between the government and the utility”

should:

“minimise the risk that market power will be misused or that production costs will be excessive”

In a similar vein, Stephen King suggested at the recent ACCC regulatory conference that monopoly price regulation for GBEs was:

“virtually indistinguishable from optimal taxation, so, why bother?”

At the same conference, Gary Banks has observed:

“With the best will in the world, price regulators will generally not be able to correct for problematic policies implemented elsewhere, which need to be tackled directly”

And:

“Given that prescriptive price regulation has to date been singularly unsuccessful in promoting efficient water procurement and service delivery, there is a strong case for trying the alternative”

In my opinion, these suggestions are not well founded.

I began this address by recollecting some of the very serious problems that beset Sydney Water when I first came to know it twenty years ago.

To my mind, the essential cause of those problems was clear at the time:

- government ownership - no private business could justify the pricing distortion that existed then, let alone many of the organisational inefficiencies that also existed at the time; and
- a high level of day-to-day government meddling in the objectives and operations of what should, essentially, be a commercial operation.

So, my first source of disappointment with the perspective put by the PC is its explicit support for continued government ownership.

I appreciate that private ownership of water is a touchy subject, but I thought the role of the PC was precisely to bring our attention to the very significant trade-offs and costs we incur in maintaining politically convenient arrangements, such as continued government ownership of water.

If Rod Sims - who does live in a much more politically sensitive world than the PC - can call for privatisation of electricity networks, why cannot the PC remind us what we all know in our own hearts – that the private sector is just better at running infrastructure businesses.

My second source of disappointment in the PC's conclusion is:

- its rather narrow interpretation of the role of economic regulation, ie, as purely serving the function of preventing the misuse of market power;

in combination with

- its inattention to the literature on the economics of institutional design and its importance for performance outcomes.

The PC's essential proposition is that a charter between a water utility and a Minister can do better than arms' length, formal price regulation.

Let me be clear, if we must continue in a world of public ownership of water utilities, I fully support any measure that:

- establishes clarity between government and utilities as to its objectives as regards service delivery;
- preferably, establishes clarity, under separate arrangements, as to its commercial objectives (given the agreed service delivery standard); and
- if private ownership is not an option, includes requirements for extensive, arm's length procurement of inputs.

These kind of reform objective have been around for nearly 30 years in the form of the corporatisation model for GTEs, and we should be thankful to the PC for reminding us of them.

However, the very experience of corporatised GTEs should lead the PC to be highly sceptical of its own suggestion that Ministers will be willing instigators of and participants in:

- processes and procedures for choosing supply augmentation options that are transparent, and involve (meaningful) public consultation;
- processes for setting prices (for which those supply augmentation options are a critical input) that are transparent, and involve public consultation

We don't need to look far to see examples of Ministers systematically seeking to keep such processes anything but transparent:

- try asking for the cost benefit analysis that underpinned the NBN;
- try asking for the cost benefit analysis that underpinned any of the major desalination plants that have been or are being built in each major capital city in Australia, or
- try asking a Minister to run a public consultation process on pricing proposals, in the manner that is frequently overseen by IPART and other economic regulators.

The PC's response to these observations is more or less along the lines that:

“...with the best will in the world, price regulators will generally not be able to correct for problematic policies implemented elsewhere, which need to be tackled directly.” (Banks, 2012)

At one level, this is a very reasonable statement – no, price regulation cannot solve all the policy-related problems that we have in the water sector or, for that matter, the electricity sector.

However, a better question to ask might have been:

Can price regulation assist with maintaining or strengthening transparency and accountability in relation to our water sector utilities?

Or, better still:

Are there areas where price regulation can be strengthened, in order further to mitigate the risks of bad policy outcomes?

For example, in the electricity network sector (much of which is publicly owned, including in NSW), which is subject to regulation under a national framework of economic regulation:

- any significant investment in new (not replacement) transmission or distribution infrastructure is subject to a public cost benefit test (the RIT-T or RIT-D).

That cost benefit test has great significance from two perspectives:

- it forces transparency around major investment decisions; and
- it carries with it the implicit threat that any investment made that does not meet the test will not be recoverable through customer prices.

In my opinion, rather than a set of recommendations for urban water that, in large part, ask all the existing players and institutions to keep doing the same thing but do it better, it would have been more helpful for the PC to have contemplated:

- a strengthening of the breadth of economic regulation, the principal purpose of which would have been to make it harder for government owners to mandate investment decisions that, quite probably, entail a great deal of inefficiency.

This is effectively what we have in place for electricity networks.

Taking an alternative perspective, if one turns the PC's reasoning on its head, it is not obvious to me why it is also not calling for the elimination of price controls and its replacement with price monitoring for *electricity networks* in those states where public ownership remains.

If the PC's principle that "public ownership means that price monitoring would be better than price control" is good for water, why does that same principle not extend to electricity networks?

I believe the analysis should be turned around.

What can be learned from the national framework for electricity network regulation that might assist improved performance of water sector regulation?

To me, a clear ‘learning’ from the national electricity rules is the merit of regulatory oversight applied to major investment decisions. That being the case, why should we not contemplate the national harmonisation of water sector regulation, along the lines of the national electricity or gas rules?

The PC points out the high cost of administering price controls for water (and in general), and I agree we should be constantly vigilant in seeking ways to limit regulatory creep, and make processes more efficient.

However, my strong suspicion is that a beefed-up electricity network style framework of economic regulation that reached into investment decision-making processes in the urban water may well have prevented just one of the many, multi-billion dollar desalination plants that have been built around the country from going ahead (or even slowed its timing).

If that had been the case, the economic cost of administering the current framework of water sector price controls would have paid for itself many times over.

Thank you.

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