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Dear Mr Roberts

REVIEW OF WESTERN AUSTRALIA'S WATER SERVICE LEGISLATION: DRAFT REPORT

The Economic Regulation Authority (**Authority**) would like to thank the Department of Water for the opportunity to contribute to the Review of Western Australia's Water Service Legislation. The Authority welcomes this opportunity to highlight some key features of the economic regulatory regime for water services in Western Australia and to provide comments on the governance issues raised in the Draft Report (**Report**). The focus of this submission will be on the regulation of water service providers and the role of the Authority in this regard.

The Functions and Role of the Authority

The Authority was established by Government on 1 January 2004 as an independent regulatory agency which now has two principal functions. The first is as the State's independent economic regulator, involving the administration of industry-specific legislation in the areas of water, gas, electricity, and rail. The Authority is responsible for regulating the terms and conditions of access (including prices) to rail track infrastructure, gas pipelines and electricity networks. The Authority is also responsible for the licensing and monitoring of water, gas and electricity service providers and monitoring of rail track service providers.

The second function of the Authority is to undertake economic inquiries referred to it by the State Government. This second function is similar to that of the Productivity Commission at the federal level.

A further function formally commenced on 21 September 2006 when the Authority assumed responsibility for market surveillance of the Western Australian Wholesale Electricity Market.¹ The Authority also has a number of other market related activities in both electricity and gas relating to competition in those markets and market rules.

In performing these various functions, the Authority seeks to produce outcomes that promote fair prices, quality services and choice for the long-term benefit of all Western Australians.

The Authority is mindful of the importance of water resources and services to the future economic development of Western Australia. The Authority has undertaken a number of inquiries and reviews relevant to water services, including:

- Inquiry into Urban Water and Wastewater Pricing;²
- Inquiry into Country Water and Wastewater Pricing;³ and
- Inquiry on the Cost of Supplying Bulk Potable Water to Kalgoorlie-Boulder;⁴

The Authority is currently undertaking two further inquiries namely:

- Inquiry on Harvey Water Bulk Water Pricing, Draft Report issued 14 December 2006 (*current*);⁵ and
- Inquiry on Water Corporation's Tariffs (*current*);

The Authority has two major avenues to facilitate the efficient provision of water services. These are the inquiry function into water prices and the monitoring of water service providers' compliance with licence conditions, including in relation to operational audits and reviews of asset management systems.

The Authority's Licensing Functions

Licensing is the conferring of a right to undertake a specified activity (or activities) generally in exchange for a fee as well as compliance with certain conditions. In the case of utility licensing, the conditions are largely specified by Government with the licensing system generally administered by an independent regulator.

The Authority's licensing role includes:

- determining various customer protection arrangements and service standards, such as standard form contracts, codes of conduct, customer service charters and supplier of last resort provisions;
- designing licences that apply the Government's service standards;
- assessing whether prospective licensees conform to the eligibility provisions in the relevant legislation;
- issuing licences to suppliers that are eligible to hold a licence;
- monitoring and enforcing licensees' compliance with their licence obligations; and

¹ These functions include determining the allowable revenue for the Independent Market Operator and Western Power's System Management, the annual approval of price limits for reserve capacity and energy and, with the assistance of the Independent Market Operator, monitoring the short-term electricity market.

² <http://www.era.wa.gov.au/water/urbanWater.cfm>

³ <http://www.era.wa.gov.au/water/countryWaterInquiry.cfm>

⁴ <http://www.era.wa.gov.au/water/kalBulkWaterInquiry.cfm>

⁵ <http://www.era.wa.gov.au/water/harveyWater.cfm>

- informing the relevant responsible Minister(s) about any failure by a licensee to meet licence requirements and reporting on the operation of the licensing schemes.

The Authority's statutory power to carry out its functions with regards to water services is provided by the following legislation:

- *Economic Regulation Authority Act 2003*; and
- *Water Services Licensing Act 1995*.

Water Regulation

Much of the infrastructure in the water sector has natural monopoly characteristics that may be provided at least cost by a single business and without duplication of infrastructure. However, a consequence of this feature is that there is a lack of competitive incentives for efficiency and innovation in provision of the services. While the existence of natural monopoly may necessitate some degree of regulation, this need not, however, preclude the development of a commercially based industry including, in some parts of the business, competitive trading mechanisms.

