

Better regulation for customers

WSAA position statement on improving economic regulation

August 2014

The Water Services Association of Australia (WSAA) is pleased to release the Report 'Improving economic regulation of urban water'. Elements of a best practice model are set out drawing on regulatory experience from other industries, both here and overseas.

Economic regulation has played an important role in the water industry's development and needs to evolve to meet future challenges. Improvements to economic regulation of water are required to better meet the long term needs of customers. In addition, greater certainty and predictability are a must for more private investment in urban water.

State action alone is not enough. WSAA is calling for a national urban water agreement through the Council of Australian Governments with clear minimum and agreed standards backed by rewards and sanctions to be met by all jurisdictions.

Context

The urban water sector is critical to Australia's economy, society and environment. It provides healthy, safe and reliable water and wastewater services that support Australia's high standards of living and underpin its economic success. The sector delivers services to over 20 million Australians in more than 9 million connected properties. Its annual revenue is over \$15 billion and it manages over \$120 billion in assets.

WSAA's vision for the urban water sector is '*customer driven; enriching life*'. The vision highlights the industry's commitment to anchor its services to customers' values and enrich communities where water services have broad economic, environmental and social values.

The urban water sector in Australia performs well on measures of customer satisfaction. Less than five per cent of complaints to energy and water ombudsmen across Australia relate to water¹. However, the sector recognises that it can always improve.

The role of economic regulation

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. WSAA members understand that 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.

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.

1. Source: Energy and Water Ombudsman Annual Reports 2013 from Qld, Vic, NSW and SA

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

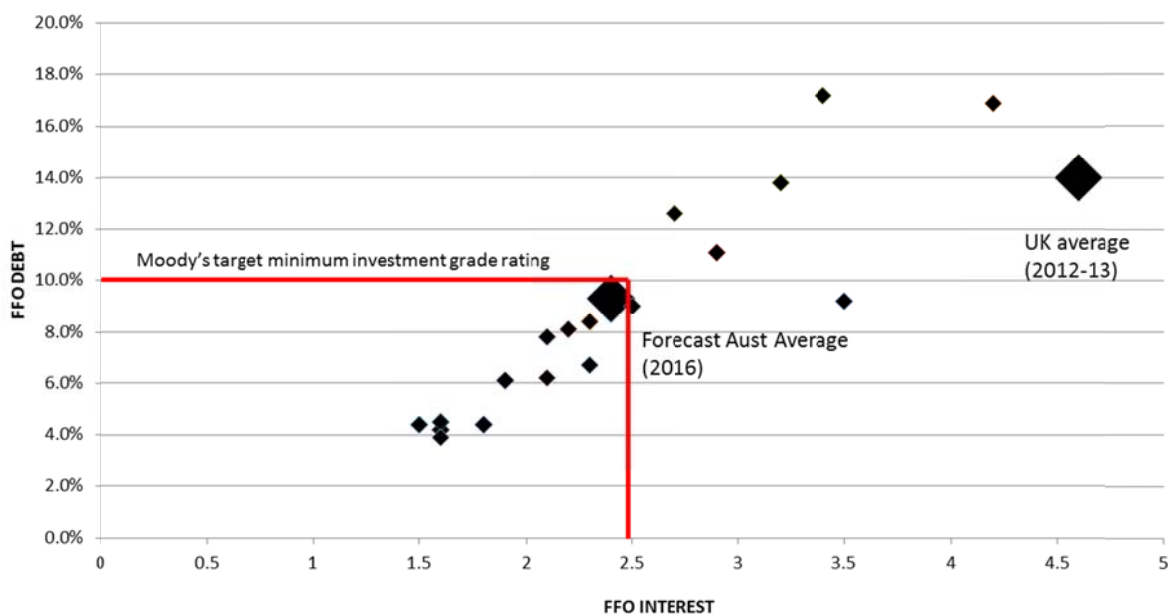
WSAA considers that current economic regulation:

- Does not provide sufficient incentives for innovation and productivity
- Some jurisdictions have requirements to maintain financial viability. Others need to do better to ensure 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.

Financial pressure growing in urban water

The best way to compare the financial health of water businesses is measures used by credit ratings agencies such as Moodys and S&P to assess the financial strength of commercial companies.

These measures show the ability of a business to generate sufficient cash to service its debt. Two important measures are the level of cashflow (funds from operation, FFO) to interest payments and to the total level of debt (FFO debt). In the graph below each point is a water utility.



The graph shows that the average for Australian water businesses is well below the UK. In its last price determination, OFWAT (UK economic regulator of water) set target levels for companies well above the Moody's minimum and UK firms are meeting or exceeding these benchmarks. The Australian average is just within the 'ideal' target level identified by Moodys. However, some water businesses in Australia have little financial room to move if they are to maintain an investment grade credit rating. WSAA's view is that water utilities are long term businesses that need strong credit ratings for resilience against future shocks including climate events.

Source: WSAA Working Paper - Financial stock take of urban water utilities December 2013 (available on request)

Key findings

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

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| 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.

Innovative alternative approaches to regulation

In the UK, regulators such as OfGem and OfWat are testing new frameworks that put customers at the heart of the regulatory process and more emphasis on efficient delivery of outputs.

New developments being tested include:

- The onus on businesses to engage with customers to develop their Business Plans (price submissions to the regulator)
- Rewards for good pricing submissions and sanctions for poor submissions
- Longer price control periods (up to 8 years) to allow businesses to more effectively plan
- Uncertainty mechanisms to mitigate risks that are difficult to plan for
- Assessing the efficiency of expenditure in terms of total expenditure (Totex) instead of Opex and Capex separately.

The Report is intended to be a reference document for governments, regulators and water businesses to lead change over the years ahead and provide a catalyst for early action.

Benefits for customers

Customers are the ultimate beneficiary of reforms to economic regulation. Better economic regulation means:

- Prices are kept as low as possible through:
 - Providing greater incentives for productivity and efficiency
 - Discipline on utilities to demonstrate efficiency
- Services and investments are targeted at areas of highest customer value
- There are greater opportunities for customer engagement and more transparent decision making.

Next steps

Addressing the shortcomings in economic regulation will require action from government, economic regulators and water businesses. Regardless of the future reform path for the urban water industry, good economic regulation is a foundation for a resilient industry to be able to meet the challenges of urban growth, the liveability of our cities and towns and climate change.

The Report sets out the elements of a best practice model for economic regulation of urban water, but does not specify the path to get there. WSAA recommends the following actions for governments, regulators and water businesses.

For Regulators

Consider the transparency of their own processes to increase customer engagement, regulatory incentives and reduce regulatory burden where feasible.

For Governments

State governments have legislative responsibility for economic regulation. WSAA urges all state jurisdictions to consider the improvements to their framework for economic regulation. It notes that a number of reviews are underway. However, even with good will, state action alone is likely to see an uneven and piecemeal approach to reform.

For Water businesses

A focus on further developing and enhancing their engagement with customers and stakeholders with a greater emphasis on demonstrating the link between expenditure and outcomes.

Call for national action

WSAA strongly 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 strongly 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.**