

**PRICING OF REGULATED WATER AND
SEWERAGE SERVICES:
REVIEW OF THE REGULATORY FRAMEWORK**

FINAL REPORT

February 2015



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Water and Sewerage Pricing Framework Review

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Disclaimer

This report has been prepared by Mr Peter Grant PSM at the request of the ACT Government in accordance with the Terms of Reference.

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Mr Andrew Barr MLA
Chief Minister and Treasurer
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Dear Chief Minister

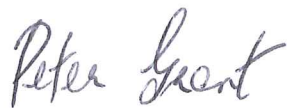
Pricing of Regulated Water and Sewerage Services: Review of the Regulatory Framework

I am pleased to submit my report on the above review, which you announced in your media release of 25 November 2014.

As required by the terms of reference for the review, I have considered both potential improvements to the current framework for the pricing of regulated water and sewerage services and some possible alternatives to that framework. In that regard, I have highlighted some threshold issues which will require consideration by your government in determining the future form of the pricing framework.

I would like to place on record the assistance provided in this review both by the regulator, the Independent Competition and Regulatory Commission, and the regulated utility, Icon Water Limited. I acknowledge also the support provided by your directorate in facilitating the work of the review.

Yours sincerely,

A handwritten signature in cursive script that reads "Peter Grant".

Peter Grant PSM

20 February 2015

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Executive Summary and Recommendations

The ACT's current regulatory system is largely a product of the national competition policy reforms and related regulatory reforms initiated in the 1990s. The ACT Government moved swiftly to implement these reforms, and was one of the first jurisdictions to put in place an independent framework for the pricing of water, sewerage and other regulated services. Legislation for this purpose was passed by the ACT Legislative Assembly in 1997, meaning that independent price regulation of water and sewerage services has now been in place for more than 17 years.

Why an independent regulator?

The dominant rationale for independent price oversight in the urban water sector is that, with most water utilities operating as 'natural monopolies', price regulation is needed to ensure that these utilities do not abuse their market power in terms of either pricing or service standards. In practice, this objective means that the utility must be encouraged to conduct its business as efficiently as possible. There are various ways of seeking to achieve this goal: among them, strong governance arrangements, an effective performance and accountability framework, and robust regulatory processes. No single approach is likely to be fully effective in isolation.

Another important objective of independent economic regulation is to provide a safeguard against the politicisation of pricing decisions. In earlier periods, high levels of government involvement in water pricing often meant that prices were set inappropriately: either well below cost recovery levels or in some cases, for revenue reasons, at higher than efficient levels. The existence of an independent regulator with price-setting powers, operating at arm's length from government, offers some protection against both of these undesirable outcomes.

Economic regulation has its costs as well as its benefits, and it is important that regulatory approaches are designed to maximise net benefits. There is no single 'best' approach to economic regulation which will be optimal in all conditions. Circumstances change over time, requiring regulatory systems to adapt. Even in a relatively stable environment, improvements are always possible to the design and operation of a regulatory system.

Strengths of the current regulatory framework

The ACT's current regulatory framework has a number of significant strengths. The *Independent Competition and Regulatory Commission Act 1997* confers statutory independence upon the regulator and provides a number of protections against external interference in the price determination process. Moreover, as the ACT's independent regulator, the ICRC *determines* the maximum water prices which the regulated utility, Icon Water Limited, may charge; in some other jurisdictions, by contrast, the role of the regulatory body has been advisory rather than determinative, with government still making the final pricing decisions.

The ICRC's arrangements for the determination of water and sewerage prices meet the important test of transparency. They provide reasonable opportunities for public consultation and public

input to the price determination process. They place a strong emphasis on the principle of full cost recovery, the assessment of prudent and efficient costs, and thereby the promotion of efficient prices. Appropriately, also, the ACT's regulatory framework provides a mechanism by which an appeal can be made against a pricing decision of the independent regulator and a review conducted in response to the issues raised in the appeal.

In these and other respects the ACT's regulatory framework compares favourably with the arrangements applying in most other jurisdictions.

Weaknesses and potential vulnerabilities

Notwithstanding these significant strengths, there are also some important areas of weakness or potential vulnerability in the current regulatory arrangements.

Costs are one area of significant concern. Considering all sources of expenditure, including those associated with the current process of independent review of the ICRC's original pricing decision, it seems likely that the total cost of determining the ACT's water and sewerage prices for the regulatory period starting in July 2013 will be close to \$9 million. These costs are ultimately passed on to customers in the form of higher prices.

A total cost in the order of \$9 million is unacceptably high, especially in the circumstances of the ACT: per \$m of regulated revenue, for example, it seems likely to have been the most expensive price determination process ever undertaken in the urban water sector in Australia. There were a number of special factors, including a range of identified inefficiencies, which contributed to the high costs of the latest pricing investigation. Also, the need to undertake an industry panel review of the ICRC's original decision (the first occasion on which such a review has been conducted) has been a significant factor in increasing overall costs. Assuming that the current regulatory framework is to continue, however, costs will need to be contained and better managed in the future.

The timeliness of the regulatory process is another area of concern. The ICRC's latest pricing investigation took longer to complete, from receipt of the regulated entity's business proposal to the making of a final price determination, than the pricing reviews conducted by any of seven other regulators examined in a recent survey. The ICRC itself has acknowledged that the length of its investigation was a significant factor contributing to its cost, and that there is a case for streamlining its investigation processes to shorten the time required for the conduct of a pricing review.

An important hallmark of effective regulatory practice is a high level of consistency and predictability in the regulatory process and its outcomes. The ICRC did not meet this requirement in its latest pricing investigation. Its draft report was released later than originally planned and contained a number of 'novel features' which could not reasonably have been anticipated on the basis of earlier indications or guidance. The Commission's final report also contained a number of major changes in methodology relative to its draft report, which in turn led to significant changes in the terms of its final price direction. The issue here is not that changes were made, but the

process by which they were made: in particular, without adequate lead-time, consultation or explanation in advance. As a result, some expectations raised by the draft report were not realised, and public confidence in the regulatory process was put at risk.

There were significant shortcomings also in the ICRC's administrative processes. The ICRC has acknowledged that it was 'poorly prepared' to conduct its latest pricing investigation of water and sewerage services, and that its administrative processes suffered as a result. Planning for the conduct of the review was not of an adequate standard. Methodological issues and related information requirements were not established, at least at an adequate level of detail, at a sufficiently early stage in the investigation. There were also delays in publishing key papers related to the investigation.

There were several factors contributing to these problems, not all of them entirely within the Commission's control. Assuming, however, that the current regulatory framework is to be maintained, it will be essential that the Commission is both better prepared and better equipped to conduct its next pricing investigation. This means, among other things, that planning should be completed, and administrative processes settled, at least several months before the terms of reference for the pricing investigation are issued.

The effective operation of the regulatory framework depends critically on a strong and professional working relationship between the regulator and the regulated entity. There needs to be mutual understanding and acceptance of respective roles and responsibilities, a willingness to share relevant information, and an openness at all times to constructive dialogue and debate. Again, however, these requirements were not met in the ICRC's latest pricing investigation, which was marked by an unproductive and costly dispute between the ICRC and ACTEW, as the regulated entity. A particular source of conflict was ACTEW's refusal to comply with the ICRC's request that it supply some information required for purposes of its draft report by way of an amendment to its main submission to the Commission.

It is unrealistic to expect that disagreements or disputes will not arise again in the future but, assuming that the current regulatory framework is to be maintained, it will be essential that means be found to manage such disputes more effectively and thereby contain their consequences. Better planning and clearer guidance at an early stage of a pricing investigation would clearly help in this regard, especially with regard to key matters such as the information required to be provided by the regulated entity. Broadly speaking, the objective should be to settle at the earliest possible stage the overall framework for the pricing investigation, and to reduce to a minimum the number of areas of potential contention or dispute.

The legislative framework governing the operation of the regulatory system has served the ACT well since its enactment in 1997, but a number of significant weaknesses have become evident in recent times. As discussed below, changes to the *ICRC Act* will be needed regardless of the decision taken by the ACT Government on the future form and structure of the regulatory framework.

Finally, current resourcing arrangements are another source of weakness and potential vulnerability. The small scale of the ICRC, significant variations in its workload and a volatile and unduly complex funding structure all make it difficult for the Commission to operate efficiently. These matters are discussed further below.

Has the current framework met its objectives?

A key question relevant to any decision on future pricing arrangements for water and sewerage services is whether the current regulatory framework has met its main objectives: in particular, the objective of consumer protection against possible abuses of monopoly powers. This is not an easy question to answer, at least definitively, mainly because it is not possible to observe directly, or estimate reliably, what pricing outcomes there may have been if there had been no regulation, or if a different regulatory framework had been in place. The available evidence, however, supports a positive view.

Increases in the ACT's water prices have moderated significantly in recent years, after the sharp rises recorded during the early years of the new millennium. As a result, by 2012-13, the water prices charged to residential customers in the ACT were only slightly higher than the median price charged to customers in a range of other metropolitan centres across Australia. At the same time, service standards have generally, if not uniformly, improved. In addition, recent survey evidence indicates that the margin between the prices proposed by the regulated utility in its submission to the regulator and the prices ultimately approved by the regulator was larger in the ACT (at 26 per cent) than in any other jurisdiction.

In summary, there are a number of indications which suggest that the ACT's system of price regulation of water and sewerage services has worked as intended to constrain the misuse of monopoly powers and promote the efficiency of service provision, while at the same time safeguarding the financial viability of the regulated utility. None of these indications is conclusive on its own, but in combination they constitute a reasonable body of evidence that the ACT benefits from its current regulatory framework, and that customers are better off than if there were no system of regulation in place. Clearly, this is not to imply that the current regulatory system cannot be improved. On the contrary, there is substantial room for improvement in many of the areas just discussed, and an agenda of constructive reform should be implemented in the event that the ACT Government decides to retain the current regulatory framework.

Should the ACT retain its current system of price regulation?

The threshold question for the ACT Government arising from this review will be whether it should retain the current regulatory framework for the determination of water and sewerage prices in the Territory. Even if the current regulatory framework is judged to be working effectively, it is not the only option available; no regulatory system can be considered 'ideal' in any sense, and there are other possible arrangements which warrant consideration by Government in taking its final decision on this matter. Ultimately, the key judgement required will be which of the various options best meets the tests of cost-effectiveness and practicability.

The review has examined five possible alternatives to the current regulatory framework (as discussed in Chapter 6). These are:

- **Option 1:** The ACT Government to set future prices for water and sewerage services.
- **Option 2:** The ACT Government to contract a regulator from one of the larger jurisdictions to undertake independent pricing regulation on behalf of the ACT.
- **Option 3:** The ICRC to contract a regulator from one of the larger jurisdictions to undertake the detailed work required for a pricing investigation on its behalf, while retaining ultimate decision-making power over the determination of prices.
- **Option 4:** The regulated utility (Icon Water) to set the prices of water and sewerage services, subject to a 'light-handed' price monitoring regime.
- **Option 5:** In the context of a possible new national water agreement, the ACT Government to transfer its powers of determination of water and sewerage prices to a new national regulator.

Independent price regulation would continue to apply under Options 2, 3 and 5, but under different arrangements from those currently in place. Options 1 and 4, by contrast, would represent a more radical move away from the model of independent price regulation which has operated in the ACT for the past 17 years.

A reversion to a system in which government sets the prices of water and sewerage services would be a retrograde step, and should not be considered further. Despite some superficial attractions, such an arrangement would risk the 'politicisation' of pricing decisions, raise significant conflict of interest issues, and be in clear conflict with the ACT's commitments under various national agreements. More fundamentally, it would offer no guarantee or reasonable level of assurance that the prices charged for water and sewerage services would reflect the prudent and efficient costs of delivering these services in the ACT.

There is some potential merit in the 'contracting out' arrangements represented by Options 2 and 3. While these options would offer some scope for efficiency benefits relative to the current framework, any arrangement along these lines would need to be carefully structured to ensure that sovereignty was preserved and regulatory independence protected. In addition, any decision to contract out the price investigation function would need to be made alongside a consideration of the ongoing viability of the ICRC, unless some other functions were added to its remit.

A move away from regulatory price-setting to a price monitoring regime would represent a high-risk option, at least in current circumstances, and should not be pursued at this time. However, the ACT Government should retain this as an option for possible future consideration,

once reforms to Icon Water’s governance arrangements have been implemented and there is a higher level of assurance of ongoing efficiency in its operations.

There are arguments both for and against the option of a national regulator for the water sector, as canvassed in the recent draft report of the Competition Policy Review. The ACT Government should keep its options open on the issues raised in that report, evaluating the proposals more fully when further details become available.

Under each of the alternative arrangements discussed above there would be questions as to whether the residual elements of the ICRC’s role would be sufficient to warrant the retention of the Commission in its current form; and if not, the means by which its other functions, such as price determinations for retail electricity or the handling of competitive neutrality complaints, should be performed in the future. If the ACT Government were inclined to favour one of these alternatives, a consideration of this matter should form part of its overall decision-making process.

Allowing for the uncertainties and risks attached to these various alternative arrangements, the review considers that the safest option for the time being is to retain the current regulatory framework while pursuing the various changes and improvements recommended elsewhere in this report (**Recommendation 1**). It suggests also, however, that the ACT Government retain a ‘contracting out’ arrangement (Option 2 or Option 3) as a live option in the event that it is not satisfied with the adequacy or speed of progress made in implementing any agreed changes. The options of a price monitoring regime (Option 4) and the transfer of price-setting powers to a new national regulator (Option 5) should be reserved for more detailed evaluation in the longer term, when conditions require or are appropriate.

Recommendation 1: The regulatory framework

The review recommends that the ACT Government:

- (a) retain the current regulatory framework at least for the time being, while pursuing the various changes and improvements recommended elsewhere in this report;*
- (b) keep open the option of a ‘contracting out’ arrangement (Option 2 or Option 3 above), to be activated in the event that it is not satisfied with the adequacy or speed of progress made in implementing any agreed changes arising from this review; and*
- (c) reserve the options of a price monitoring regime (Option 4) and the transfer of price-setting powers to a new national regulator (Option 5) for more detailed evaluation in the longer term, when conditions require or are appropriate.*

Whatever the final decision taken by the ACT Government, some significant consequences will flow and need to be managed. For example, each of the possible alternatives to the current regulatory system presents its own set of risks and challenges, and a clear strategy would need to be developed for managing these before any commitment was made to adopt one of these alternatives. Equally, if the decision were taken to maintain the current regulatory framework, it

would be essential to act to address the significant weaknesses and potential vulnerabilities identified in this report.

Governance and accountability arrangements

Sound governance and accountability arrangements are critical to the effective operation of a regulatory system. A key requirement is that they engender trust in the regulatory system and confidence in the ability and impartiality of the regulator.

While many aspects of the ACT's current regulatory framework accord with best-practice governance principles, these are not sufficient on their own. The weaknesses evident in the conduct of the latest water and sewerage pricing investigation, for example, demonstrate that there can be a sizeable gap between the *potential* performance of a well-designed regulatory system and the *actual* performance of that system at any given time. It cannot be taken for granted that a sound governance framework will necessarily generate trust and confidence in regulatory system, or in the regulator's ability and performance. Rather, the regulator needs to *earn* that trust and confidence by the way it goes about its work: in particular, by the effectiveness of its consultative arrangements, the management of its key relationships, the rigour of its analysis, the transparency of its processes, and the quality of its ultimate decisions. Strong accountability arrangements are needed for this purpose.

A careful balance needs to be struck between respect for the statutory independence of the ICRC and an appropriate system of accountability, by which the Commission is held to account for its performance. An effective accountability framework needs to define clearly what the regulator is to be held accountable for, how it is to conduct itself and how this will be assessed. Clear expectations and common understandings are essential if such a framework is to succeed.

The ICRC is accountable to the Legislative Assembly through the responsible Minister, currently the Treasurer. It prepares an annual report on its activities, performance, finances and compliance with various legislative and whole-of-government requirements in the previous financial year. It also produces an annual Statement of Intent, co-signed with the responsible Minister, for the year ahead and the following three years. These accountability arrangements are reasonable and appropriate as far as they go, but could be significantly improved and strengthened. In particular, there is a strong case for the ACT Government to be more forthcoming and proactive in making clear its requirements and expectations of the ICRC, without impinging on the Commission's statutory independence (**Recommendation 2**). The objective should be a clear set of expectations and common understandings as to what the regulator is to be held accountable for, and how it should conduct its business.