The regulatory structure for the State water sector separates the responsibility and accountability for licensing and monitoring the provision of water services from the allocation of water resources. The Authority is responsible for licensing water services providers, while the allocation of water resources is licensed by the Department of Water (**DoW**). The role of the Authority is to grant (and amend where necessary) licences for the delivery of services in the water industry and to monitor water licensees' compliance with their licence conditions. The Authority has established consistent licensing procedures, including requiring licensees to provide regular reports on the effectiveness of their asset management systems and audits of their compliance with licence conditions.

The Authority has also reviewed its licensing functions aimed at reducing regulatory burden and complexity, improving efficiency and achieving desired outcomes more effectively.

Furthermore, the Authority as a multi-utility regulator (water, gas, electricity and rail) minimises the risk of undue influence by any specific industry sector and of duplication or overlap of regulatory requirements.

The natural monopoly characteristics of the water industry – large sunk costs that make duplication of infrastructure by more than one provider uneconomic – means that appropriate regulation will enhance market efficiency and service quality. The advantage of a legislative framework which supports an independent regulator providing advice to Government on water pricing (rather than a system of ad hoc references from Government) is that it provides industry stakeholders with a transparent, predictable and stable framework for price setting.

The Authority has no formal role in the regulation of prices in the water sector except through its review functions at the request of Government. In Western Australia, the Minister for Water has the statutory authority to set water and wastewater prices for some licensees as part of the State budget process.

The Authority has assisted the Government (in the 2006/07 budget process) in the setting of water prices by undertaking an inquiry into urban water and wastewater prices, which included recommendations that were largely accepted. In addition, the Authority has recently provided recommendations on country water and wastewater prices, which will be considered during the 2007/08 budget process. The Authority's role is consistent with the National Water Initiative (NWI)⁶ recommendations which requires an independent regulator

⁶ The NWI is a joint commitment between the Federal and State governments to water reforms, with the aim of managing water resources in a way that results in optimal economic, social and environmental outcomes.

to either set or advise on water prices. Further, the Government has recently referred to the Authority an annual inquiry on the most appropriate level of tariffs for the Water Corporation.

The Authority's Response to DoW's Draft Report

In November 2006, the Authority provided feedback on an issues paper prepared by DoW on this topic. The overall principles and underlying assumptions presented in that paper appear to have been expanded and developed in the Draft Report.

The Report focuses on the areas in the existing water service legislation that DoW considers is in need of change and improvement. Reflecting this point, the Report notes that "a number of policy issues need to be clarified in order for the legislation to be developed". The Report presents 23 key recommendations regarding these policy issues, namely recommendations on regulation and governance of water service providers and the powers required by service providers to efficiently provide water services. The Authority has only provided comment on the recommendations most relevant to regulation. Accordingly, the Authority provides the following views set out below for consideration by DoW.

REGULATION

DoW RECOMMENDATION 1

That the Minister for Water Resources be given the capacity to regulate prices for all licensed services providers by order published in the Government Gazette.

It needs to be recognised that some licensees are, or could be, private entities, co-operatives or Local Government Authorities. The legislative mechanism to provide for the Minister to set prices in these cases will need to be carefully considered.

To date, the Authority has carried out two inquiries into water and wastewater pricing in Western Australia, one for urban centres (Perth, Bunbury and Busselton) and another for country towns. These inquiries were the first independent reviews of water and wastewater prices in the State. Under the current legislative framework, the Authority has no formal role in the regulation of prices in the water sector except through its review functions at the request of Government.

South Australia, Queensland and Tasmania follow the Western Australian model (whereby the regulatory agency carries out reviews on matters referred to them by Government, including water pricing). However, in Victoria, New South Wales and Canberra, the regulatory agencies have a formal role in regulating prices and reviewing pricing policies in the water industry. As water pricing in many cases involves decisions relating to Community Service Obligations most appropriately made by Government, the Authority is comfortable with the approach adopted in this State whereby it advises Government on pricing as opposed to regulating prices.

