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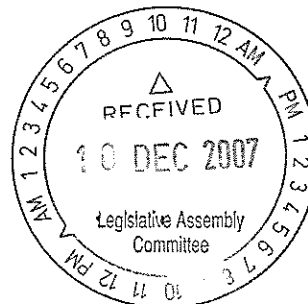
Your Ref: 7658 V1

Our Ref: RF/128/06-01

7 December 2007

Hon. R.C. Kucera, APM JP MLA
Chair
Economics and Industry Standing Committee
Parliament House
PERTH WA 6000

Dear Mr Kucera



PARLIAMENTARY INQUIRY – WATER LICENSING AND SERVICES

Thank you for your letter of 16 November 2007 inviting the Economic Regulation Authority to make a submission to the Inquiry into Water Licensing and Services.

Unfortunately, the Authority is not in a position to investigate this matter in detail, as its inquiry functions are limited to that of formal inquiries referred to it by government under Part 5 of the *Economic Regulation Authority Act 2003*.

However, I note the following points.

- The Water Reform Implementation Committee's *Blueprint for Water Reform in Western Australia* recommended the introduction of a water administration licence fee, and also recommended that the Economic Regulation Authority independently review the structure and amount of such a fee within two years of its introduction and regularly thereafter. The Government, in its February 2007 response to the *Blueprint*, supported these recommendations. It is therefore anticipated that the review of a water administration licence fee will be a matter referred to the Authority by the Government in the form of a future inquiry.
- As part of any such review, it is likely that the Authority would be required to consider the requirements of the National Water Initiative, including the requirement to identify any costs attributable to water access entitlement holders and to ensure that any charges are linked as closely as possible to the costs of activities.
- The National Water Commission, through its Steering Group on Water Charging, is currently finalising a set of pricing principles to promote consistency in charging across jurisdictions, including in approaches to identifying and recovering the costs of water planning and management. The outcome of this process would be relevant to your inquiry. The expected timeframe for this work is for the pricing principles to receive Ministerial endorsement in May 2008, followed by implementation in each State from mid-2008.
- In its 2005 review of Water Corporation tariffs the Authority assessed the appropriateness of a separate fee to cover water resource management activities and concluded in its final report that such a fee, if properly audited for cost efficiency, could improve the transparency and cost reflectivity of water prices. It is likely that this form of analysis could apply equally to that of a water licence administration fee. The relevant sections of this report are attached as **Attachment 1**. The final report is

available on the Authority's website, www.era.wa.gov.au, under Investigations / Past Investigations / Urban Water Pricing / ERA Reports.

- The Authority published a set of guidelines in January 2007 on *Best Practice Utility Licensing*. The guidelines were developed through a public consultation process to determine the principles for best practice licensing, as part of the Authority's reviews of its gas and water licensing regimes. These guidelines may be of practical use in the development of a framework for a water licence administration fee. They are available on the Authority's website, www.era.wa.gov.au, under Licensing / Gas Licensing / Publications.

I look forward with interest to the outcome of the inquiry.

A handwritten signature in black ink, appearing to read 'Lyndon Rowe', with a stylized, cursive script.

LYNDON ROWE
CHAIRMAN

Attachment 1: Extract from Economic Regulation Authority (November 2005), *Final Report on the Inquiry on Urban Water and Wastewater Pricing*:

3.9 Pricing to Reflect Environmental Impacts

3.9.1 Terms of Reference

In relation to the pricing of urban water services, the Terms of Reference of the inquiry require the Authority to investigate and report on:

- *any additional resources needed to meet the required standards of quality, reliability and safety, including such matters as the protection and development of future water resources; and*
- *the need to maintain ecologically sustainable development, including by appropriate pricing policies that take account of all feasible options for protecting the environment.*

3.9.2 Background

The provision of water and wastewater services can potentially cause substantial environmental impacts through, for example, impacts of dams and reservoirs on catchments and aquatic environments, environmental impacts of groundwater abstraction on plant communities and wetlands, and impacts of wastewater disposal practices.

The provision of water services also entails management of catchment areas and groundwater areas for the purposes of protecting water quality.

There are two main classes of initiatives to control environmental impacts and to manage water resources.

Firstly, providers of water and wastewater services are required to undertake activities in accordance with standards and regulatory frameworks that apply generally to business activities throughout Western Australia. The water businesses would incur costs in complying with the relevant requirements, which would comprise part of the capital and operating costs of the businesses.

Secondly, the Department of Environment in Western Australia undertakes a wide range of activities for the protection of aquatic environments and water resources. Some of these activities are undertaken directly for the benefit of water users – for example, catchment management activities to maintain the quality of surface water. Users have a strong incentive to ensure that these activities are undertaken because they benefit directly. Other activities are principally undertaken for “public benefit” outcomes – such as the protection of environmental quality.

The Department of Environment is responsible for allocating access licences to defined volumes of water and use licences which impose obligations and conditions on use. The Department has four main roles:

- resource characterisation – which involves investigating the resources, their relationship to environmental factors and sensitivity to withdrawal;

- water allocation – managing the efficient and fair allocation of water to various uses while maintaining environmental values;
- protection and conservation of water quality; and
- waterways and catchment protection – protecting rivers and wetlands through land use planning, salinity management and floodplain management.