The role of government

The ACT Government has many roles to play in ensuring a safe and efficient supply of water and sewerage services to the residents of the ACT. It is directly responsible for managing the policy framework relating to water security, supply and availability, and for setting the high-level objectives of water policy. In its owner and shareholder role it provides governance oversight of

Icon Water Limited, as the sole supplier of water and sewerage services to the ACT. It is also responsible for providing governance oversight of the ICRC, as the independent regulator. A key responsibility is its role in appointing members to the board of Icon Water, and Commissioners to serve on the ICRC, given that the quality of these appointments will be critical to the effective performance of both bodies. The government has other important responsibilities as well, including protecting the interests of low-income consumers and funding community service obligations more generally.

Some careful balances need to be struck in performing these different roles. For example, distributional and equity objectives need to be balanced with efficiency requirements and goals. Consumer interests need to be balanced with budgetary objectives. The potential conflicts inherent in the government's multiple roles need to be recognised and managed effectively. The government must respect the roles and authority of the Icon Water Board and the independent regulator, while holding them appropriately to account. It needs to be prepared to intervene where necessary, but guard against inappropriate intervention.

There is a case for government to play a more direct and active role in supporting the operation of the regulatory system than appears to have been the case in recent times (**Recommendation 2**). To the extent that government is best placed to make decisions on some aspects of the high-level framework for a pricing investigation it should do so at the outset, via the terms of reference for the investigation, rather than by representation, submission or intervention in the course of the review. Government should generally set the period over which a price direction is to apply, unless there is good reason to the contrary. It should also set the dates by which both the draft and final reports on a pricing investigation are to be made available. Further, if the current regulatory framework is to continue, the government should take responsibility for ensuring that Commission is well prepared and equipped to conduct its future pricing investigations.

Recommendation 2: Governance and accountability arrangements

The review recommends that, if the current regulatory framework is to continue, the ACT Government should play a more direct and proactive role in supporting the operation of the regulatory system by:

- (a) strengthening the current accountability arrangements applying to both the ICRC and Icon Water Limited;*
- (b) providing an annual 'statement of expectations' to the ICRC, designed to make clear its requirements and expectations of the Commission without impinging on its statutory independence. After consultation with the responsible Minister, the ICRC should respond by preparing a 'statement of intent', which would then be the basis of a formal agreement between the Government and the Commission. The objective should be a clear set of expectations and common understandings as to what the regulator is to be held accountable for, and how it should conduct its business;*

(c) taking a more active role in setting the high-level framework for a pricing investigation; and

(d) ensuring that the ICRC is well prepared and equipped for the conduct of its future pricing investigations.

The legislative framework

The ICRC Act has served the ACT well since its enactment in 1997. It provided a sound basis for establishing the ICRC, and for the Commission to exercise its statutory powers independent of ministerial direction. It established also the general framework by which price directions can be made, and the procedures to be followed in this process. Suitably, the ICRC Act is cast in flexible terms. For example, it does not prescribe the particular industries or sectors in which a price direction must be made, but rather provides the means by which an industry may be identified as subject to the price determination powers of the Commission.

While many reports and price directions have been produced under this general framework since 1997, a review of the ICRC Act is timely and necessary on a number of grounds. Over the 17 years for which the Act has been in place, competition policy and practice have evolved and changed at least to some degree, and the balance of the Commission's activities has also shifted significantly. In addition, the Auditor-General's report highlighted some significant areas of ambiguity or lack of clarity in the current legislation, and further anomalies and weaknesses have become apparent in recent times. In particular, the current review of the ICRC's price direction for 2013-2019, the first such review to be conducted under the current regulatory framework, has raised a number of issues about the adequacy and appropriateness of the provisions of Part 4C of the ICRC Act.

For these and other reasons, it seems clear that significant changes will be needed to the ICRC Act even if the decision is taken to retain the current regulatory framework. While the current review has focussed on those provisions of the ICRC Act relating to the determination of prices for water and sewerage services, it will be essential that any broader review of the ICRC Act consider also the other functions given to the ICRC under this Act, as well as the interaction with the *Utilities Act 2000*, which assigns to the Commission a range of further important functions and powers.

The review's recommendations on desirable changes to the ICRC Act are predicated on a continuation of the current regulatory framework. The arguments supporting the individual components of **Recommendation 3** below are set out in Chapters 3, 4 and 5.

Recommendation 3: The legislative framework

The review recommends that, if the current regulatory framework is to be retained, the ICRC Act be amended as follows:

(a) to insert an overarching objects clause into the Act which makes it clear that the primary objective of the regulatory framework is to promote the goal of economic efficiency, while safeguarding the financial viability of the regulated entity (Conclusion 5.5);

- (b) *to confer on the Minister the power to determine the period over which a price direction is to apply, but with an option to delegate this decision to the ICRC (Conclusion 4.2);*
- (c) *to clarify that the requirement imposed under subsection 20(4) applies equally to a proposed price direction as to a final price direction; in both cases, the Commission must indicate the extent to which it has had regard to the matters listed in section 20(2) (Conclusion 4.3);*
- (d) *to require that the terms of reference for a pricing investigation be issued by the Minister a specified number of months before the expiry of a current price direction (Conclusion 4.13);*
- (e) *to provide that the terms of reference for a pricing investigation may specify a date by which a draft report and proposed price direction are to be made available for public inspection (Conclusion 4.4);*
- (f) *to require the ICRC to publish a statement of its information requirements within one month of receiving the terms of reference for a pricing investigation, and the regulated entity (and any other relevant parties) to provide the required information within the time period specified in the ICRC's statement (Conclusion 5.6);*
- (g) *to give the Minister a power to establish a dispute resolution process on a procedural matter if, after receiving a written request by either party, the Minister judges this to be the most effective and efficient way of resolving the dispute (Conclusion 5.7);*
- (h) *to give the Minister the power to establish or appoint a review body, once an application for a review has been submitted, but without limiting the form of that review body to the industry panel model prescribed in the current legislation (Conclusion 4.11);*
- (i) *to provide that the appointment of members to an industry panel, or other review body, should be subject to scrutiny by the Legislative Assembly (Conclusion 3.6);*
- (j) *to provide that an application for a review of a price direction must be accompanied by evidence that one or more of the following failings has occurred in the initial price determination process:*
- *a significant error in the application of law;*
 - *a material error of fact;*
 - *a material error in calculation or methodology; or*
 - *a significant failure in due process, procedural fairness or natural justice;*
- (Conclusion 4.9)*

- (k) to require an industry panel, or other review body, to provide the ICRC with an opportunity to respond to the issues and arguments raised in an application for review before any decision is taken on whether a review is to proceed (Conclusion 4.9);*
- (l) to provide that an application for a review should be dismissed if the evidence presented in the application is found not to be sustained, or not to be sufficiently strong for a review to proceed (Conclusion 4.9);*
- (m) to provide that an individual consumer, group of consumers or any other body with a relevant interest should be able to make an application for a review of a price direction by the regulator, with each party to a review required to bear its own costs (Conclusion 4.10);*
- (n) to provide an option for an industry panel, or other review body, to refer a matter raised in an application for a review back to the ICRC, as the original decision-maker, with directions for the making of a fresh decision (Conclusion 4.7); and*
- (o) to require an industry panel, or other review body, to transfer to the ICRC, on completion of a review, all information it has collected or created in the course of conducting the review which may be relevant or necessary to the Commission's role in implementing and managing a substituted price direction (Conclusion 4.14).*

Regulatory principles

There is broad agreement on the general principles which should guide the work of a regulator, and the attributes which characterise a best-practice regulatory regime. These include qualities such as independence, transparency, accessibility, predictability, cost-effectiveness, adaptability and procedural fairness. It is not clear, however, that codifying such attributes into a statement of formal requirements would have a significant influence on behaviours or outcomes in any given institutional setting. A preferable alternative is to target directly any areas of perceived deficiency or concern, or areas where greater clarity and assurance is needed, and take specific measures to address those concerns in a reasonable and cost-effective way. The regulator should then be held to account for its performance in these areas.

More generally, a careful balance needs to be struck between prescription and discretion: that is, the extent to which the regulatory role performed by the ICRC should be bound by government prescriptions or guidelines, or alternatively left to the regulator's best judgement and discretion. Any system of detailed prescription has not only the potential to undermine the necessary independence of the regulator, but also runs the risk of limiting necessary flexibility over time and imposing additional costs in updating and maintaining the regulatory 'rules'. Ultimately it is a matter of judgement as to where the balance between prescription and discretion should lie. In general, however, if government sees a particular requirement as sufficiently important as to be deemed essential and ongoing, it should aim to reflect that requirement in the legislation governing the operation of the regulatory framework.

Administrative and procedural issues

Better planning processes and administrative arrangements will be important for the future if the current regulatory framework is to continue. A key objective should be to provide greater clarity at an earlier stage of a pricing investigation so that all stakeholders are better informed at the outset of the ICRC's plans and their own responsibilities.

The ICRC has acknowledged that the administrative processes and project management arrangements it used in its last pricing investigation were deficient in a number of respects, and has taken some remedial action on its own account. Ultimately, it must be the responsibility of the Commission itself to ensure that its administrative processes and related project planning, monitoring and reporting procedures meet the necessary high standards. The ICRC should be held to account in these respects under the governance and accountability arrangements proposed in Recommendation 2.

The prioritisation of objectives

Section 20(2) of the ICRC Act lists a number of considerations to which the Commission must have regard in making a price direction in a regulated industry. Broadly speaking, these cover issues relating to the protection of consumer interests, economic efficiency, the financial viability of the regulated entity and environmental protection objectives. There are elements of potential conflict between these considerations, meaning that balances need to be struck and trade-offs made by the ICRC.

There is a strong case to insert an overarching objects clause into the ICRC Act which makes it clear that the primary objective of the regulatory framework is to promote the goal of economic efficiency, while safeguarding the financial viability of the regulated entity. A primary emphasis on economic efficiency can be expected to best serve the overall public interest, provided that social and equity objectives are addressed by government in other ways.

Ensuring that information requirements are met

Access to high-quality information is a *sine qua non* of a regulator's work, and the regulator must be confident that it can obtain the information it needs for a pricing investigation in an assured and timely way. The current provisions of the ICRC Act do not provide that assurance. If the current regulatory framework is to continue, amendments are needed to the ICRC Act to require the ICRC to publish an early statement of its information requirements, and the regulated entity (and any other relevant parties) to provide the required information within a reasonable period of time.

Arrangements for dispute resolution

Any dispute resolution process needs to respect the statutory independence of the ICRC and its authority as the ultimate decision-maker in a price determination process. For that reason, a dispute resolution process should not apply to a dispute involving issues related to the content of

a price direction, or a substantive conclusion reached in an ICRC report on a pricing investigation. In the case of disputes on procedural matters, however, such issues should not arise.

If the current regulatory framework is to continue, an amendment should be made to the ICRC Act to give the Minister a power to establish a dispute resolution process on a procedural matter if, after receiving a written request by either party, the Minister judges this to be the most effective and efficient way of resolving the dispute. The Minister would have the discretion to determine the appropriate form of any dispute resolution mechanism in the circumstances of a particular dispute. Such an arrangement should be invoked only as a last resort, when best efforts by the parties to reach an agreement have failed.

Pricing principles

The review is not convinced that it would be desirable to build a set of detailed or highly prescriptive pricing principles into legislation. Such an approach could reduce the level of desirable regulatory discretion, limit necessary flexibility over time, and potentially entail additional costs in refining or updating the principles as needs or circumstances change. There is a case, however, for a set of pricing guidelines to be incorporated into the terms of reference for the next pricing investigation of water and sewerage services, assuming that the current regulatory framework is to continue.

Peer review of the ICRC's processes

Resources permitting, it would be prudent for the ICRC to adopt the practice of some other regulatory bodies and engage a regulator from another jurisdiction to conduct a peer review of its price investigation methodologies and processes. Such an arrangement would add confidence to the integrity of the overall pricing process and, among other benefits, could serve to reduce the risk of an appeal against a price determination.

Resourcing arrangements

The current resourcing arrangements for the ICRC are deficient in a number of respects, and represent a source of potential vulnerability.

The ICRC is a very small agency, far smaller than its counterpart regulators in other jurisdictions; this factor alone creates a number of risks and challenges. It is also subject to major fluctuations in demand for its services, as well as changes in the balance of its functions over time.

The pricing investigations undertaken by the ICRC – the bulk of its work in recent years – are inherently cyclical in nature: intensive work is undertaken over a period of some 12-18 months, but given a regulatory period of 5 or 6 years, there is an inevitable lull in activity before preparation for the next investigation begins. Whether other work becomes available to fill the resultant gap is uncertain at best. The risk in these arrangements is that, when its workload troughs, the Commission is unable to fund a viable level of staffing, and quality staff may be tempted to leave; conversely, when workload picks up, the Commission has difficulty in finding the required resources (both in quantity and quality) to respond.

In the face of these challenges, the Commission has tried to maintain a degree of flexibility in its staffing arrangements while also maintaining a core of experienced staff, especially to handle its larger and more sensitive references. Striking this balance has not been easy: in 2011-12, for example, the Commission's available resources proved insufficient to meet the demands of three significant inquiries running simultaneously. Significant variations in workload have been a recurring problem throughout the history of the ICRC, and make it difficult for the Commission to operate efficiently.

These problems are compounded by an unduly complex funding structure, and a high level of volatility in the ICRC's funding levels. The Commission draws its funding from four separate sources: cost recovery charges; licence fee revenue; a budget appropriation; and a service level agreement with the Chief Minister, Treasury and Economic Development directorate. These arrangements are largely a legacy of history, and warrant review. Assuming that the current regulatory framework is to continue, a simpler and more transparent funding structure should be developed for the future (**Recommendation 4**).

A significant element of cost-recovery is appropriate for a regulatory body such as the ICRC, partly as a means of making transparent the costs of regulatory activity in areas such as pricing investigations, but also as a means of maintaining a cost-conscious culture within the ICRC itself. Costs which need to be recovered will also need to be explained and justified as relevant, reasonable and efficient.

Beyond that, the structure of licence fees should be rationalised and a single budget appropriation (rather than the current service level agreement) should fund those functions which the ICRC is required to perform but for which it cannot recover costs: for example, research into regulatory approaches and methods, interaction with other regulators, requirements such as the preparation of annual reports or appearances before the Public Accounts Committee, and the developmental work required to ensure that the Commission is well prepared for the conduct of future pricing investigations.

Assuming that the current regulatory model is to be retained, means will need to be found to boost the viability of the ICRC so that it is not so exposed to the adverse effects of cyclicity in its workload and marked swings in its resourcing base. Options here include the assignment of additional responsibilities to the Commission; a merger with one or more other bodies with related functions; and an increase in the level of budget funding for the Commission to undertake a range of designated functions for which cost-recovery is either inapplicable or inappropriate.

Recommendation 4: Resourcing arrangements

The review **recommends** that, if the current regulatory framework is to continue, the ACT Government:

- (a) consider options designed to boost the viability of the ICRC so that it is not so exposed to the adverse effects of cyclicality in its workload and marked swings in its resourcing base. The options to be explored should include the assignment of additional responsibilities to the Commission, a merger with one or more other bodies with related functions, and an increase in the level of budget funding;*
- (b) retain a significant element of cost-recovery in the resourcing of the ICRC, partly as a means of making transparent the costs of its regulatory activity but also as a means of maintaining a cost-conscious culture within the ICRC itself;*
- (c) review and rationalise the structure of licence fees payable under the Utilities Act 2000, and the revenue derived by the ICRC from this source; and*
- (d) provide a single budget appropriation (rather than the current service level agreement) to fund those functions that the ICRC is required to perform but for which it cannot recover costs: for example, research into regulatory approaches and methods, interaction with other regulators, the meeting of accountability requirements, and the developmental work required to ensure that the Commission is well prepared for the conduct of future pricing investigations.*

The determination of water and sewerage prices now represents the most substantive and resource-intensive activity of the ICRC. Consequently, if this responsibility were to be removed from its remit, the viability of the Commission in its current form would be in serious question. It follows that, in taking its decision on the future framework for regulating the prices of water and sewerage services, the ACT Government will need to pay specific regard to the other functions performed by the ICRC, and how these functions would be undertaken under any alternative arrangements for price determination.