This recommendation is seen as providing a simplified mechanism to set prices than currently exists. However, the framework for regulation needs clarification. To date, the water and wastewater reviews undertaken by the Authority for the Government have primarily reviewed large suppliers. There is no indication in the Report of any implications for the Authority's existing role in relation to pricing reviews, given that the *Minister for Water Resources 'be given the capacity to regulate prices for all licensed services providers'*. In

addition, the Report also recommends “*that the legislation provide for the establishment of licence classes*” (Recommendation 5). Further details on the regulatory requirements associated with these different licence classes (e.g. whether these classes would require different types of pricing reviews) would be helpful.

Overall, the Authority considers that the primary focus in Western Australia should be on the structure of the water industry. Other States in which independent regulators operate have been through a process of industry restructuring, namely, separation of the functions of bulk water supply from water distribution and retail. A review of industry structure and its impact on competition would greatly enhance any consideration of the pricing role.

DoW RECOMMENDATION 2

That head works and minor works charges should be regulated by the Minister for Water Resources

This recommendation is aimed at developing a consistent approach to setting charges across the State. While the Minister has the power to approve these charges for Water Boards, the Minister does not directly regulate these prices for the Water Corporation.

The Report identifies a function for the Authority in determining the average cost for head works and minor works charges across all providers. Head works charges need to send appropriate signals regarding the costs of development of various forms and in various locations. However, the setting of standard charges can be inefficient and impede competition. The Authority considers that a review is required of head works charges and the extent to which cost sharing arrangements with developers is cost-reflective. The need for such a review was noted in the Authority’s report on *Country Water and Wastewater Pricing in Western Australia* (June 2006).

Consistent with the comment in recommendation 1, consideration will need to be given in respect to the legislative framework for private entities, co-operatives and Local Government Authorities.

DoW RECOMMENDATION 3

That the Minister for Water Resources have (has) the capacity to implement codes, as currently exist for the energy sector

The Report states that due to the Authority being the administrator of the current licensing system:

there is no direct means by which Government can influence the conditions imposed upon licence holders.⁷

In addition the Report states that:

current regulatory arrangements have limited Government’s ability to implement its policy agenda, as it relates to both the behaviour of water service providers and the economic regulation of those providers. The new legislation will aim to ensure that the Government has the ability to directly and unequivocally set the policy parameters that define the responsibilities of existing and new service providers, and the means by which the independent economic regulator will regulate these providers.⁸

The Authority notes that:

⁷ Draft Report, pg 15.

⁸ Draft Report, pg 12.

- The current legislative framework enables Government to determine conditions imposed on licence holders by means of Section 61 of the Water Services Licensing Act 1995 (WSLA), which provides for regulations to be made:

The Governor may make any regulations prescribing all matters that are required or permitted by this Act to be prescribed or are necessary or convenient to be prescribed, for giving effect to the purposes of this Act”.

There is therefore scope for Government to achieve policy objectives, within the current water services legislative framework by making regulations including prescribing licence conditions.

- There is also scope for Ministerial direction in respect to the *Water Corporation Act 1995* and the *Water Board Act 1904*. These Acts provide Government the opportunity to prescribe any matter of the relevant licensee’s operations within the scope of the legislation.

The operations of the Authority in respect of licensing also requires that in every decision relating to the issuing, renewal, transfer or amendment of a licence, the Authority must be satisfied that the decision would not be contrary to the public interest. Matters relevant to the determination of public interest to be considered by the Authority are outlined but not limited to those matters referred to in Section 19(1b) of the WSLA. In particular, Section 19(1b) (g) states the policy objectives of Government in relation to water services that are to be taken into account.

The Authority believes that best practice licensing requires independence from Government, industry and users thereby ensuring impartiality in respect to the issuing of licences and the monitoring of licensees compliance with licence conditions.

Regulations or Codes which prescribe the parameters within which licensees would operate provide for the achievement of broad Government policy objectives in a transparent and accountable way, whilst retaining the impartiality and independence of the licence issuing and monitoring roles.

The Authority supports the implementation of Codes similar to those in the energy sector. The Authority believes that the current model in the electricity sector, whereby Codes are developed, reviewed and amended by either the Authority or the Minister, is consistent with the principles of good licensing practice and is consistent with current practice in other States.