The predecessor agency to the Department of Environment (the Water and Rivers Commission) estimated that in 2002-03, its recurrent expenditure on resource management activities was approximately \$46 million and it had a capital program of \$2.5 million. The Commission's costs are funded almost entirely by the Western Australian Government, the exception being some joint State-Commonwealth initiatives which receive funding through programs such as the Natural Heritage Trust. No resource management costs are recovered from urban water users.

In 1994 the Council of Australian Governments (COAG) agreed to a package of water reform pricing principles which included the need to signal to users a share of the costs associated with managing the resource and any environmental impact costs caused through extractive use. This principle has recently been reiterated by the 2004 National Water Initiative, an inter-governmental agreement which updates and builds on the earlier COAG reforms. Although Western Australia is not a signatory to the agreement, the relevant provisions of the agreement provide guidance to current thinking in Australia on the recovery of resource management costs from water users. Sections 67 and 68 of the National Water Initiative relate to recovery of resource management costs:¹

67. The States and Territories agree to bring into effect consistent approaches to pricing and attributing costs of water planning and management by 2006 involving:
 - (i) The identification of all costs associated with water planning and management, including the costs of underpinning water markets such as the provision of registers, accounting and measurement frameworks and performance monitoring and benchmarking;
 - (ii) The identification of the proportion of costs that can be attributed to water access entitlement holders consistent with the principles below:
 - (a) charges exclude activities undertaken for the Government (such as policy development and Ministerial or Parliamentary services)
 - (b) charges are linked as closely as possible to the costs of activities or products.
68. The States and Territories agree to report publicly on cost recovery for water planning and management as part of annual reporting requirements, including:
 - (i) the total cost of water planning and management; and
 - (ii) the proportion of the total cost of water planning and management attributed to water access entitlement holders and the basis upon which this proportion is determined.

Some States have taken the step of introducing resource management charges for urban water users. For example, urban water customers in the Australian Capital Territory pay a Water Abstraction Charge of 25 cents per kilolitre which covers certain catchment management costs, a notional value of the environmental costs associated with the removal of water from the river system and the value of this water in alternative downstream irrigation

¹ Intergovernmental Agreement on a National Water Initiative, between the Commonwealth of Australia and the Governments of New South Wales, Victoria, Queensland, South Australia, the Australian Capital Territory and the Northern Territory, 25 June 2004.

uses (a measure of scarcity value). The New South Wales, Victorian and South Australian governments also recover some resource management costs from water users.

In Western Australia, the Government's 2003 State Water Strategy opted for a policy of continuing to fund resource management activities from consolidated revenue. However, it committed to investigating the applicability of implementing resource management charges in consultation with stakeholders, considering the possible timeframe, potential impacts and overall applicability of any possible implementation.²

In a submission to the Authority during the course of the current inquiry, the (then) Water and Rivers Commission provided the results of a preliminary investigation it had undertaken into its resource management expenditures and the degree to which these could be attributed to water users. Working off an annual cost base of \$46 million, the Commission estimated that approximately \$15 million of resource management costs are attributable to urban and rural water users. The cost share to rural users was not calculated, but the Commission submitted that this would be a small proportion of the \$15 million.

The Water and Rivers Commission also outlined a proposal for the recovery of resource management costs through water charges. In the absence of reliable cost data at a regional level, the Commission suggested that a State-wide uniform tariff would be appropriate. For Corporation customers, the Commission proposed a volumetric tariff of 4.6 cents per kilolitre, which would be sufficient to recover the \$15 million of costs – based on the 329 GL of water *supplied* by the Corporation in 2003. The Commission further proposed that the charge could be levied to the Corporation, which would pass through the costs to its customers. A three-year staged implementation is suggested, with the tariff initially being introduced at 30 per cent of the full tariff.

In a submission received from the CSIRO, support is given to implementation of a resource management charge. CSIRO's views are as follows:

We agree with the recommendation that the cost of water resource management costs should be passed on to water users...Given that potential environmental impacts – and hence the need for management of water allocation decisions – are positively correlated with total water use, it would appear reasonable to charge on a volumetric basis.

We agree that the use of externality charges to address issues that are not being dealt with through institutional arrangements is problematic, because of the uncertainty regarding the setting of such charges, and the likelihood that resource management can be better achieved through administrative arrangements that address property rights issues. (CSIRO, Draft Report submission, p17)

3.9.3 Authority Assessment

The standards of environmental performance required of the providers of water and wastewater services and the activities undertaken for the management of water resources are determined by Government policies and initiatives that are outside of the sphere of price determinations.

To the extent that the water businesses incur costs in meeting standards of environmental performance, these costs will be reflected in the cost forecasts of the water businesses and thus recovered through prices. The recovery of resource management costs incurred by the Department of Environment is a further matter that is determined by Government policy, which to date has been that these costs be met from consolidated revenue rather than through charges imposed on water users.