1 Introduction

1.1 Background

On 2 April 2014 the ACT Auditor-General released a performance audit report, *The Water and Sewerage Pricing Process*.¹ The report examined the governance and administrative arrangements for the investigation of water and sewerage prices conducted by the Independent Competition and Regulatory Commission (ICRC) in response to the terms of reference issued by the ACT Treasurer in October 2011. The performance audit found that the administrative and communication processes associated with this pricing investigation had been ineffective and inefficient, with poor communication and a poor relationship between the ICRC and the regulated utility (ACTEW Corporation Limited). The audit also found that there was a lack of clarity in some key aspects of the legislation governing the pricing investigation process, the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act). The report made a series of recommendations designed to address its findings.

In responding to the release of the Auditor-General's report, the ACT Government announced that it would use the report's findings as the basis for a broad reassessment of the framework for the pricing of water and sewerage services in the ACT:

*"It is important that the ACT community has confidence that the process for determining the price for water and sewerage is independent, transparent and efficient.....The ACT Government will now undertake a comprehensive review of the legislative, governance and administrative arrangements of the ICRC in relation to their pricing process, and where appropriate, introduce improvements to that process."*²

In discharge of that commitment, the current review was commissioned in November 2014 and announced by the ACT Treasurer on 25 November 2014.³

1.2 Terms of Reference

The Terms of Reference for the review are provided at *Appendix A*. These require the review to examine the current framework for the pricing of water and sewerage services in the ACT and within that context, to provide comments and recommendations on:

- the governance and administrative arrangements for the provision of independent pricing for regulated water and sewerage services in the Territory, including consideration of both the current model and other potential options;

¹ ACT Auditor-General, *The Water and Sewerage Pricing Process*, Report No. 2/2014, April 2014. The ICRC subsequently issued a formal response to the Auditor-General's report (see ICRC 2014a, *Appendix C*), in which it contested a number of the findings of the audit report and took issue with several of its recommendations.

² ACT Government Media Release, *Release of the Auditor-General's Performance Audit: The Water and Sewerage Pricing Process*, 2 April 2014

³ ACT Government Media Release, *Review of Water and Sewerage Pricing Framework announced*, 25 November 2014

- all relevant legislation related to the pricing framework for regulated water and sewerage services, in particular the ICRC Act;
- whether the ACT would benefit from a set of principles for conducting pricing investigations for regulated water and sewerage services, and outline the principles to be included; and
- any other matters considered relevant to improving the pricing framework.

The Terms of Reference also require a consideration of other possible frameworks for the determination of water and sewerage prices in the Territory.

1.3 *Objective and focus of the review*

The primary objective of the review is to assess both the strengths and weaknesses of the current framework for determining the prices of regulated water and sewerage services, and thereby to identify a range of practical options for improvement or reform. These options would then serve to inform the ACT Government's consideration of the form and structure of future price determination arrangements.

The key focus of the review is on the framework within which the ICRC, as the independent regulator, determines the prices for regulated water and sewerage services in the ACT. Under its governing legislation the ICRC has a potentially wide range of other responsibilities, including for the determination of prices in other regulated industries, advice to government on industry matters, advice on access to infrastructure, the determination of access disputes, the determination of competitive neutrality complaints and advice on other government-regulated activities. In addition, under the *Utilities Act 2000*, the Commission has responsibility for licensing utility services and ensuring their compliance with licensing conditions. None of the additional matters just listed is within the ambit of the present review. It will be important, however, that eventual government decisions on this review should have regard to these wider roles and responsibilities of the ICRC, so that the regulatory system as a whole remains both viable and coherent.

As required by its Terms of Reference, the review concentrates on the *regulatory framework* by which the prices of regulated water and sewerage services are set: for example, on the pricing powers and functions of the ICRC, as the independent regulator; the roles played by the various parties to the price determination process, and the relationships between them; the adequacy of current regulatory governance arrangements; the strengths and weaknesses of the legislative framework; the suitability of current appeal and review mechanisms; and the administrative processes and systems used in the conduct of the ICRC's pricing investigations. The review is not concerned, at least directly, with any of the following matters:

- the actual prices set for the supply of water and sewerage services, or the tariff structures for those services;

- the technical details of the methodology by which prices are determined, or the relative merits of different methodologies;
- governance arrangements for the regulated entity, except to the extent that these bear directly on the performance of the regulatory framework;⁴
- the ICRC’s final report⁵ and price direction⁶ (June 2013) covering the six-year period from 1 July 2013 to 30 June 2019; or
- the draft decision of the Industry Panel⁷ appointed by the ACT Treasurer in April 2014 to review the price direction released by the ICRC in June 2013.

Careful distinctions need to be drawn in a number of these areas. For example, while technical commentary on the methodology by which prices are set is outside the scope of this review, the handling of any significant changes to the regulator’s methodological approach is very much a ‘framework’ issue, and therefore needs to be dealt with. Similarly, it would be inappropriate, and beyond the remit of this review, to comment on the ICRC’s latest price direction or the draft report of the Industry Panel, whose work is still in train; notwithstanding this, the general form and structure of appeal and review mechanisms, and the terms on which these can be accessed, are a vitally important part of the regulatory framework, and therefore need to be examined. Likewise, the *processes* used by the ICRC in reaching the decisions in its latest price direction, as distinct from the results generated by those processes, are within the scope of the review.

As well as providing the impetus for this review, the performance audit conducted by the Auditor-General also contained a large amount of information which is broadly relevant to the review’s terms of reference. The reviewer has been mindful, however, that many of the audit findings and conclusions have been vigorously contested by the ICRC. It has therefore been important to form independent judgements on any significant matters of contention, to the extent that this has been relevant and possible from the available evidence.

1.4 *Processes of the review*

As first steps in the process of review, a public website on the review was set up and an Issues Paper prepared, canvassing a number of the high-level issues which the review would need to address. The Issues Paper was released on 24 November 2014, with comments or submissions invited by 12 December 2014. Three responses were received: a formal submission from the ICRC, as the independent regulator; another submission from Icon Water Limited (previously ACTEW Corporation Limited), as the regulated utility; and an email response from an interested member of the public, Dr David Denham AM, proposing some changes to the structure of tariffs

⁴ The institutional and governance arrangements for ACTEW Corporation Limited were the subject of a separate review which reported in December 2013 (see Cohen, B, Appendix C)

⁵ Independent Competition and Regulatory Commission, *Final Report: Regulated Water and Sewerage Services, 1 July 2013 to 30 June 2019*, Report No. 5 of 2013, June 2013

⁶ Independent Competition and Regulatory Commission, *Price Direction: Regulated Water and Sewerage Services, 1 July 2013 to 30 June 2019*, Report No. 6 of 2013, June 2013

⁷ Industry Panel, *Review of the Independent Competition and Regulatory Commission’s 2013 Price Direction for Regulated Water and Sewerage Services in the ACT: Draft Report*, December 2014

for water and sewerage services. Copies of the Issues Paper and the three responses received are available on the review website.⁸

Regular contact was maintained through the course of the review with the ICRC and Icon Water, as key parties to the price determination process. Meetings were also held with relevant ACT government officials; the Auditor-General; members of the Industry Panel; and a number of persons with interests in, and knowledgeable of, the operation of the regulatory framework. A workshop on legislative issues relevant to the price determination process was held on 11 December 2014. Details of the various consultations held are provided in *Appendix B*.

There is an extensive literature on economic regulation both in Australia and internationally, as well as many studies of the operation of regulatory frameworks in the water sector specifically. The Productivity Commission conducted a major inquiry into Australia's urban water sector in 2011, recommending improvements to the governance arrangements for both regulators and regulated utilities as well as significant changes to the price regulation framework itself.⁹ In 2011 also, the National Water Commission conducted a review of pricing reform in the Australian water sector.¹⁰ Reviews of economic regulation and pricing principles in the water sector have also been carried out by a number of jurisdictions, most recently Queensland and Victoria.¹¹ In support of the Victorian inquiry, Deloitte was engaged to undertake a comparative study of regulatory approaches and decision-making arrangements across the Australian States and Territories, as well as another study reviewing the strengths and weaknesses of different regulatory pricing models.¹² Even more recently, Frontier Economics was engaged by the Water Services Association of Australia to review the operation of economic regulation in Australia's urban water sector, and to identify improvements which would be in the long-term interests of customers.¹³

The review has examined and drawn upon the information contained in these and other relevant documents. A list of key reference documents is provided at *Appendix C*.

Approximately three months were allowed for the conduct of this review, with a final report required to be lodged by 20 February 2015. Administrative and research support was provided by two officers from the Chief Minister, Treasury and Economic Development Directorate.

⁸ www.act.gov.au/frameworkreview

⁹ Productivity Commission, *Australia's Urban Water Sector*, Report No. 55, Final Inquiry Report, Canberra, 2011

¹⁰ National Water Commission, *Review of pricing reform in the Australian water sector*, 2011

¹¹ Queensland Competition Authority, *Statement of Regulatory Pricing Principles*, August 2013, and *Economic regulation, governance and efficiency in the Victorian water sector: Preliminary advice from the Independent Reviewer*, Victoria, May 2014

¹² Deloitte Touche Tahmatsu, *Comparison of water regulatory approaches – Final report*, Report prepared for the Essential Services Commission, Victoria, April 2014; also Deloitte Touche Tahmatsu, *Regulatory pricing models for the Victorian Water sector – Final report*, Report prepared for the Essential Services Commission, Victoria, April 2014

¹³ Frontier Economics Pty Ltd, *Improving economic regulation of urban water*, Report prepared for the Water Services Association of Australia, August 2014

1.5 Terminology

On 28 October 2014 the former ACTEW Corporation Limited (trading as ACTEW Water) registered a change of name to Icon Water Limited (Icon Water). For purposes of this report, the entity is generally referred to by its new brand name 'Icon Water', with 'ACTEW' or 'ACTEW Water' used only in a historical context (i.e., with reference to events that took place prior to 28 October 2014).

For ease of reference, and to avoid undue repetition, the Independent Competition and Regulatory Commission is usually referred to by its acronym 'the ICRC', or alternatively 'the Commission'. Likewise, the Commission's governing legislation, the *Independent Competition and Regulatory Commission Act 1997*, is usually referenced as 'the ICRC Act', or simply 'the Act', where this is clear in context.

Unless otherwise stated, references to 'the regulatory framework' should be taken to refer to the existing regulatory, governance and administrative framework for the pricing of water and sewerage services in the ACT. References to 'the review' relate to the current review of the regulatory framework.

Reference documents cited in subsequent chapters of this report are usually shown in abbreviated form (e.g. COAG 2004). Full details are available from the reference documents at *Appendix C*.

1.6 Structure of the report

The remainder of this report is structured as follows:

- **Chapter 2** considers the role and purpose of economic regulation in the pricing of water and sewerage services, and examines both the strengths and weaknesses of the price regulation framework which currently operates in the ACT.
- **Chapter 3** examines the adequacy of current governance and accountability arrangements to support the effective and efficient operation of the regulatory framework. It also examines the role of government in the regulatory process.
- **Chapter 4** examines the legislative framework which supports the operation of the regulatory framework. It highlights a number of weaknesses which have become evident in the operation of the ICRC Act, and recommends a series of legislative amendments.
- **Chapter 5** examines whether the ACT would benefit from a set of principles for conducting pricing investigations for regulated water and sewerage services. It also considers some important administrative and procedural issues raised by the Auditor-General.
- **Chapter 6** explores a range of possible alternatives to the current regulatory framework, and assesses their likely strengths and weaknesses.

Conclusions are presented at the end of each chapter. As many of the **recommendations** made are inter-linked and to some extent contingent, these are presented in a single block in the **Executive Summary** at the front of this report.

2 The current regulatory framework

2.1 Objectives of economic regulation

Economic regulation in the form of independent prices oversight has been a key feature of reform in the urban water sector in Australia. In committing to the *National Water Initiative* in 2004, for example, all Australian governments agreed to use independent bodies to set or review prices, or price-setting processes, for water storage and delivery by government water service providers.¹⁴ The dominant rationale for this approach has been that, with most water utilities operating as ‘natural monopolies’, and in the absence of the protections provided by competitive forces, price regulation is needed to ensure that these utilities do not abuse their market power in terms of either pricing or service standards.¹⁵ This rationale applies whether the monopoly service provider is a private company or, as is more commonly the case in the urban water sector, a government-owned utility.

In practice, the objective of safeguarding against the abuse of monopoly powers means that the utility must be encouraged to conduct its business as efficiently as possible. There are various ways of seeking to achieve this goal, including strong governance arrangements, an effective performance and accountability framework, and robust regulatory processes. No single approach is likely to be fully effective if applied in isolation.

As the independent price-setter, the regulator’s role is to set prices at the level necessary to recover the prudent and efficient costs of supplying the regulated services, including an appropriate return on the assets involved. The regulator must have regard both to the long-term interests of the utility’s customers and the financial viability of the regulated business. To these ends, the regulator aims to promote efficient investment in, and operation and use of, the utility’s assets, while ensuring that service standards are maintained at appropriate levels and the business remains financially viable. Inevitably, this role requires some fine judgements and a careful balancing of objectives — in particular, between the obvious imperative to maintain continuity of supply, at appropriate standards of service, and the provision of incentives for the utility to achieve necessary efficiencies.

Another important reason for the independent economic regulation of urban water utilities is to provide a safeguard against the politicisation of pricing decisions. In earlier periods, high levels of government involvement in water pricing often meant that prices were set well below cost recovery levels, thereby encouraging inefficiently high levels of water consumption, and risking the deferral of necessary maintenance or capital investment.¹⁶ Alternatively, as the National Water Commission observed, governments could be tempted to see utilities as an easy source of

¹⁴ COAG (2004), page 16

¹⁵ Productivity Commission 2011a, pages 298-299. The transmission and distribution networks of water utilities account for a significant proportion of the total cost of supplying water and wastewater services, and in most cases, it would be uneconomic to duplicate this infrastructure. It is in this sense that water utilities are often characterised as ‘natural monopolies’.

¹⁶ Productivity Commission 2011a, Chapter 11

revenue and encourage them to set prices at above efficient levels.¹⁷ The existence of an independent regulator with price-setting powers, operating at arm's length from government, offers some protection against both of these undesirable outcomes.

Economic regulation has its costs as well as its benefits, and it is important that regulatory approaches are designed to maximise net benefits. Regulatory costs include the direct costs of funding regulatory agencies and the compliance costs they impose on regulated entities.¹⁸

2.2 *The national framework*

Water pricing, and the management of water resources more generally, is principally a responsibility of State and Territory governments. Over the past 20 years, however, economic reform of the water sector has become a significant national issue, reflecting concerns about security of water supply, the impact of drought conditions, the management of water resources, the protection of water quality, and the importance of ecologically sustainable development. National action on water sector reform has been driven principally through the Council of Australian Governments (COAG) forum.

The *COAG Water Reform Framework* of 1994 provided the first agreed set of national reforms for the sector, with a strong emphasis on pricing and institutional reform. The framework committed to pricing reform based on the principles of consumption-based pricing and full cost recovery, the reduction or elimination of cross-subsidies, and making any remaining subsidies transparent.¹⁹ The *COAG Water Reform Framework* and the related *National Competition Policy* reforms also recognised the need for institutional reform, given the inherent conflicts involved in government control over prices for publicly owned water suppliers. Accordingly, they called for structural separation of service delivery, policy and regulatory roles, including independent economic regulation of government-owned monopoly water businesses. Under the *Competition Principles Agreement* signed in 1995, governments also agreed to apply competitive neutrality principles to government-owned businesses, principally to ensure that these businesses gained no competitive advantage by reason of their public ownership.²⁰

Ten years later, in 2004, Heads of Government signed the *National Water Initiative (NWI)*, an intergovernmental agreement designed to achieve 'a nationally compatible, market, regulatory and planning based system of managing surface and groundwater resources for rural and urban use that optimises economic, social and environmental outcomes'.²¹ Once again, this agreement emphasised the importance of best-practice pricing and institutional arrangements, designed to promote water-use efficiency and innovation. Paragraph 77 of the NWI agreement specifically committed governments to use independent bodies to set or review prices or price-setting

¹⁷ National Water Commission, Submission to the Productivity Commission Inquiry into Australia's Urban Water Sector 2011, page 4

¹⁸ Productivity Commission 2011a, page 244

¹⁹ COAG (1994)

²⁰ COAG (1995)

²¹ COAG (2004), page 3

processes, and to publicly review and report on pricing by government and private water service providers.²² The agreement also required jurisdictions to report independently and publicly each year on benchmarking of the pricing and service quality of their water service providers.