In the electricity sector, the following Codes and responsibilities exist under the *Electricity Industry Act 2004*:

Code Name	Responsibility for Amendment	Review Provisions
Code of Conduct (For the Supply of Electricity to Small Use Customers) 2004	Authority	Pursuant to s81 (1) of the Act, the Authority is to establish a consultative committee to advise it on matters relating to the Code of conduct. The committee is to carry out the review of the Code - s88 (1) of the Act.
Electricity Networks Access Code 2004	Minister	The Minister is to cause a review of the Code to be carried out - s111 (1) of the Act.

Electricity Industry Metering Code 2005	Minister	The Authority may recommend to the Minister an amendment of the Code - clause 9.1.
Electricity Industry Customer Transfer Code 2004	Minister	The Authority may recommend to the Minister an amendment of the Code - clause 8.1.
Electricity Industry (Network Quality and Reliability of Supply) Code 2005	Minister	No relevant provision.

The Authority believes that the responsibilities and provisions in the electricity area provide sufficient flexibility for the Authority to remain responsive to changing circumstances, particularly in the customer protection area (covered mainly by the Code of Conduct) and in pursuing best practice outcomes (e.g. working with stakeholders in developing the Code after the objectives are specified in the Act).

Consistent with gas and electricity licensing, the Authority should have the responsibility to develop and review the Code of Conduct for the supply of water to small use customers. In the gas and electricity legislation, there are specified processes that the Authority must follow in developing and reviewing such codes.

The Authority recommends that DoW provide further information regarding the types of Codes under consideration and their objectives, the consultative mechanisms to be adopted and the respective roles of the Authority and the Minister regarding the development, review and amendment of the Codes. As is the case in the energy sector, each of these matters should be dealt with in the legislation.

In addition, the Authority recommends that the wording of the recommendation be amended to include the Authority, as it is understood that DoW intend the capacity to implement Codes under this recommendation is to be shared between the Minister and the Authority.

DoW RECOMMENDATION 4

That the following definition of a water service be adopted: A water service is an ongoing (1) supply of water to; or (2) removal of sewerage or drainage water from; a customer's property for which a fee is paid, and by the means of conduits or channels. It does not include arrangements where water supply, sewerage or drainage is charged for by a property owner to a tenant as part of a lease arrangement.

This definition endeavours to address historical anomalies around the types of water services exempted from licensing. Currently cartage, bottled water supply and self supply services providers do not require a licence. In the Report, discussion on the rationale for these exemptions is not explicit. The reference in the definition to 'the means of conduits or channels' is a way to exempt these services. However, further complications arise as not all types of exceptions or derivatives are captured in the definition. For example, in practice there are significant differences in licence conditions relating to potable and non-potable water supply. Neither of these types of services are defined in the legislation and the above definition omits to distinguish these forms of supply.

As outlined in the comments for Recommendation 5, further refinement is required to clearly specify the size and scale of operations that would be the subject of the water licensing regulatory framework.

DoW RECOMMENDATION 5

That the legislation provide for the establishment of licence classes.

The Report indicates that licence classes will determine differing obligations and conditions relative to size. The Report states that:

flexibility within the licensing regime is needed to ensure that these conditions can vary in accordance with the nature of the service provided.⁹

The Report notes that licence classes (with the relevant classes separating large organisations from small providers) could provide the flexibility required for the range of water service providers currently licensed by the Authority.

One of the difficulties of the current WSLA is a lack of specification of the minimum size and scale of a water service which would require a licence. The Authority notes that the Report suggests that the requirement to licence some water service schemes (e.g. non-potable supplies) may be a disincentive to the provision of these services and further suggests the obligations of reporting and auditing may outweigh the benefits of regulating service quality.

The current licensing regime, which does not distinguish between potable and non-potable water supplies, provides more than just the setting of service standards. An important additional function is ensuring the effective maintenance of assets used to provide the water service and the compliance of licensees with their licence conditions. A particular problem encountered by the Authority in relation to non-potable water supplies relates to liability. Experience suggests that, without appropriate supervision and monitoring such as that afforded by licensing, there is a significant risk that some households will use non-potable water for potable purposes, exposing the State and local Government to liability in the event of a serious health incident. It is therefore appropriate that non-potable services be regulated and managed in some form, taking account of the size and scale of operation. Again this could be managed by way of Regulation and appropriate licence exemption provisions in the legislation.