² Government of Western Australia, Water Task Force (February 2003), *Securing Our Water Future: A State Water Strategy for Western Australia*.

The Authority is of the view that there is a strong case for a share of efficient resource management costs to be recovered from users, principally to improve the efficiencies of resource use by sending price signals to users about the management costs associated with their consumption.

However, as part of any policy to recover costs, effort should be made to examine whether the current level of resource management is in fact efficient – that is, is enough or too much management being undertaken. This is largely a question of what values the public places on the environmental outcomes of resource management relative to the costs of delivering the outcomes. A second efficiency consideration is whether or not the same level of outcomes can be achieved at lower levels of management cost – a measure of cost-effectiveness. Neither of these questions has been considered by the Authority, as both lie outside of the scope of the current inquiry.

Notwithstanding this, on the issue of efficient costs, a 2003 report by the Western Australian Auditor General into the management of State's water resources concluded that the then Water and Rivers Commission should be provided with a substantial increase in funding to meet its statutory obligations in an environment of growing water demand.³ In its submission, the Commission supported this analysis and projects that to fully implement the principles contained in the National Water Initiative would require its annual budget to be increased by approximately \$20 million. A submission received from the Environmental Protection Authority describes similar sentiments:

In the face of the evidence of dimensions of the required resource management task and the documented performance it is hard not to conclude the water resource management performance has fallen below that required to ensure ongoing sustainable management of the State's water resources. From the environmental protection viewpoint, there is a danger of unacceptable impacts with both quantity and quality. (Environmental Protection Authority, Issues Paper submission, p6)

This would suggest that the estimated cost of resource management activities of \$46 million may be too low.

While the Authority supports the case for attributable resource management costs to be passed through to users, the actual cost share to be recovered from users, and the allocation of these costs to different customer groups, needs to be established in a rigorous and transparent manner. At a minimum, the following matters should be considered:

- Whether or not the resource management activity is being undertaken to rectify the environmental impacts of past use patterns or inappropriate infrastructure (known as "legacy impacts"). If this is the case, these costs might be allocated to government because current users might be inappropriately burdened with the "environmental debt" of past users. To the extent that current users are adding to or exacerbating previous damage – these resource management costs should be allocated to users.
- For those resource management activities that do not fit the "legacy" category, consideration must be given to the proportion that should be passed through to users.
- If the activity is being undertaken principally for the private benefit of water users – for example, improved potable water quality – this cost should be allocated to users.
- If the resource management activity does not fit the "private benefit" category, it follows that the activity must be focused on producing public good (environmental) outcomes. The allocation of these activity costs between users and government

³ Auditor General for Western Australia (September 2003), Control, Compliance and Accountability Examination of Management of Water Resources in Western Australia.

depends on the policy stance taken with respect to who (notionally) holds the rights to environmental quality:

- If all rights to modify the environment have been allocated to water users, then government should pay for measures to address environmental impacts. For example, water businesses are not expected to maintain rivers and groundwater systems in a pristine state. Water extraction implies some modification of the natural environment. In the extreme case, if all rights to modification are allocated to utilities, the government would be required to pay for all remedial activities that seek to restore the environment to a desired condition.
- At the other extreme, if all rights to the environment have been allocated to the public, then water utilities should pay for all resource management activities that seek to address the environmental impacts of water extraction. Currently water utilities must bear the cost of meeting their licence obligations. If the view is taken that all environmental rights reside with the public, the water businesses would also be obliged to pay for any impacts not covered by their licence obligations.
- It is generally accepted that water utilities and other licence holders have some rights to modify the environment, but have a duty of care to maintain a minimum standard which may be set at some specified level at or above the licence requirements. If this view is taken, performance below the minimum standard implies that the user should pay for resource management. However, the public should pay for any environmental demands that exceed the minimum standard. Thus, there is scope for some resource management costs to be shared between government and users. This principle has been endorsed by the National Water Initiative, in which explicit cost-sharing rules have been devised for assigning the cost/risk of reductions in water allocation to users (due to increased demands for environmental flows).

Once the recoverable cost share has been established using these principles, decisions must be made about an appropriate allocation of costs to different user groups and the type of tariff structure to be used. While a uniform, State-wide resource management charge would be administratively simple to implement, the Authority recommends that this option be assessed further to determine whether it would lead to inefficient levels of cross-subsidisation between different regions and/or types of water users. For the purposes of this inquiry, the Authority has not incorporated a resource management charge into the costs and tariffs of the water businesses.

Recommendations

- 11 The costs of environmental impacts caused by provision of water and wastewater services is appropriately passed through to water users through the imposition of regulatory requirements and standards on the water businesses and the inclusion of the costs of meeting these requirements and standards in the cost forecasts for service provision.
- 12 Recovery from water users of the costs of the water-resource management activities of the Department of Environment is ultimately a matter for determination by the State Government. In the event that the Government determines that such costs should be recovered from water users, attention should be given to the efficiency and equity considerations of different mechanisms for recovery of these costs from water users in different regions of the State.