At the COAG meeting of November 2008, governments agreed to a work program comprising a number of actions designed to improve the security of urban water, including a review of consumer protection arrangements in relation to services provided by water utilities and the finalisation and adoption of pricing principles under the NWI. Subsequently, in April 2010, the Natural Resource Management Ministerial Council on behalf of COAG endorsed a set of pricing principles which had been developed jointly by the Commonwealth, State and Territory governments, with the aim of assisting jurisdictions to implement the NWI water pricing commitments in a coherent and consistent way. The NWI pricing principles comprise four elements, dealing with the recovery of capital expenditure; urban water tariffs; water planning and management costs; and recycled water and stormwater reuse.

Each government is responsible for the implementation of these national agreements within its own jurisdiction, and is ultimately free to make its own decisions on the matters which they cover. It is notable, for example, that some jurisdictions have stopped short of implementing fully the commitment to use independent bodies to set or review prices for water services, preferring to leave final decisions in the hands of government (in some cases after the consideration of independent advice). As a party to these national agreements, the ACT Government has arguably gone further than many other jurisdictions in implementing their various requirements and commitments, especially in the area of pricing reform. It will be important that any changes to current price-setting arrangements for water and sewerage services in the ACT should have regard to the ACT's commitments under the various elements of the national framework just described. That said, the ACT as a sovereign government must ultimately make its own decisions on these matters, in the best interests of the citizens of the ACT.

2.3 The ACT's regulatory framework

The ACT Government moved swiftly to implement the national agreements on competition policy and regulatory reform struck in the mid-1990s, and was one of the first jurisdictions to put in place an independent framework for the pricing of water, sewerage and other regulated services. The predecessor legislation²³ to the current ICRC Act was passed by the ACT Legislative Assembly in 1997, meaning that independent price regulation of water and sewerage services has now been in place for more than 17 years.

Some key features of the current regulatory framework are outlined below. Section 2.4 then analyses the strengths and weaknesses of the ACT's current regulatory arrangements.

²² *ibid.*, page 16

²³ The *Independent Pricing and Regulatory Commission Act 1997*. Amendments establishing the ICRC in its current form were passed three years later, in 2000.

The powers and functions of the independent regulator

The ICRC is a statutory authority established under the ICRC Act. The Commission is constituted under the ICRC Act by one or more standing commissioners and any associated commissioners appointed for particular purposes. A Senior Commissioner and a Commissioner, both statutory appointees, currently make up the Commission. The Commission is supported in its work by a Chief Executive Officer and supporting staff, all of whom are employed under the *Public Sector Management Act 1994*. The Chief Executive Officer is not a member of the Commission.

The ICRC Act establishes the objectives for the Commission (section 7), its functions (section 8) and the procedures which the Commission is to follow when conducting an industry reference and making a price direction (Parts 3 and 4).²⁴ Part 4 of the ICRC Act empowers the Commission to make a price direction in a regulated industry, with prices to be set within the general framework set out in section 20A. As noted in Chapter 1, the ICRC Act (in conjunction with the *Utilities Act 2000*) confers a broad range of roles and responsibilities upon the ICRC, of which the conduct of pricing investigations and the making of price directions is only one. In practice, however, this is the principal role exercised by the Commission under current circumstances, and consumes the majority of its available resources.

The ICRC Act does not prescribe the particular industries or sectors in which an industry reference for a pricing investigation may be provided; instead, it provides for terms of reference to be issued by the responsible Minister (as the 'referring authority') which will specify, among other things, the industry or sector which is to be the subject of the reference. The terms of reference may also prescribe such details as the period within which a report on the reference is to be submitted, the date by which a price direction is to be published, and particular matters to which the Commission must have regard in conducting the reference (section 16 of the ICRC Act). A determination of the terms of reference for a pricing investigation (or other industry reference) is a disallowable instrument (section 16(3)). In consequence, should a disallowance motion be moved, the terms of reference for an investigation may be subject to scrutiny and debate by the Legislative Assembly.

A critical feature of the ICRC Act is its conferral of statutory independence upon the Commission. Section 10 of the ICRC Act provides that:

Except as provided by this or any other law of the Territory, the commission is not subject to the direction or control of the Minister or any other referring authority.

²⁴ The *Utilities Act 2000* prescribes a range of further objects for the ICRC.

The rationale for this provision is well summarised by the ICRC in its submission:

*The appointment of a Commissioner... entrust(s) that individual with making these judgements on behalf of the community and within the framework of law that has been created for this purpose. Having entrusted Commissioners with this responsibility it is important that they be given the freedom to exercise their judgement about where the best interests of the community lie in any matter that they must consider. This is the reason that statutory independence is critical to the proper functioning of the Commission. Only if it is afforded this independence is it reasonable for the community to hold the Commission accountable for the consequences of the decisions it makes.*²⁵

Section 20(2) of the ICRC Act lists a number of considerations to which the Commission must have regard in making a price direction in a regulated industry. Broadly speaking, these cover issues relating to the protection of consumer interests, economic efficiency, the financial viability of the regulated entity and environmental protection objectives. There are elements of tension between the multiple (11) considerations listed in this section, meaning that balances need to be struck, trade-offs made, and fine judgements exercised. The case for greater clarity of regulatory objectives, and clearer guidance to the regulator, is considered in Chapter 5.

The conduct of a pricing investigation

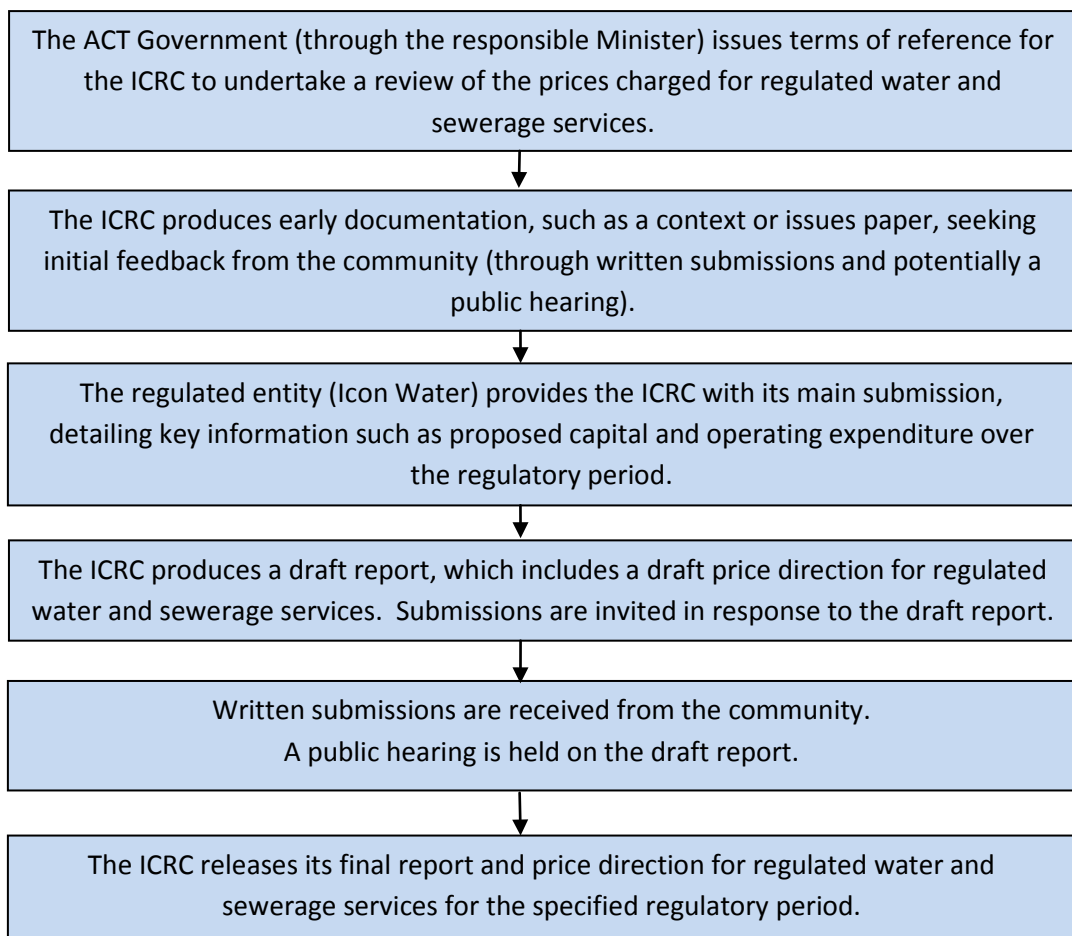
Part 3 of the ICRC Act sets out the procedural requirements to be met by the ICRC in conducting an industry reference investigation. In the case of a price regulation investigation, these include a requirement to invite public submissions and conduct public hearings (section 17(4)). The Commission is also required to prepare a draft report on its investigation and make this available for public inspection and comment over a defined period; any written comments received must be taken into account in preparing the final report (section 18(6)). A simplified diagram of the key steps involved in conducting a pricing investigation is provided at *Figure 2.1* below.

Apart from the specific requirements just mentioned, the ICRC Act is not highly prescriptive on how the Commission is to conduct an industry reference investigation: indeed, section 17(6) provides that:

Subject to this Act, the commission may conduct an investigation in any way the commission considers appropriate.

²⁵ ICRC 2014e, page 32

Figure 2.1: Key steps in a pricing investigation



Like most other Australian regulators, the ICRC has used the ‘building blocks’ model as its key technique to establish efficient cost benchmarks. Under this model, a total revenue requirement for the regulated entity is produced by determining the level of revenue appropriate to each of the ‘building blocks’ in the model; prices are then determined by dividing the revenue requirement by forecast demand (taking into account the division of demand between different ‘tiers’ within the overall pricing structure). The regulator undertakes an assessment of operating and capital expenditure to ensure that the building blocks, and therefore prices, reflect only efficient and prudent expenditure. Specialist engineering, financial and other advice will often be sought in making these assessments. The building blocks model typically provides for prices to be adjusted each year over the course of the regulatory period to ensure that the revenue recovered is equivalent to the ‘efficient’ revenue requirement.

The building blocks methodology is a well-established regulatory approach which has a number of significant advantages. The methodology is well-documented, transparent in its application, and well understood and accepted. It usually leads to a relatively stable and predictable set of outcomes over time and, from the regulated utility’s point of view, offers a reasonable level of assurance that it will be able to recover the cost of its investments. Importantly, also, the methodology can provide strong incentives for achieving operating efficiencies. The regulator

reflects in its pricing decisions only those costs which are deemed to be 'prudent and efficient'. In addition, the regulated entity will have incentives to reduce its costs below those deemed efficient by the regulator: if the business out-performs the cost benchmarks used by the regulator, while maintaining service standards, it will keep usually some or all of those efficiency gains. The longer the regulatory period, the stronger are these incentives, as any early efficiency gains will be retained for a longer period of time.

The drawbacks of the building block methodology are also well known. The approach is heavily information-dependent and data-intensive, and therefore potentially costly. Detailed reviews of forecast costs can impose an onerous burden on both the regulator and the regulated entity. Even if a substantial amount of information is collected, the regulator will always suffer from 'information asymmetry', in that the regulated entity will invariably have access to more comprehensive and up-to-date information than the regulator. It is difficult for the regulator to determine the regulated entity's efficient costs unless it has a high degree of understanding and information about the business, which often is not easy to obtain. There is also scope for 'regulatory gaming' on the part of the regulated entity: for example, a regulated business may submit inflated estimates of its revenue requirements in anticipation of a downward adjustment by the regulator.²⁶

Finally, the application of the building block methodology requires a number of fine judgements to be made, and balances struck, by the regulator. As the ICRC commented in its submission:

*Consideration of these matters will inevitably involve the exercise of judgment in assessing the likelihood of various outcomes in the future, the reliability of evidence and expert opinion placed before the Commission, the applicability of various regulatory principles to questions arising in the course of the investigation, and the priority to be accorded to the frequently competing objectives to which the Commission must have regard. Making such judgements will inevitably entail making tradeoffs, including between the benefits available if a certain outcome can be secured against the risks involved in pursuing that outcome.*²⁷

While such judgements are both necessary and unavoidable, they do carry a material risk that they will be subject to debate and disagreement. If key issues of contention cannot be resolved in the course of a pricing investigation, this can ultimately lead to an application for review of the regulator's decisions, leading to a further increase in overall regulatory costs.

Three general comments should be made on the matters discussed in this section.

Firstly, the regulation of monopoly prices is not an exact science, and no single methodology is clearly 'best' in all circumstances. As Dr David Cousins advised the Auditor-General in the context of the recent performance audit:

²⁶ Productivity Commission 2011a, page 303

²⁷ ICRC 2014e, page 31

*Whilst there has been a clear evolution to a relatively common model in Australia, as well as the UK and USA, there is no reason why experimentation with other approaches should not occur. Indeed, it is desirable that such experimentation does occur. Further, different methodological approaches should not be seen as ends in themselves, but rather as means to inform regulators as to the decisions on prices they have to make. Price regulation is, or should be seen as, an art just as much as a science. Regulators need to take many factors into account and these factors need to be balanced by informed and wise judgement.*²⁸

Secondly, and regardless of the particular methodology chosen, the effective operation of the regulatory framework will depend critically on a strong and professional working relationship between all parties to the process, and in particular between the regulator and the regulated entity. There needs to be mutual understanding and acceptance of respective roles and responsibilities, a willingness to share relevant information, and an openness at all times to constructive dialogue and debate. There is inevitably some degree of tension in the relationship between a regulator and a regulated entity, but this tension needs to be managed in a constructive and professional manner. A breakdown in this key relationship, as occurred in the course of the ICRC's latest pricing investigation, will serve no party well.

Thirdly, the costs of the regulatory process need to be monitored and contained as far as reasonably possible, sufficiently at least to be confident that these costs are outweighed by the benefits flowing from regulation. Cost and cost-effectiveness issues are discussed further later in this chapter.

The regulated entity

Icon Water Limited (previously ACTEW Water Corporation) is the government-owned utility whose prices for regulated water and sewerage services are determined by the ICRC. Icon Water is the ACT's largest publicly owned entity, the sole supplier of water and sewerage services to the ACT community, and the owner of the ACT's water and sewerage infrastructure. It is an unlisted public company fully owned by the ACT Government, with the Chief Minister and the Deputy Chief Minister as its two voting shareholders. The company was created (as ACTEW) in 1995 as a wholly publicly owned corporation incorporated by and subject to Commonwealth corporations law (now the *Corporations Act 2001*). It was also prescribed as a corporation subject to the provisions of the ACT's *Territory-owned Corporations Act 1990*. These arrangements were broadly consistent with the requirements and expectations flowing from the national competition policy reforms of that time.

In the context of this review, two particular features are worthy of note. First, there is no effective competition in the supply of water and sewerage services to the ACT, meaning that the arguments for arrangements which seek to impose efficiency disciplines on the monopoly provider are particularly strong in the circumstances of the Territory. Second, in contrast to the arrangements applying in some other parts of the country, the ICRC needs to deal with only a single water

²⁸ Quoted by ACT Auditor-General, page 70

service provider in its role as the independent pricing regulator; in Victoria, by contrast, the independent regulator makes decisions on the prices to be charged by 19 separate businesses. All else equal, this would suggest that the ICRC's price investigations should be undertaken at lower cost, and completed more quickly, than the corresponding process conducted in a jurisdiction such as Victoria.

Costs and cost-recovery arrangements

Section 19(1)(d) of the ICRC Act provides that the 'reasonable costs' of an investigation on an industry reference involving a utility service are payable by the utility responsible for providing the regulated service. 'Reasonable costs' are assessed and notified by the Commission, and include any costs incurred in obtaining specialist advice (such as engineering or financial advice). In conducting its pricing investigation for the 2013-2019 period, the ICRC invoiced ACTEW for an amount of some \$2.364m (GST inclusive), in accordance with these provisions. Further costs were incurred by ACTEW itself through its participation in the pricing investigation process.

The ICRC's significant dependence on cost-recovery revenue is an important consideration in the context of this review, and is discussed further below.

Appeal and review arrangements

Part 4C of the ICRC Act provides that either the 'referring authority' (i.e., the responsible Minister) or the utility providing the regulated services may apply for a review of a price direction issued by the ICRC. An application for review must be considered by an 'industry panel' of three members appointed by the Minister (section 24M). The panel has power to dismiss the application only if deems it to be frivolous or vexatious (section 24R).

The availability of an effective appeal and review mechanism is an important characteristic of a well-designed regulatory system, providing assurance that the regulator will use its authority lawfully, fairly and accountably. The current review of the ICRC's price direction for 2013-2019 is the first review of a price direction to be conducted under the ICRC Act. Some important issues relating to the current arrangements for review of a price direction are examined in Chapter 4.