Furthermore the licensing reporting and compliance requirements for each type of licence are identical notwithstanding the size and complexity of the particular service. This recommendation is an endeavour to address these problems. Unfortunately, there is insufficient information in the paper to understand how the proposed licence classes will be structured to ensure the regulatory framework will be tailored to the specific needs of each class.

DoW RECOMMENDATION 6

The ERA be given the capacity to specify a water service provider that is to step in to provide services in the event of failure of the licensed service provider for an area.

The Report notes that the Authority may specify an electricity service provider to provide services in the event of failure of the licensed service provider. The report also notes that although this event would be rare in the water industry, such an arrangement would give customers and Government certainty in continuity of supply. If such a scheme is to be developed for the Water Industry then greater understanding of the details and operation of a Supplier of Last Resort (SOLR) would be required.

⁹ Draft Report, pg 12.

DoW RECOMMENDATION 7

That the capacity to exempt service providers from licensing be retained

One of the difficulties of the current WSLA is that it does not provide a framework to determine the criteria on which a service provider might be exempted from requiring a licence. This does present some difficulties when the size and scale of the service provider, including the number of customers, is such that the impost of a licensing regime on the operations of the business does not warrant the regulatory cost. This is currently dealt with in the WSLA by the inclusion of provisions that enable a service provider to be exempted from the licensing scheme, by order of the Governor. As this is a political and Ministerial decision to recommend such an exemption to the Governor, advice on the exemption application is provided by the Department of Water.

Similarly, there is an exemption provision in the *Electricity Industry Act 2004*. The Government has chosen to provide a general exemption by way of Regulation which significantly reduces the administrative burden. Such an opportunity for regulation currently exists in the WSLA that may be applied to the water industry, thus not requiring the specification of exemption criteria within the principal Act.

DoW RECOMMENDATION 8

That the ERA be given the capacity to issue licences with on-going terms subject to licence compliance

Around Australia there are a variety of terms for which licences are issued for the operation of water services. The paper indicates that in Victoria the licence terms are on-going, whilst in New South Wales licence terms are 5 years.

Within Western Australia most water service licences are for periods of up to 25 years. The Authority has on occasions issued shorter term licences when additional information has been required or asset management systems have required major reviews. The capacity for the Regulator to issue licences of various terms has proven to be useful as a mechanism to ensure improvements are made to the maintenance of assets and provision of services.

DoW RECOMMENDATION 9

That the provisions relating to the establishment of controlled areas be repealed, with the requirement for service providers to be either licensed or exempted from the licence requirement to apply throughout the State.

Currently, the Authority does not determine controlled areas within the State of Western Australia but simply operates the licensing scheme within those controlled areas. It is therefore a matter for Government as to the extent of application of the legislation regarding controlled areas.

One of the principal difficulties for Government in repealing the provisions relating to controlled areas is that there are a large number of very small water services operating outside controlled areas that would not meet the technical and financial capability tests for the grant of a licence. It is likely that these services would need to be exempted at the time that the controlled area provisions are repealed.

There are also a number of disadvantaged communities in regional Western Australia with water schemes that do not comply with existing standards. Significant capital investment

would be required before these schemes would be able to meet the technical and financial capability requirements of the WSLA.

The Authority is concerned that granting exemptions to these water schemes could be viewed as discriminatory.

DoW RECOMMENDATION 10

That the ERA be given the capacity to appoint independent experts to conduct audits and asset management system reviews and recover the costs from licensees.

Due to the water industry's high fixed costs and long infrastructure life, effective asset management systems are an important component in ensuring the ongoing viability of water services and delivering the licensed levels of service to the customer.

The Authority uses licence conditions as a means of requiring licensees to provide for an asset management system in respect of its assets. The licence also includes conditions requiring the licensee to provide to the Authority a report on the effectiveness of the asset management system (Asset Management System Reviews) from an independent expert approved by the Authority. These same licence conditions are repeated in respect of conducting audits of the licensee's compliance with licence conditions (Operational Audits).