2.4 Assessment of the current regulatory framework

The various reports mentioned in Chapter 1 – in particular the Deloitte reports,²⁹ the Frontier Economics report³⁰ and the National Water Commission review of pricing reform in the Australian water sector³¹ – provide a useful checklist of characteristics and features against which the structure and performance of any given regulatory system may be judged. Using the broad assessment frameworks employed by these reports, this section examines both the strengths and weaknesses of the ACT's current regulatory framework.

²⁹ Deloitte Touche Tohmatsu 2014a and Deloitte Touche Tohmatsu 2014b

³⁰ Frontier Economics 2014

³¹ National Water Commission 2011

Strengths of the current framework

It is important to acknowledge at the outset that the ACT's regulatory framework has a number of notable strengths. Among them are the following significant features.

(a) Statutory independence and determinative powers

As noted above, the ICRC Act confers statutory independence upon the ICRC and provides a number of protections against political (or other) interference in the price determination process. Moreover, the ICRC as the ACT's independent regulator *determines* the maximum water prices which the regulated utility, Icon Water, may charge. In a number of other jurisdictions, by contrast, at least until recently, the role of the regulatory body has been largely confined to providing advice to government (which ultimately set or approved prices), or reviewing the price-setting process.

This combination of statutory independence and determinative powers is critical to the effective achievement of the objectives discussed at the start of this chapter. In its 2011 review of pricing reform in the water sector, the National Water Commission assessed the ACT's arrangements in this regard as among the three strongest in the country (along with Victoria and parts of New South Wales).³²

(b) Transparency of processes

At least at a high level, the ACT's arrangements for determination of water and sewerage prices meet the important test of transparency. All documents relevant to a pricing investigation, including initial discussion papers, submissions received and the commissioned reports of independent experts, are published on the ICRC's website, subject only to the protection of any confidential material. The methodology used by the ICRC – a particular form of the 'building block' methodology – uses transparent assumptions which are thereby open to challenge and debate. Moreover, the Commission has been careful to document its sources and to explain the rationale for its assumptions and general approach by reference to published data and the relevant economic literature. While there are issues (discussed below) about the adequacy of the ICRC's conduct of its latest pricing investigation, this review has found no evidence to suggest that the Commission has other than a strong commitment to transparency.

³² National Water Commission 2011, page xi. A number of jurisdictions have made changes to their regulatory arrangements since the release of this report. The recent Frontier Economics study (*Frontier Economics, 2014*) concluded that the regulators in New South Wales, Victoria, South Australia, the ACT and Tasmania had deterministic powers to set water prices. The Economic Regulation Authority in Western Australia makes recommendations only to the responsible Minister. The *Queensland Competition Authority Act 1997* provides for the regulatory oversight of water monopoly business activities, but the powers of the Authority are limited to making recommendations to government about the pricing practices of these businesses. In the Northern Territory, the Treasurer is responsible for regulating water and sewerage prices and service standards, with prices and standards being enforced by the Utilities Commission.

(c) Public consultation and community engagement

The ICRC states that “public consultation is a crucial element of the Commission’s processes,”³³ and its practices are broadly consistent with that commitment. In conducting its most recent pricing investigation, for example, the ICRC released an initial ‘context paper’ and then an ‘issues paper’, on which it invited public comment and submissions. Seven submissions were received, including four from interested members of the public. Subsequently, it released a community consultation paper, which it used as the basis for a public forum held on 27 September 2012. Five submissions were lodged in response to this paper. The ICRC also sought public submissions on its draft report, which it released on 26 February 2013. A public forum and a public hearing on the draft report were held in March and April 2013, respectively. A total of 18 submissions were lodged in response to the draft report, the majority of these from interested individuals or community organisations.

While the ICRC does not have a formal mechanism for community consultation, such as the Consumer Challenge Panel,³⁴ which contributes to the Australian Energy Regulator’s price determination processes, its practices in this area seem both reasonable and appropriate to the scale of its operations. The recent Deloitte analysis suggests that the ICRC’s arrangements in this regard are at least on a par with those employed by its counterparts in other jurisdictions.³⁵

There is a broader issue here for government consideration. Individuals often lack the means, the time, resources and know-how to represent their views as consumers in regulatory forums. The technicalities and language used in price determination processes are complex to the interested outsider, and represent a potential deterrent to effective engagement with the regulator. One result of this is that regulatory decision-makers such as the ICRC often have limited information on consumer views and preferences, such as their willingness to pay for particular services or the importance they attach to high standards of service. As the Productivity Commission has argued, there is a sound case for governments to help ensure that consumer representatives have the financial wherewithal to make an effective input into policy and regulatory processes:

*... there would potentially be net benefits from the provision of additional taxpayer resources for consumer advocacy provided there are means of ensuring that it generates advocacy that is appropriately representative and that benefits significant numbers of consumers.*³⁶

The review suggests that the ACT Government consider the introduction of measures designed to support more effective consumer advocacy, research and engagement in the regulatory decision-making process.

³³ ICRC 2013a, page xv. A similar statement is made in all recent ICRC reports on which public comment is invited.

³⁴ <http://www.aer.gov.au/about-us/consumer-challenge-panel>

³⁵ Deloitte Touche Tohmatsu 2014a, pages 11-12

³⁶ Productivity Commission, *Review of Australia’s Consumer Policy Framework*, page 281 (quoted in Productivity Commission 2011a, page 237).

(d) Focus on efficiency

Consistent with the principles endorsed in the *COAG Water Reform Framework* (1994) and the *National Water Initiative* (2004), the ICRC's processes place a strong emphasis on the principle of full cost recovery, the assessment of prudent and efficient costs, and thereby the promotion of efficient prices. Full cost recovery is a well-established public policy principle, and has been the primary basis for the pricing of water and sewerage services in the ACT since the current regulatory arrangements were put in place in the late 1990s. In applying this principle, the ICRC sets prices which aim to allow the regulated entity to recover the full prudent and efficient costs of the services provided to its customers during the regulatory period. In assessing the prudence and efficiency of costs, the Commission first has regard to the processes employed by the regulated entity itself to ensure that its planned expenditures are prudent and efficient, and then employs benchmarking and similar processes, on a selective basis, to provide independent assurance that planned expenditures meet reasonable industry standards.³⁷

These arrangements are consistent, at least at a high level, with accepted and well-established regulatory practice and principles. If well designed and implemented, they will serve the long-term interests of the ACT community by promoting prices and pricing structures which are justifiable, efficient and sustainable over time.

(e) Appeal and review arrangements

Appropriately, the ACT's regulatory framework provides a mechanism by which an appeal can be made against a pricing decision of the independent regulator and a review conducted in response to the issues raised in the appeal. As noted above, the availability of an effective appeal and review mechanism is an important characteristic of a well-designed regulatory system. Such an arrangement helps to ensure that regulatory authorities exercise their authority within the scope permitted by their legal powers, exhibit procedural fairness, and have justifiable reasons for their decisions.³⁸ An effective review or appeals process will also help to prevent abuse of discretionary authority, and preserve the integrity of the regulatory system by making the regulator accountable for its decisions.³⁹ The recent Frontier Economics report identifies Victoria and the ACT as the two jurisdictions with the most broad-ranging arrangements for the appeal and review of regulatory decisions.⁴⁰

Notwithstanding these evident strengths, the review arrangements applying under the ICRC Act raise a number of important issues which warrant consideration in the context of this review. These go to matters such as the appropriate form and type of review, having regard to considerations of proportionality and cost-effectiveness; the basis on which an application for a review may be lodged; the parties which should be able to lodge an application for a review; and

³⁷ ICRC 2013a, Chapter 7

³⁸ Frontier Economics 2014, page 34

³⁹ *ibid.*, pages 34-35

⁴⁰ Frontier Economics 2014, page 40

the body which should be responsible for conducting a review. These issues are examined in Chapter 4.

Areas of weakness or vulnerability

Having established that there are some significant strengths of the ACT's current regulatory framework, as discussed above, it is important also to consider any material areas of weakness or concern, as well as any areas of risk or potential vulnerability for the future.

(a) Costs

A significant concern relates to the overall cost of the regulatory process for determining water and sewerage prices. Key components of the cost of the ICRC's most recent pricing investigation are listed in Table 2.1 below, the data in which are drawn from the performance audit report issued by the Auditor-General in April 2014. The direct costs shown for the ICRC are the amounts for which the ICRC invoiced ACTEW under section 19 of the ICRC Act, representing the costs it incurred in conducting the pricing investigation process. The indirect costs shown are those which ACTEW advised the Auditor-General it had incurred by reason of its participation in the pricing investigation.

Table 2.1: Costs of the ICRC's pricing investigation for 2013-19

	\$'000
ICRC's direct costs	
<i>Staffing costs</i>	843.4
<i>Consultancy costs</i>	471.8
<i>Administrative costs</i>	151.2
<i>Overhead costs</i>	898.0
Total ICRC costs	2,364.3 (a)
Indirect costs (incurred by ACTEW)	
<i>Staffing and overhead costs</i>	2,482.6 (b)
<i>Contractor and consultancy costs</i>	1,262.3
<i>Legal fees</i>	200.1
<i>Other costs</i>	20.8
Total ICRC costs	3,965.8
Total costs	6,330.2

(a) Inclusive of GST. (b) Exclusive of GST.

Total costs from these two sources combined amounted to some \$6.3 million. If the likely costs (both direct and indirect) of the current industry panel process are added to this amount, along

with the costs incurred to date in the ICRC's 'biennial recalibration' process, it seems likely that the total cost of determining the ACT's water and sewerage prices for the regulatory period starting in July 2013 will be close to \$9 million.⁴¹ These costs are ultimately passed on to customers in the form of higher prices.

Direct comparisons of costs across regulatory boundaries are fraught with difficulty, but some limited evidence is provided by the recent Deloitte report⁴² commissioned by the Essential Services Commission in Victoria. Considering only the direct costs of the most recent regulatory price reviews conducted in each jurisdiction, the Deloitte study found that the highest direct cost was incurred by the regulator in Victoria (\$2.8m), with direct costs for the regulators in other jurisdictions (excluding the ACT) ranging from less than \$300,000 to around \$1.5 million. Deloitte warns that the data provided by its survey respondents were estimates only, and that the methodology for estimation may have varied between respondents. A key area of uncertainty is how 'overhead costs' were interpreted and treated by respondents to the survey.⁴³

Allowing for these significant qualifications and uncertainties, the direct costs incurred by the ICRC in its latest pricing review appear to be at the higher end of regulatory costs incurred, especially if allowance is made for considerations of scale. The direct costs of \$2.8 million incurred by the Essential Services Commission in Victoria, for example, covered the work involved in undertaking reviews of 19 different water businesses and making three separate price determinations. On a unitised basis – per regulated business, for example, or per \$m of regulated revenue – the costs incurred by the Victorian regulator were markedly less than those recorded in the ACT. Similarly, the costs reported by several other regulators were less in absolute terms than the costs incurred by the ICRC, even if the 'overhead costs' element (\$898,000) of the ICRC's invoiced costs is removed.⁴⁴

The ICRC itself has identified a number of factors which may have served to increase the costs of its latest pricing investigation in ways which might have been avoided,⁴⁵ including inefficiencies in the processes by which the Commission gathered information for its investigation and the fact that the Commission was "poorly prepared to receive the terms of reference for the review of water and sewerage services prices".⁴⁶ These factors are discussed further below. It is relevant also to note that the direct costs incurred by the ICRC in conducting its latest pricing investigation

⁴¹ On the latest estimate available, the direct costs incurred by the Industry Panel in conducting its review are likely to total approximately \$1.4 million, while Icon Water has estimated that its costs in contributing to this process have amounted to some \$600,000. The direct costs incurred by the ICRC in conducting its biennial recalibration process have amounted to some \$270,000 to date, and additional costs have also been incurred by Icon Water in this process.

⁴² Deloitte Touche Tohmatsu 2014a, pages 18-19

⁴³ Overhead costs incurred by the ICRC amounted to \$898,000, or some 38 per cent of its direct costs in conducting the pricing investigation (Table 2.1 above).

⁴⁴ The New South Wales regulator, IPART, advised the Productivity Commission in 2011 that it estimated the direct cost to IPART of a typical water price review at around \$360,000. This estimate included staff costs, expenditure on consultancies, the costs associated with public hearings and costs incurred through the various stages of the IPART review process. (Productivity Commission 2011a, page 315)

⁴⁵ ICRC 2014e, pages 10-15

⁴⁶ *ibid.*, page 12

were some 70 per cent higher than the corresponding costs of its previous investigation of water and sewerage prices, concluded in 2008.⁴⁷

In the absence of any comparative data, it is difficult to make any comment about the reasonableness or otherwise of the indirect costs incurred by ACTEW in contributing to the latest pricing investigation, other than to say that an indirect cost of nearly \$4 million (more than 60 per cent above the ICRC's direct costs) seems particularly high. As discussed below, there were some particular features of the latest pricing investigation which would clearly have added to the costs incurred, both direct and indirect, with the \$200,000 spent by ACTEW on legal fees being one manifestation of this. The costs incurred by a regulated entity in participating in a pricing investigation are largely a matter for its board and its shareholders; however, where the entity is a publicly owned utility, there is also a wider public interest in ensuring that these costs, like the utility's costs more generally, are both prudent and efficient.

It is fair to note that the absolute level of costs incurred in the regulatory process is not the measure which counts most. The key issue, rather, is cost-effectiveness (discussed below): in other words, whether the long-term benefits of regulation outweigh the costs involved. It is also the case, as the ICRC has noted, that the unit costs involved in administering other regulatory frameworks – in particular, the national energy framework regulated by the Australian Energy Regulator – are probably significantly higher than the equivalent costs of administering the ACT's water and sewerage pricing framework. While accepting these arguments, the review holds to the view that a total cost of some \$9m for the most recent pricing investigation is unreasonably and unacceptably high; per \$m of regulated revenue, for example, it seems likely to have been the most expensive price determination process ever undertaken in the urban water sector in Australia. If the current regulatory framework is to continue, costs will need to be contained and better managed in the future.

There will be no one single method for achieving this, but a combination of better preparation and planning, clearer and more streamlined processes, better arrangements for the collection of information, a more professional relationship between the regulator and the regulated entity, and a stronger and more active role for government, should go a long way towards ensuring that the regulatory costs incurred are justifiable and efficient. These and related matters are discussed in later chapters of this report.

(b) Timeliness and time management

The timeliness of the ICRC's latest pricing investigation – the overall time taken, the management of time available and the problems experienced in meeting deadlines – is another significant area of concern. Some important papers originally scheduled to be released within the first nine months of the investigation were not in fact produced.⁴⁸ The Commission released the draft

⁴⁷ ACT Auditor-General, page 135

⁴⁸ These were a 'preliminary conclusions report', originally planned for release in May 2012, and a 'working conclusions report', originally planned for release in July 2012.

report on its investigation in February 2013, some 16 months after the terms of reference were issued; this was some three months later than originally planned and only two months before the scheduled completion date for the investigation. Subsequent processes were compressed as a result; for example, the consultation period on the draft report was reduced from the three months originally planned to six weeks.

In normal circumstances this may not have mattered greatly but in the circumstances of this investigation, where the proposals contained in the draft report were matters of significant contention and the Commission itself was about to make some major changes for purposes of its final report, a severely compressed timetable for the final stage of the investigation did not meet the requirements of good process. In the event, the ICRC sought and received from the Treasurer an extension of time for the delivery of its final report and price direction, initially from the date specified in the terms of reference (1 May 2013) to 12 June 2013. Subsequently, the Government further extended this date to 30 June 2013, in order to allow for final consideration of some key matters related to the Commission's price direction.

Consistent with these concerns, the recent Deloitte study found that the ICRC's latest pricing investigation took longer to complete, from receipt of the regulated entity's business proposal to the making of a final price determination, than the pricing reviews conducted by any of the seven other regulators surveyed.⁴⁹ The ICRC itself has acknowledged that the length of its investigation was a significant factor contributing to its cost, and that there is a case for streamlining its investigation processes to shorten the time required for the conduct of a pricing review. It has suggested that, by adopting a number of process improvement measures, "it may be possible to bring the time required for a water and sewerage services (review) back closer to 12 than 20 months".⁵⁰

It is notable that the problems experienced in relation to cost control and time management, as discussed above, occurred despite the relative maturity of the ACT's regulatory framework. In normal circumstances it could be expected that a mature regulatory regime would have put in place streamlined investigation processes and a stable framework for the conduct of its pricing reviews, thereby reducing timeframes and costs. Clearly this was not the case with the latest pricing investigation for regulated water and sewerage services in the ACT. There were probably several reasons for this, including the changes in the membership of the Commission and in the senior management of the ICRC which had taken place only months before the start of the pricing investigation; the significant pressures which had been placed on the regulatory framework by the severe drought conditions and other exceptional circumstances which had prevailed for most of the previous 10 years; and not least, the highly variable and somewhat fragile resourcing base of the ICRC (discussed below).

⁴⁹ Deloitte Touche Tohmatsu 2014a, page 13

⁵⁰ ICRC 2014e, page 15

(c) Predictability and stability

An important hallmark of effective regulatory practice is a high level of consistency and predictability in the regulatory process and its outcomes. The framework for economic regulation should provide a stable and objective environment marked by well defined decision-making criteria and clear timetables which enable all of those affected to anticipate the context for future decisions and, in the case of the regulated entity, to make long-term investment decisions with some degree of confidence.⁵¹

Consistent with these requirements, the regulator needs to make clear at an early stage of a pricing investigation the issues it considers to be important to the investigation and the approaches it intends to adopt to address these issues. There also needs to be effective follow-through. Sudden changes in methodology or approach need to be avoided as far as possible, not least because they can undermine confidence in the regulatory process. Where significant changes in methodology or approach are deemed to be essential or unavoidable, these need to be accompanied by a very clear and public explanation of the reasoning behind them, followed by an effective process of public consultation.

The processes adopted by the ICRC in its latest pricing investigation fell well short of the requirements just outlined. As already noted, two of the early papers which would have been helpful in signalling the Commission's general approach and the conclusions drawn from its initial work on the pricing investigation were not in fact published. The draft report, when released in February 2013, was not only later than originally planned but also contained a number of 'novel features'⁵² which could not reasonably have been anticipated on the basis of earlier indications or guidance. The final report released in June 2013 contained a number of major changes in methodology relative to the draft report (for example, the removal of the 'fair cost recovery scheme' and changes to the way that the return on capital was calculated) and, partly in consequence of those changes, a significant change also to the terms of the draft price direction which had accompanied the draft report. The final price direction determined an overall increase of 5 per cent in the price of water services, compared with the reduction of 16.8 per cent flagged some four months previously. In the case of sewerage services, the Commission determined a price reduction of 18 per cent in its final price direction, compared with the reduction of 24 per cent foreshadowed in its proposed price direction of February 2013.

The ICRC argues strongly that it should not be held solely responsible for the delays which occurred in the production of its draft report, and there is doubtless some substance in that argument. It is also the case that the ICRC set out clearly in its final report the main factors accounting for the significant changes it made relative to its draft report, and the reasons underlying those changes: in other words, it satisfied the requirements of transparency in explaining its final decisions.

⁵¹ Frontier Economics, page 17

⁵² ICRC 2013a, page iii

Accepting these points, however, it remains the case that dramatic shifts such as those which occurred between the ICRC's draft and final reports do not meet reasonable standards of 'predictability and stability', and run the risk of undermining public confidence in the regulatory system. This is especially the case if, because of time pressures or for other reasons, significant changes are not accompanied by an adequate process of public consultation. As the Auditor-General noted in her report, the ICRC's draft report raised expectations among stakeholders, including the community, for water price reductions, but these were ultimately not delivered in the final report produced just four months later.⁵³

None of the foregoing commentary should be taken as implying that no changes should be made between a draft report and a final report, or that regulatory methods and practices should be set in stone. Just as the regulatory and business environment changes over time, so too there should be scope for changes in the regulator's methodology and general approach; indeed, on precisely these grounds, the development of new techniques and regulatory tools should be supported and actively encouraged. What is also essential, however, is that in the process of making such changes, the regulator must bring other parties on board by explaining clearly its rationale, consulting effectively on the changes it proposes and, in particular, by observing meticulously the requirements of due process. It is in these latter respects, in the judgement of this review, that the ICRC fell short in the conduct of its latest pricing investigation.

(d) Administrative processes

The ICRC has acknowledged that it was "poorly prepared" to conduct its latest pricing investigation of water and sewerage services, and that its administrative processes suffered as a result.⁵⁴ Planning for the conduct of the review was not of an adequate standard. Methodological issues and related information requirements were not established, at least at an adequate level of detail, at a sufficiently early stage in the investigation. There were also delays in publishing key papers, such as the issues paper originally scheduled for release in December 2011 but not produced until late February 2012.

As already noted, there were several factors contributing to this lack of preparation for the pricing review and the resultant deficiencies in the ICRC's administrative processes: among them, the small scale of the Commission (meaning that institutional memory and staff expertise are both fragile assets, easily lost in times of change); the changes in the membership of the Commission and in the senior management of the ICRC which had taken place only a few months previously, and the significant adjustments required as a result; and some substantial pressures placed on the Commission's limited available resources.

Looking to the future, and assuming that the current regulatory framework is to be maintained, it will be essential that the Commission is both better prepared and better equipped to conduct its next pricing investigation. This means, among other things, that planning should be completed,

⁵³ ACT Auditor-General, page 75

⁵⁴ ICRC 2014e, page 12

and administrative processes settled, at least several months before the terms of reference for the pricing investigation are issued. In turn, this raises some important issues of resourcing (discussed below).

(e) Communication and relationship management

The Auditor-General's performance audit found that the communication processes associated with the 2013 water and sewerage pricing processes were ineffective and inefficient.⁵⁵ The audit report cited several examples of what it saw as poor communication between the ICRC and ACTEW, reflected in different understandings and expectations on a number of key issues. More generally, the report also concluded that there had been a poor relationship between the ICRC and ACTEW, marked by "organisational and personal conflicts between the agencies".⁵⁶ A particular source of conflict had been ACTEW's refusal to comply with the ICRC's request that it supply some information required for purposes of its draft report by way of an amendment to its main submission to the Commission.⁵⁷ Noting that this and other matters of contention had not been resolved in a timely manner, the Auditor-General recommended that a process be put in place for mediation or dispute resolution in the course of a pricing investigation, in order to limit the risk that similar protracted disputes would occur in the future.⁵⁸

The ICRC contested these findings of the Auditor-General, arguing in effect that the performance audit's treatment of these issues had been unbalanced and selective.⁵⁹ The ICRC rejected outright the conclusion that there had been "personal conflicts" between the Commission and ACTEW, and suggested that the disagreements and organisational tensions which had occurred were those to be expected in a relationship between a regulator and a regulated entity.⁶⁰

It is not the business of this review to adjudicate between these competing views of history. On the available evidence, however, it does seem clear that there was a major breakdown in the relationship between the ICRC and ACTEW in the course of the latest pricing investigation, and that the protracted dispute over the provision of information, in particular, detracted from the overall efficiency of the process. The ICRC's resort to the issue of a formal demand for information under section 41 of the ICRC Act raised the stakes in the dispute, and led to lengthy arguments about whether ACTEW actually held the information sought (i.e., forecasts of billed water consumption). The ICRC's requirement that ACTEW provide such information by way of an amendment to its main submission was another source of argument and contention. Legal advice was taken on both sides, and high levels of legal costs incurred.

In the judgment of this review, this was an unproductive and costly dispute which served neither party well; certainly, it did not meet the requirement discussed earlier in this chapter for a strong

⁵⁵ ACT Auditor-General, page 135

⁵⁶ *ibid.*, page 137

⁵⁷ *ibid.*, Chapter 5

⁵⁸ *ibid.*, 129-130

⁵⁹ ICRC 2014a, pages vi and 15-16

⁶⁰ *ibid.*, page 15

and professional working relationship between the regulator and the regulated entity. It is unrealistic to expect that disagreements or disputes will not arise again in the future but, assuming that the current regulatory framework is to be maintained, it will be essential that means be found to manage such disputes more effectively and thereby contain their consequences.

Better planning and clearer guidance at an early stage of a pricing investigation would clearly help in this regard, especially with regard to key matters such as the information required to be provided by the regulated entity. Broadly speaking, the objective should be to settle at the earliest possible stage the overall framework for the pricing investigation, and to reduce to a minimum the number of areas of potential contention or dispute. In its submission to the review, Icon Water commented on these matters in the following terms:

*The (price control) framework has in the past been heavily reliant on responsible use of regulatory discretion and maintenance of professional working relationships (and goodwill) between the parties. Icon Water submits that the key shortcoming of the framework as it stands is that it does not ensure the provision of sufficient guidance on how regulatory independence, judgement and discretion will be exercised. Icon Water does not dispute that the regulator should have and should exercise discretions over elements of a pricing determination but argues that the exercise of such broad discretions requires robust, transparent guidance to provide confidence to the community and utility that are the subject of the discretion.*⁶¹

(f) Legislative framework

Legislative issues are examined in Chapter 4, and are not discussed in detail here. It is sufficient to note for this purpose that, while the ICRC Act has served the ACT well in establishing and governing the operation of the regulatory framework since 1997, the Act is now showing its age. The Auditor-General's report highlighted some areas of significant ambiguity in the legislation, where clarification at least is needed, and further anomalies and weaknesses have become apparent in recent times. For reasons discussed in Chapter 4, changes to the ICRC Act will be needed even if the decision is taken to retain the current regulatory framework.

(g) Resourcing arrangements

For the ICRC, as for any regulatory body, an adequate level of resourcing is essential if the regulator is to discharge its responsibilities effectively and efficiently. The current resourcing arrangements for the ICRC are unusual in several respects, and present some major challenges to the Commission in performing its role. For the reasons discussed below, they also represent a potential source of vulnerability for the effective operation of the regulatory system. Four particular features warrant mention.

Scale: The ICRC is a very small agency, especially by comparison to its counterpart bodies in other jurisdictions. At 30 June 2014, the ICRC employed a total of 10 staff, four of whom were temporary; in full-time equivalent terms, the staffing complement was just 8.6 FTE.⁶² By contrast,

⁶¹ Icon Water Limited 2014b, page 5

⁶² ICRC 2014c, pages 27-29

the ICRC's counterpart regulators in New South Wales (IPART) and Victoria (the Essential Services Commission) employed 131 and 68 people respectively on the same date, albeit to perform a somewhat broader range of functions.⁶³

The small scale of the ICRC creates some obvious risks and challenges; for example, the loss of a key staff member at a critical time will have a far more serious impact than in a larger agency. Career paths and opportunities for advancement are also more restricted in an agency the size of the ICRC; in turn, this may discourage capable people from seeking employment with the Commission.

Diversity of funding sources: Under current arrangements the Commission has four separate sources of funding:⁶⁴

- cost recovery for work done on matters referred to the Commission, including for price directions;
- licence fees paid by non-energy licensed utilities;
- a budget appropriation, at least partly in lieu of licence fees from licensed energy utilities; and
- a service level agreement (SLA) with the Chief Minister, Treasury and Economic Development Directorate, designed to fund functions that the ICRC is required to carry out but for which it cannot recover costs.

This complex funding structure is largely a legacy of history, and warrants review. A significant element of cost-recovery is appropriate for a regulatory body such as the ICRC, partly as a means of making transparent the costs of regulatory activity in areas such as pricing investigations, but also as a means of maintaining a cost-conscious culture within the ICRC itself. Costs which need to be recovered will also need to be explained and justified as relevant, reasonable and efficient.

To the extent that the ICRC is required to perform functions for which cost-recovery would either be inapplicable or inappropriate, a stream of budget funding is also appropriate. It is not clear, however, that the current SLA with the Treasury directorate is the best means of achieving this; for example, the amount paid under the SLA is determined through the budget process with no input from the ICRC. The two funding streams related to licence fees also lack coherence: it is not clear, for example, why licence fees for energy utilities should be treated differently from licence fees for other utilities, with one determined by and paid to the ACT Revenue Office and the other determined by and paid to the ICRC itself. Moreover, there is no clear connection between the quantum of the 'energy levy' collected by the ACT Revenue Office and the size of the corresponding budget appropriation received by the ICRC.

Assuming that the current regulatory framework is to be maintained, a simpler and more transparent funding structure should be developed for the future. Cost-recovery should be

⁶³ Data are taken from the latest annual reports of IPART and the Essential Services Commission.

⁶⁴ ICRC 2014e, page 24

maintained, for the reasons discussed above, and the structure of licence fees rationalised. A single budget appropriation (rather than the current SLA) should fund functions that the ICRC is required to perform but for which it cannot recover costs: for example, research into regulatory approaches and methods, interaction with other regulators, requirements such as the preparation of annual reports or appearances before the Public Accounts Committee, and the developmental work required to ensure that the Commission is well prepared for the conduct of future pricing investigations. The Commission would then be accountable to the Budget Estimates Committee of the Legislative Assembly for its expenditure of this budget funding.

A funding mix along these lines would have benefits in simplicity, clarity and transparency; it should also serve to bolster the viability of the Commission while protecting its independence. As a further transparency measure, the ICRC has suggested that the regulatory costs of any pricing review process could be reported on customers' bills.⁶⁵

Changes in functions: In addition to making determinations of water and sewerage prices, the ICRC is responsible for undertaking a potentially wide range of other functions. These include:

- the licensing functions for which the ICRC is responsible under the *Utilities Act 2000*;
- the determination of prices in other regulated industries, including periodic determinations and annual resets of the regulated retail prices for electricity;
- the conduct of industry references other than pricing investigations;⁶⁶
- monitoring and reporting annually on the performance of the licensed water, electricity and gas energy networks;
- approval, on an annual basis, of the standard customer contract for ACTEW and ActewAGL Retail (Electricity), to ensure that tariff offerings are consistent with the current price direction;
- the preparation of monitoring reports for the Environment and Planning Directorate on greenhouse gas emissions and the use of renewable energy in the ACT;
- the arbitration of disputes about access to services under access regimes; and
- investigating and reporting on competitive neutrality complaints and government-regulated activities.

In practice, the ICRC has not been called upon to perform a number of these functions; for example, the Commission has not been required to arbitrate any disputes about access to services under access regimes, or to investigate and report on government-regulated activities. Likewise,

⁶⁵ ICRC 2014e, page 25

⁶⁶ For example, in recent years the ICRC has conducted inquiries at the Government's request into the ACT racing industry (2010-11) and secondary water use in the ACT (2012).

the Commission has handled only a small number of inquiries on competitive neutrality matters; even so, it must be in a position to deal with any inquiries or complaints it does receive in this area, and have the capacity to assess whether a full investigation is warranted.

Apart from its licensing functions under the *Utilities Act 2000*, the principal activity of the Commission in recent years has been the conduct of reviews in response to industry references from the Minister, including the development of price directions for a specified utility service. Even in this area, however, the balance of the Commission's functions has shifted markedly in recent times. In particular, with the establishment of the National Energy Customer Framework in July 2012, the Australian Energy Regulator took responsibility for a number of the energy regulation functions which had previously been performed by the Commission. The ICRC's staff numbers were reduced as a result, with several redundancies processed in the course of 2012-13.⁶⁷ Following these changes, the most substantial ongoing function of the ICRC is its role in the determination of water and sewerage prices, which, as discussed below, is by nature a highly cyclical activity.

Major fluctuations in demand: The pricing investigations conducted by the ICRC – the bulk of its work in recent years – are inherently cyclical in nature: intensive work is undertaken over a period of 12-18 months, or thereabouts, but on completion of the investigation, and assuming a regulatory period of 5 or 6 years, there is an inevitable lull in activity before preparation for the next investigation commences. Whether other work will be available to fill the resultant gap is uncertain at best. The cyclical nature of the ICRC's workload is well illustrated by Table 2.2, which highlights the sharp fluctuations in the Commission's resourcing base over the past four years. Of particular note are the large swings in total income received (from \$1.8m in 2010-11 to a peak of \$4.0m in 2012-13, falling again to \$2.6m in 2013-14), and the Commission's high reliance cost recovery as a source of revenue.

A major challenge for the ICRC in recent years has been to manage its resources against these major fluctuations in demand for its services. Since early 2011, for example, the reference workload of the Commission has varied from three significant references running simultaneously in 2011-12 to a brief period in 2013-14 when the Commission had no references at hand.⁶⁸ In the face of this varying workload, the Commission has tried to maintain a degree of flexibility in its staffing arrangements, while also maintaining a core of experienced staff, especially to handle its larger and more sensitive references.