One of the on-going problems with the current WSLA is the process for the appointment of independent experts to conduct audits and reviews. The current provisions of the legislation do not provide for the Authority, as the interested party, to appoint the independent experts, rather the licensee nominates a preferred expert to the Authority for its approval.

In most other similar jurisdictions nationally and internationally, it is the Regulator that appoints the independent expert to undertake an audit or review. This framework provides for much greater independence and rigour of the audit process. Under the current arrangement the licensee becomes the principal of the contract, with the Authority simply the recipient of the report. The contractual relationship established between the licensee and the auditor provide a means for the licensee to influence the independent expert's report prior to it being submitted to the Authority. The Authority supports legislative change providing for the Authority to appoint the independent expert and recoup the cost of audits and reviews from the licensee.

DoW RECOMMENDATION 11

That a provision be included in the Bill that enables the ERA to ensure that the licensee keeps records that allow the ERA to determine the ongoing financial position and technical capacity of the service provider.

Currently, the Authority must be satisfied that an applicant has, and is likely to continue to have, the technical and financial capability to provide the water services. This means the Authority currently assesses the technical and financial capability of applicants at the point of application for Licence.

Once a licence is issued there are performance reporting requirements on the licensee. These include incident reports (where the licensee has been unable to supply the services or specified incidents have occurred) and the obligations in the National Performance Framework. In other industry areas licensed by the Authority (notably electricity and proposed for gas), there is an obligation in the licence for the licensee to notify the Authority within 2 business days of any change of circumstance that could impact on the service that has been licensed. It is intended that water licences will be redrafted to achieve consistency across licensed industries. When this occurs, a similar obligation to notify the Authority of any change of circumstance is likely to be proposed for water licensees.

The Authority also requires ongoing reports, undertakes Asset Management Reviews and Operational Audits to ensure the licensee is complying with the licence conditions. The Authority uses the licence instrument to ensure that appropriate records are provided to the Authority to monitor compliance. The Authority notes also that the Essential Services Commission in Victoria has produced regulatory accounting guidelines for the water service providers it regulates.

One difficulty of Recommendation 11 is that it may shift the onus of responsibility of a licensee to maintain its financial and technical capacity on the Authority. In the event that a service fails, because the licensee is no longer financially or technically viable, Recommendation 11 could potentially leave the Authority open to claims for damages notwithstanding the Authority's best endeavours. Alternatively, if the Authority received information that a licensee is no longer financially or technically viable and acted on that information (to mitigate the risk of a damages claim against the Authority) it could create a regulatory risk for licensees that the Authority might act to shut down a viable licensee because it appeared to lack the financial or technical ability to perform the obligations in the licence.

Finally, there are existing legislative instruments that require organisations to keep appropriate financial and operational records. The important question is what essentially does the WSLA require that is not already provided for? There are also no record keeping requirements to allow the Authority to determine the ongoing financial position and technical capacity of a service provider in the recently proclaimed Electricity Industry Act 2004, and therefore such a requirement would seem inconsistent with current Government practice.

DoW RECOMMENDATION 12

<p>That the Water Service Bill include provisions similar to the <i>Energy Coordination Act 1994</i> to support the performance of a water service ombudsman function. Initially, this function would continue to be supported by the Department of Water.</p>

The Authority supports the concept of an independent water industry ombudsman.

The Authority recommends that DoW provide clarity within the paper regarding this recommendation as issues such as the governance model, scheme approval arrangements and scheme membership arrangements remain unclear. Under the Energy Coordination Act 1994 and the Electricity Industry Act 2004, the governance model of the scheme and these other details are clearly outlined. However, the degree to which these provisions are proposed to be adopted in the new water legislation remains unclear.

GOVERNANCE

DoW RECOMMENDATION 21

That the <i>Water Boards Act 1904</i> be repealed and provisions of the <i>Water Corporation Act 1995</i> be amended to cover the operations of the Boards.

Whilst, in principle, the proposal to amend the legislation governing Water Boards to be consistent with that of the Water Corporation is generally supported, the paper provides little detail on what is proposed. A more thorough review of this matter would assist the provision of more detailed and in-depth comments.

Should you have any queries in relation to this matter please contact Mick Geaney on 9213 1900.

Yours sincerely

LYNDON ROWE
CHAIRMAN