As the Commission has noted on several occasions, striking a balance between these competing objectives is not an easy task.⁶⁹ The risk is that, when its workload troughs, the Commission is unable to fund a viable level of staffing, and quality staff may be tempted to leave; conversely, when workload picks up, the Commission has difficulty in finding the required resources (both in quantity and quality) to respond. These risks were realised in 2011-12, when the

⁶⁷ ICRC 2013e, page 3

⁶⁸ ICRC 2014c, page 6

⁶⁹ *ibid.*

Commission's available resources were insufficient to meet the demands of three significant inquiries running simultaneously. For example, the Commission has attributed the delay in publishing the issues paper for its latest investigation of water and sewerage prices to "the prioritised sequencing of tasks that we were forced to adopt in late 2011 and early 2012, while we recruited staff, obtained new office premises and hired a new CEO".⁷⁰ It notes also that these significant variations in workload, and therefore funding, have been a recurring problem throughout the ICRC's history, and "militate strongly against the Commission operating efficiently".⁷¹

Table 2.2: ICRC income by revenue source, 2010-11 to 2013-14

<i>Revenue source</i>	2010-11	2011-12	2012-13	2013-14
	(\$'000)	(\$'000)	(\$'000)	(\$'000)
Government payments for outputs	497	621	518	406
User charges – ACT Government	476	1,561	2,500	773
User charges – Other	--	--	--	715
Fees (a)	792	670	933	639
Interest	81	75	52	51
Other	--	200	--	--
Total income	1,846	3,127	4,003	2,584
<i>User charges as % of total income</i>	<i>25.8</i>	<i>49.9</i>	<i>62.5</i>	<i>57.6</i>

(a) Utility licence fees are collected from entities providing water and wastewater services and gas transmission services, and are designed to recover the reasonable costs incurred by the ICRC, the Environment and Planning Directorate (EPD) and the ACT Civil and Administrative Tribunal (ACAT) in undertaking their respective regulatory activities. The fees payable in respect of all three agencies are recognised in the financial statements of the ICRC; accordingly, the amounts shown against 'Fees' in the table above include licence fees payable in respect of EPD and ACAT as well as the Commission itself.

Source: ICRC Annual Reports, 2010-11 to 2013-14

While there are no 'easy' or obvious answers to these problems, some broad conclusions may be drawn from the discussion above. One implication is that, if the current regulatory model is to be retained, means will need to be found to boost the viability of the ICRC so that it is not so exposed to the adverse effects of cyclicity in its workload and marked swings in its resourcing base. Options here include the assignment of additional responsibilities to the Commission; a merger with one or more other bodies with related functions; and an increase in the level of budget funding for the Commission to undertake a range of designated functions for which cost-recovery is either inapplicable or inappropriate. The ICRC itself has made some particular suggestions in these respects; for example, it has argued that there is a strong case for the functions of the Technical Regulator to be combined with those of the ICRC.⁷² It has also highlighted the synergies

⁷⁰ ICRC 2014e, page 12

⁷¹ ICRC 2014c, page 6 and ICRC 2014e, pages 12-13

⁷² ICRC 2014e, pages 22-23

between its licensing work under the *Utilities Act 2000* and its price determinations for retail electricity and water and sewerage services.⁷³

As noted above, the determination of water and sewerage prices now represents the most substantive and resource-intensive activity of the ICRC; consequently, if this responsibility were to be removed from its remit, the viability of the Commission in its current form would be in serious question. The implication here is that, in taking its decision on the future framework for regulating the prices of water and sewerage services, the ACT Government will need to be mindful of the full consequences of that decision. In particular, specific regard will need to be paid to the other functions currently performed (either actually or potentially) by the ICRC, and how these functions would be undertaken under any alternative price determination arrangement.

2.5 Have the objectives of economic regulation been achieved?

A key question relevant to any decision on future pricing arrangements for water and sewerage services is whether the current regulatory framework has met the objectives discussed at the front of this chapter. Important as this question obviously is, it is far from easy to answer, at least definitively. The obvious problem is the absence of a counter-factual: in other words, it is not possible to observe directly, or estimate reliably, what pricing outcomes there may have been had there been no regulation, or if a different regulatory framework had been in place. Some broad observations and qualified judgements are however possible.

The National Water Commission, in its 2011 review of water pricing reform of the Australian water sector, concluded that the pricing and institutional reforms initiated in the 1990s had delivered a number of significant benefits.⁷⁴ These included reductions in residential water consumption (per property), following the introduction of consumption-based charging in urban areas; increased scrutiny of water businesses' expenditure, with resultant cost savings to customers; and higher levels of transparency and accountability for all parties. The Commission also noted that the movement to full cost recovery had meant that many water businesses (particularly in metropolitan areas) were better placed to fund major new investments than would otherwise have been the case.

In the ACT context, water prices rose sharply during the early years of the new millennium to a point where, by 2008, Canberra residents were paying higher prices for their water than the residents of any other major city in Australia.⁷⁵ Since that time, however, the growth in the ACT's water prices has moderated significantly. Over the five years to 2012-13, for example, the typical residential water bill in the ACT rose by less than 20 per cent in total (in real terms), far less than the corresponding increases recorded in other major cities.⁷⁶ As a result, by 2012-13, the water

⁷³ *ibid*, page 8.

⁷⁴ National Water Commission 2011, pages 84-85

⁷⁵ ICRC 2008, page x

⁷⁶ This recent narrowing in the water price differentials between the ACT and other jurisdictions can probably be attributed in part to the major investments in water supply projects (such as desalination plants) undertaken in a number of States, the costs of which must now be recovered through water prices.

prices charged to residential customers in the ACT were only slightly higher than the median price charged to customers by the water utilities listed in Table 2.3 below.

Once again, it is difficult to judge with any surety the extent to which these outcomes may be attributed to the operation of the regulatory framework. A broad indication of this may be gleaned, however, by comparing the prices proposed by a regulated utility in its submission to the regulator with the prices ultimately approved by the regulator in its final decision. Table 2.4 below is drawn from the recent Frontier Economics study, and makes this comparison for six different water utilities across Australia, based upon the most recent regulatory decisions in each case.⁷⁷ In every case the 'approved revenue' (the revenue approved by the regulator) is less than the 'proposed revenue' (the revenue proposed by the water utility), with the margins varying between 6 per cent and 26 per cent. Notably, the ACT recorded the highest margin of 26 per cent.

This sizeable margin provides indicative support for the view that the ACT's regulatory system is working effectively: customers are paying lower prices than would otherwise be the case, while Icon Water remains financially viable. Again, however, this evidence cannot be taken as definitive, mainly because there can be no certainty that the prices a water utility proposes to the regulator are those which it would have adopted in the absence of regulation.

**Table 2.3: Water utilities with 100 000+ connected properties:
Changes in water prices, 2007-08 to 2012-13**

Utility	2007-08 (\$)	2012-13 (\$)	% change
(a) Changes in a typical residential bill (based on average residential water supplied)			
ACTEW (ACT)	985	1,174	19.2
Sydney Water	811	1,112	37.1
WC (Perth)	967	1,205	24.6
Yarra Valley Water	540	956	77.0
South East Water	521	856	64.3
SA Water (Adelaide)	823	1,362	65.5
City West Water	507	814	60.6
Hunter Water	676	976	44.4
Barwon Water	693	1,066	53.8
<i>Median</i>		<i>1,112</i>	

⁷⁷ Frontier Economics 2014, page 10

Table 2.3 (Continued)**(b) Changes in the prices charged for 200 kilolitres of water**

Utility	2007-08 (\$)	2012-13 (\$)	% change
ACTEW (ACT)	1,001	1,186	18.5
Sydney Water	833	1,116	34.0
WC (Perth)	905	1,120	23.8
Yarra Valley Water	623	1,106	77.5
South East Water	615	1,021	66.0
SA Water (Adelaide)	830	1,387	67.1
City West Water	600	963	60.5
Hunter Water	713	1,026	43.9
Barwon Water	779	1,154	48.1
<i>Median</i>		<i>1,154</i>	

Source: National Water Commission (NWC), *National performance reports for 2011-12 and 2012-13, Urban water utilities*. Price data for 2007-08 as published by the NWC have been indexed to make them comparable with those for 2012-13.

Table 2.4: 'Proposed' and 'approved' revenues for regulated water utilities

State/Territory	Utility	Proposed Revenue (\$m)	Approved Revenue (\$m)	Difference (%)
ACT	ACTEW	718.2	530.0	-26%
NSW	Hunter Water Corporation	2,233.3	2,109.0	-6%
NSW	Sydney Water Corporation	10,471.8	9,243.8	-12%
Victoria	City West Water	3,157.2	2,917.5	-8%
Victoria	South East Water	4,560.5	4,210.1	-8%
Victoria	Yarra Valley Water	4,936.6	4,569.7	-7%

Source: Frontier Economics: *Improving economic regulation of urban water*, August 2014 (report prepared for the Water Services Association of Australia). ACT data relate to the ICRC Price Direction for the period 1 July 2013 to 30 June 2019. The data for other jurisdictions are sourced from the most recent regulatory price determinations in each case.

Also supporting a positive view on the impact of the regulatory system is related evidence on changes in service standards in recent years. The Frontier Economics study examined the average annual rate of change in performance against some key service standards for a number of water

and sewerage utilities over the six years to 2012-13.⁷⁸ In the case of the ACT, ACTEW achieved a significant reduction (14 per cent per annum, compounded) in the incidence of water mains breaks over this period, and a more moderate reduction (4 per cent per annum, compounded) in the frequency of water interruption. There were small increases (4 per cent and 3 per cent per annum, respectively) in the duration of water interruptions and sewerage interruptions.

A key objective of economic regulation is to ensure that regulated utilities invest efficiently in long-term infrastructure and other assets, and that they operate efficiently. This is necessary, among other reasons, to ensure that customers are provided with the services they need at lowest long-term cost.⁷⁹

As in the other areas discussed above, it is extremely difficult to quantify at all precisely the impact of regulatory activity on the efficiency of a utility's operations or the quality and appropriateness of its infrastructure investments. However, the detailed scrutiny undertaken by the ICRC of ACTEW's expenditure proposals (both operating and capital) has provided a reasonable level of assurance in this regard. As one example only, the Commission in its latest pricing investigation identified three projects undertaken by ACTEW which, in its judgement, had the character of a community service obligation rather than a service designed primarily to meet customer needs. Accordingly, it treated the costs associated with those projects on the basis that they should have been funded separately from consolidated revenue, rather than paid for by ACTEW's customers.⁸⁰

The ICRC itself has put the view that the regulatory system is working effectively, and as intended. In its latest Annual Report for example, it commented as follows:

*The ACT has a safe and reliable supply of water and sewerage services and electrical energy. This reflects past investment in these services, the competence of the suppliers and the operation of the regulatory framework. In making a price direction the Commission must have regard to the protection of consumers from abuses of monopoly power. The Commission also engages with the technical regulator and the ACAT in respect of industry and technical codes which are primarily concerned with public safety, network reliability and security, and consumer protection. In respect of the regulatory framework the Commission seeks to ensure that these regulations achieve their objectives at minimum cost to the community.*⁸¹

and again:

The Commission's view, based on public comments by ACTEW, is that the price direction is working as designed. Prices increases have been kept at or near inflation, the community is

⁷⁸ Frontier Economics 2014, pages 8-9

⁷⁹ *ibid.*, page 11

⁸⁰ These were the provision of sewerage services to the community at Uriarra, the construction of the Cotter Discovery Trail and Precinct, and the achievement of carbon neutrality for the water security projects (see ICRC 2013b, Chapter 6).

⁸¹ ICRC 2014c, page 7

*using more water, although still significantly below pre-drought levels, while ACTEW's profitability has exceeded that anticipated in the Commission's Final Report.*⁸²

Similar comments were made in the ICRC's submission to this review, albeit with an acknowledgement that there are some significant aspects of the current regulatory framework in which there is scope for improvement in cost-effectiveness.⁸³

In summary, there are a number of indications which suggest that the ACT's system of price regulation of water and sewerage services has worked as intended to constrain the misuse of monopoly powers and promote the efficiency of service provision, while at the same time safeguarding the financial viability of the regulated utility. None of these indications is conclusive on its own, but in combination they constitute a reasonable body of evidence that the ACT benefits from its current regulatory framework, and that customers are better off than if there were no system of regulation in place.

Clearly, this is not to imply that the current regulatory system cannot be improved – on the contrary, it is evident that there is substantial room for improvement – or that possible alternative arrangements to the current framework should not be considered. These matters are discussed briefly in the following section, and in more detail in Chapter 6.

2.6 Should the ACT retain its current system of price regulation?

The threshold question for the ACT Government arising from this review will be whether it should retain the current regulatory framework for the determination of water and sewerage prices in the Territory. Some preliminary comments on this issue are relevant here, in the light of the analysis of strengths and weaknesses presented in this chapter.

Perhaps the first point to be made is that, even if the current regulatory framework is judged to be working effectively, it is not the only option available; no regulatory system can be considered 'ideal' in any sense, and there are other possible arrangements (discussed in Chapter 6) which warrant consideration by Government in taking its final decision on this matter. Ultimately, the key judgement required will be which of the various options best meets the tests of cost-effectiveness and practicability. As the ICRC argued in its submission:

*The decision as to whether the ACT should have its own regulatory agency to handle the determination of water and sewerage services prices should be made on the grounds of the cost effectiveness of the alternatives. Since the ACT currently has its own regulatory agency responsible for determining the price of water and sewerage services, the decision becomes one of deciding whether that function should continue to be discharged by that agency or whether alternative arrangements should be put in place.*⁸⁴

⁸² *ibid.*, page 8

⁸³ ICRC 2014e, pages 9-10

⁸⁴ ICRC 2014e, page 6

*Any identified improvements in the current arrangements should be implemented or their likely impact allowed for in making any comparison with the costs of an alternative arrangement. Before moving to change the current arrangements a complete, viable alternative should be developed. Any comparison of cost effectiveness should include consideration of all the ramifications and associated costs of the alternative.*⁸⁵

Whatever final decision is taken by the ACT Government on this threshold issue, some significant consequences will flow and need to be managed. For example, each of the alternative arrangements discussed in Chapter 6 presents its own set of risks and challenges, and a clear strategy would need to be developed for managing these before any commitment was made to adopt one of these alternatives. Equally, if the decision were taken to maintain the current regulatory framework, it would be essential to act to address the significant weaknesses and potential vulnerabilities discussed earlier in this chapter and elsewhere in this report. In short, the Government's decision on future arrangements for determining the prices of water and sewerage services will need to be taken in full knowledge of the likely consequences of that decision.

2.7 Conclusions

Conclusion 2.1: *The ACT's current regulatory framework has a number of significant strengths. The ICRC Act confers statutory independence upon the ICRC and provides a number of protections against external interference in the price setting process. Moreover, the ICRC has determinative powers: that is, it determines (rather than merely advises on) the maximum prices which the regulated utility, Icon Water, may charge. This combination of statutory independence and determinative powers is critical if the key objectives of economic regulation are to be met.*

There are other strengths as well. The ICRC's arrangements for the determination of water and sewerage prices meet the important test of transparency. They provide reasonable opportunities for public consultation and public input to the price determination process. They place a strong emphasis on the principle of full cost recovery, the assessment of prudent and efficient costs, and thereby the promotion of efficient prices. The ACT's regulatory framework also provides a mechanism by which an appeal can be made against a pricing decision of the independent regulator and a review conducted in response to the issues raised in the appeal. In these and other respects the ACT's regulatory framework compares favourably with those applying in most other jurisdictions.

Notwithstanding these significant strengths, however, there are also some important areas of weakness or potential vulnerability in the current regulatory arrangements.

Conclusion 2.2: *Costs are one area of significant concern. Considering all sources of expenditure, including those associated with the current independent review of the ICRC's*

⁸⁵ *ibid.*, page 9

original pricing decision, it seems likely that the total cost of determining the ACT's water and sewerage prices for the regulatory period starting in July 2013 will be close to \$9 million. These costs are ultimately passed on to customers in the form of higher prices.

A total cost in the order of \$9 million is unacceptably high, especially in the circumstances of the ACT: per \$m of regulated revenue, for example, it seems likely to have been the most expensive price determination process ever undertaken in the urban water sector in Australia. There were a number of special factors, including a range of identified inefficiencies, which contributed to the high costs of the latest pricing investigation; the need to undertake an industry panel review of the ICRC's original decision has also been a significant factor in increasing overall costs. Even so, assuming that the current regulatory framework is to continue, costs will need to be contained and better managed in the future.

Conclusion 2.3: *The timeliness of the regulatory process is another area of concern. The ICRC's latest pricing investigation took longer to complete, from receipt of the regulated entity's business proposal to the making of a final price determination, than the pricing reviews conducted by any of seven other regulators examined in a recent survey. The ICRC itself has acknowledged that the length of its investigation was a significant factor contributing to its cost, and that there is a case for streamlining its investigation processes to shorten the time required for the conduct of a pricing review.*

Conclusion 2.4: *An important hallmark of effective regulatory practice is a high level of consistency and predictability in the regulatory process and its outcomes. The ICRC did not meet this requirement in its latest pricing investigation. Its draft report was not only released later than originally planned but also contained a number of 'novel features' which could not reasonably have been anticipated on the basis of earlier indications or guidance. The Commission's final report also contained a number of major changes in methodology relative to its draft report, which in turn led to significant changes in the terms of its final price direction. The issue here is not that changes were made, but the process by which they were made: in particular, without adequate lead-time, consultation or explanation in advance.*

Conclusion 2.5: *There were significant shortcomings also in the ICRC's administrative processes. The ICRC has acknowledged that it was 'poorly prepared' to conduct its latest pricing investigation, and that its administrative processes suffered as a result. Planning for the conduct of the review was not of an adequate standard. Methodological issues and related information requirements were not established, at least at an adequate level of detail, at a sufficiently early stage in the investigation. There were also delays in publishing some key papers related to the investigation.*

There were several factors contributing to these problems, not all of them entirely within the

Commission's control. Assuming, however, that the current regulatory framework is to be maintained, it will be essential that the Commission is better prepared and equipped to conduct its next pricing investigation. This means, among other things, that planning should be completed, and administrative processes settled, at least several months before the terms of reference for the pricing investigation are issued.

Conclusion 2.6: *The effective operation of the regulatory framework depends critically on a strong and professional working relationship between the regulator and the regulated entity. There needs to be mutual understanding and acceptance of respective roles and responsibilities, a willingness to share relevant information, and an openness at all times to constructive dialogue and debate. These requirements were not met in the ICRC's latest pricing investigation, which was marked by an unproductive and costly dispute between the ICRC and ACTEW, as the regulated entity.*

It is unrealistic to expect that disagreements or disputes will not arise again in the future but, assuming that the current regulatory framework is to be maintained, it will be essential that means be found to manage such disputes more effectively and thereby contain their consequences. Better planning and clearer guidance at an early stage of a pricing investigation will be important in this regard, especially on key matters such as the information required to be provided by the regulated entity. The objective should be to settle at the earliest possible stage the overall framework for the pricing investigation, reducing to a minimum the number of areas of potential ambiguity, contention or dispute.

Conclusion 2.7: *The legislative framework governing the operation of the regulatory system has served the ACT well since its enactment in 1997, but a number of significant weaknesses have become evident in recent times. Changes to the ICRC Act will be needed regardless of the decision taken by the ACT Government on the future form and structure of the regulatory framework.*

Conclusion 2.8: *The current arrangements for resourcing of the independent regulator represent another source of weakness and potential vulnerability. The ICRC is a very small agency, far smaller than its counterpart regulators in other jurisdictions; it is also subject to major fluctuations in demand for its services, as well as changes in the balance of its functions over time. These problems are compounded by an unduly complex funding structure, and a high level of volatility in funding levels. Assuming that the current regulatory model is to be retained, means will need to be found to boost the viability of the ICRC so that it is not so exposed to the adverse effects of cyclical in its workload and marked swings in its resourcing base.*

A significant element of cost-recovery is appropriate for a regulatory body such as the ICRC,

partly as a means of making transparent the costs of its regulatory activity but also as a means of maintaining a cost-conscious culture within the ICRC itself. Costs which need to be recovered will also need to be explained and justified as relevant, reasonable and efficient.

Beyond that, the structure of licence fees should be rationalised and a single budget appropriation (rather than the current service level agreement) should fund those functions that the ICRC needs to or is required to perform but for which it cannot recover costs: for example, research into regulatory approaches and methods, interaction with other regulators, the meeting of accountability requirements, and the developmental work required to ensure that the Commission is well prepared for the conduct of future pricing investigations.

Conclusion 2.9: *There are a number of indications which suggest that the ACT's system of price regulation of water and sewerage services has worked as intended to constrain the misuse of monopoly powers and promote the efficiency of service provision. Increases in the ACT's water prices have moderated significantly in recent years, after the sharp rises recorded during the early years of the new millennium. Service standards have generally been maintained, and in some areas improved. In addition, recent survey evidence suggests that the margin between the prices initially proposed by the regulated utility and the prices ultimately approved by the regulator was larger in the ACT (at 26 per cent) than in any other jurisdiction.*

While no such indicators are conclusive on their own, in combination they suggest that the current regulatory framework is meeting its objectives: customers are better off than if there were no system of regulation in place, while Icon Water remains financially viable.

Conclusion 2.10: *The threshold question for the ACT Government arising from this review will be whether it should retain the current regulatory framework for the determination of water and sewerage prices in the Territory. Whatever the Government's final decision on this issue, some significant consequences will flow and need to be managed.*

Each of the possible alternatives to the current regulatory system presents its own set of risks and challenges, and a clear strategy would need to be developed for managing these before any commitment was made to adopt one of these alternatives. Equally, if the decision were taken to maintain the current regulatory framework, it would be essential to act to address the significant weaknesses and potential vulnerabilities identified in this report.

3 Governance and accountability arrangements

3.1 The importance of good governance

The Terms of Reference require the review to provide comments and recommendations on:

... the governance and administrative arrangements for the provision of independent pricing for regulated water and sewerage services in the Territory, including consideration of both the current model and other potential options.

This chapter focuses mainly on governance issues and related accountability arrangements. Administrative arrangements and procedural issues, of the kind highlighted in the performance audit report of the Auditor-General, are dealt with in other chapters: in particular, Chapter 2 (Section 2.4) and Chapter 5 (Section 5.2).

Sound governance and accountability arrangements are critical to the effective operation of a regulatory system. As the OECD has argued in a recent report on regulatory governance:

How a regulator is established, directed, controlled, resourced and held to account — including the nature of the relationships between the regulatory decision maker, political actors, the legislature, the executive administration, judicial processes and regulated entities — builds trust in the regulator and is crucial to the overall effectiveness of regulation..... While there are different institutional models for regulators, improving the governance arrangements of regulators can benefit the community by enhancing the effectiveness of regulators and, ultimately, the achievement of important public policy goals.⁸⁶

The issues of trust and confidence are paramount. As a former CEO of the New South Wales regulatory body (IPART) commented in a recent essay published by the National Water Commission:

State and territory governments have many roles in the water industry: as owner, operator, policy maker and regulator. Tensions arise in undertaking these activities because they are subject to desirable but competing objectives. Ultimately, the resolution of these tensions is the stuff of politics but in practice resolution often falls to economic regulators.....

For regulators to play this role all stakeholders (including governments) need to respect the regulator's role. This does not mean that water and sewerage should be taken out of politics. Rather, as far as possible, governments should specify the objectives to be achieved through regulation and allow the regulator to develop the best means of achieving the objectives. This requires stakeholders to have confidence in the ability and objectivity of the regulator. Such confidence should develop through time. Regulators (need to) adopt careful, consultative processes and give clear reasons for their decisions.

⁸⁶ OECD 2014, page 15

*This will help to generate confidence and trust. The quality of the individuals appointed to make regulatory decisions is also important.*⁸⁷

The ICRC argued in its submission to the review that overall, the ACT's water and sewerage services governance framework accords with recognised best practice, both in Australia and internationally.⁸⁸ At least in some respects, that assessment is justified. In particular, the following aspects of the current framework accord with best-practice governance principles:

- There is a clear definition, and appropriate separation, of roles and responsibilities. Icon Water Limited is constituted under both the *Corporations Act 2001* (Cwlth) and the *Territory-owned Corporations Act 1990* (ACT) and, as a corporatised entity, its day-to-day operations are managed independently of executive government.⁸⁹ The determination of water and sewerage services prices is also undertaken independently of government by the ICRC. Both Icon Water and the ICRC are accountable to the Legislative Assembly for their performance.
- The ICRC's governance arrangements are set out clearly, without undue prescription, in the *Independent Competition and Regulatory Commission Act 1997*. The ICRC Act establishes the objectives and functions of the Commission, and the procedures the Commission is to follow when conducting an industry investigation and making a price direction.
- The ICRC's Commissioners are appointed on the basis of specific qualifications and experience, and have a fixed period of tenure (ICRC Act, Schedule 2). Commissioners are expected to exercise independent thought and judgement in fulfilling their statutory obligations. The ICRC Act also provides for a report on a pricing investigation to include any report by a Commissioner which dissents from the majority findings of the Commission (subsections 18(5)(c) and 21(1)(e)).
- The ICRC Act confers statutory independence upon the ICRC. It offers protection against political interference in the exercise of the Commission's price determination powers (section 10 and subsection 16(2)(c)), and provides for the ICRC to make binding regulatory decisions (section 20).
- An industry reference for the conduct of a pricing investigation is initiated by the relevant Minister. The terms of reference for a pricing investigation (or other industry reference)

⁸⁷ Cox J, *Water Utilities and state government budgets*, essay published in National Water Commission 2014, Chapter 3

⁸⁸ ICRC 2014e, page 26

⁸⁹ The institutional and governance arrangements for Icon Water Limited (then ACTEW Corporation Limited) were the subject of a separate review which reported in December 2013 (see Cohen, B, Appendix C), and these are not further considered here. It is relevant to note, however, that a key objective of the regulatory framework – namely, the promotion of efficiency – is also strongly influenced by the quality of a utility's governance arrangements. Some commentators have gone so far as to argue that improvements in governance of the utilities may be the primary means of improving efficiency, rather than a reliance on regulatory price-setting alone (see Cox, 2011, quoted in Productivity Commission 2011a, pages 307-8). As noted in Chapter 6, the Productivity Commission tied its recommendation for a shift to a price monitoring regime to separate proposals for reforms of the governance of government-owned urban water utilities (Productivity Commission 2011a, Chapter 10).

are a disallowable instrument, and are thereby open scrutiny and debate in the Legislative Assembly. They are also made publicly available on the ACT's legislation register.

- The ICRC's processes are suitably transparent. All documents relating to a pricing investigation are published on the Commission's website, subject only to the protection of any confidential material. The methodologies employed by the ICRC use transparent assumptions which are thereby open to challenge and debate; the Commission also documents its sources and, as a general practice, makes clear in its reports the reasons for its decisions.

While these are all important and desirable features of an effective governance framework, they are not sufficient on their own. The significant weaknesses highlighted in Chapter 2, for example, demonstrate that there can be a sizeable gap between the *potential* performance of a well-designed regulatory system with effective governance arrangements and the *actual* performance of that system at any given time. Put another way, it cannot be taken for granted that a sound governance framework will necessarily generate trust and confidence in the regulatory system, or in the regulator's ability and performance. Rather, the regulator needs to *earn* that trust and confidence by the way it goes about its work: in particular, by the effectiveness of its consultative arrangements, the management of its key relationships, the rigour of its analysis, the transparency of its processes, and the quality of its ultimate decisions. As the Productivity Commission commented in its report on Australia's urban water sector:

Having established independence and assigned objectives and functions, it is important to create incentives (for utilities and regulators) to perform their functions well. Open and transparent decision making can assist in holding utilities and regulators accountable. Measures to ensure accountability and transparency include public consultation, reporting of decisions and performance monitoring. There is also a requirement for sanctions in the event of underperformance.⁹⁰

Suggestions are made in other chapters on particular ways of strengthening the governance arrangements outlined above. If the current regulatory framework is to be maintained, for example, there is a strong case to insert an overarching objects clause into the ICRC Act which makes it clear that the primary objective of the regulatory framework is to promote the goal of economic efficiency, while safeguarding the financial viability of the regulated entity (Conclusion 5.5). This would provide useful guidance to the ICRC in balancing the multiple considerations listed in section 20(2) of the Act, and making the necessary trade-offs. Likewise, there are sound arguments for reforming the current arrangements for resourcing the ICRC (Conclusion 2.8); for strengthening the Commission's information-gathering powers (Conclusion 5.6); and for clarifying and streamlining various legislative requirements and administrative processes (Conclusions 5.3 and 5.4). For immediate purposes, however, the most important issue is how accountability

⁹⁰ Productivity Commission 2011a, page 256

arrangements can be strengthened to inspire greater confidence and trust in the regulatory system and respect for the regulator's role.

3.2 *Strengthening accountability arrangements*

As the OECD has argued, accountability and transparency represent the other side of the coin of independence, and a balance is needed between the two. Comprehensive accountability and transparency measures actively support good behaviour and performance by the regulator, as they allow the regulator's performance to be assessed by the legislature or other responsible authority. An effective system of accountability needs to clearly define what the regulator is to be held accountable for, how it is to conduct itself and how this will be assessed. Clear expectations and common understandings are essential to the success of any accountability framework.⁹¹

Under the arrangements applying in the ACT, the ICRC is accountable to the Legislative Assembly through the responsible Minister, currently the Treasurer. As required under the *Annual Reports (Government Agencies) Act 2004*, the ICRC prepares an annual report on its activities, performance, finances and compliance with various legislative and whole-of-government requirements in the previous financial year.⁹² Each year also, as required by the *Financial Management Act 1996*, the Commission produces an annual Statement of Intent for the year ahead and the following three years. Section 61 of the *Financial Management Act 1996* requires that a statement of intent must include, among other matters:

- a statement of the objectives of the authority for the (coming) year, and each of the next 3 financial years;
- a statement of the nature and scope of the activities to be carried out by the authority during the year, and each of the next 3 financial years;
- the performance criteria and other measures by which the performance of the authority may be assessed against its objectives for the year, and each of the next 3 financial years; and
- an assessment of the performance (or estimated performance) of the authority in the previous financial year against its objectives for that year.

The *Financial Management Act 1996* also requires that the Commission consult the responsible Minister in preparing its statement of intent (section 61(2)), and take into consideration any comment by the Minister before finalising the statement (section 61(3)).

The ICRC has complied with these requirements as best it has been able, allowing for the uncertainties attaching to its likely work program over a four-year period. The most recent

⁹¹ OECD 2014, pages 81-82

⁹² The ICRC's latest Annual Report, for 2013-14, was published in September 2014 (ICRC 2014c)

Statement of Intent, for 2014-15 and beyond, was signed in May 2014 by the ICRC's Senior Commissioner and the Treasurer, as the responsible Minister.

The review regards these current accountability arrangements as reasonable and appropriate, but considers that they could be significantly improved and strengthened. The ICRC currently prepares its Statement of Intent without any clear guidance or 'statement of expectations' from the responsible Minister, and while the Minister co-signs the resultant statement, the government typically does not exert any active influence over its contents or priorities. For the future, and assuming that the current regulatory framework is to be retained, there is a strong case for government itself to be more forthcoming and proactive in making clear its requirements and expectations of the ICRC, without impinging on the statutory independence of the Commission. Drawing upon the work of the Australian Uhrig Review,⁹³ the OECD's recent report on regulatory governance offers some helpful guidance on how such an arrangement might work in practice:

A good mechanism for ministers and regulators to achieve clear expectations is for ministers to issue a statement of expectations to each of their regulators (both independent and ministerial regulatory units). Each statement should outline relevant government policies, including the government's current objectives relevant to the regulator, and any expectations on how the regulator should conduct its operations. The statement needs to be consistent with the extent of independence of decision-making enshrined in the regulator's enabling legislation. The regulator should formally respond by outlining how it proposes to meet the expectations of government in its corporate plan or similar document, such as a statement of intent. This document should include key performance indicators agreed with the relevant minister. Where competing priorities exist within a regulator's functions for a given objective, the corporate plan should outline a set of prioritising principles.

The statement of expectations and corporate plan (including key outcomes, outputs, quality and timeliness performance indicators and targets agreed between the minister and the regulator) should be published on the regulator's website. The performance of the regulator should be clearly aligned to the achievement of the government's policy objectives. Through this process, it becomes clear to all stakeholders what the regulator is there to achieve and what it is accountable for. The statement of expectations and corporate plan should be reviewed by the minister and regulator when there is a significant change in government policies or change in the operational environment, or a new minister is appointed.

Involving relevant stakeholders, where appropriate, in defining the expectations will improve the extent of stakeholder buy-in of the regulatory activity and the outcome.

Arrangements along these lines would provide government with an opportunity to make clear its requirements and expectations of the ICRC, outside the context of any specific pricing

⁹³ Uhrig J, *Review of the Corporate Governance of Statutory Authorities and Office Holders*, Commonwealth of Australia, June 2003

investigation or other industry reference. They would allow the government, for example, to provide feedback to the Commission (both positive and critical) on its recent performance; to make clear to the Commission any concerns it had over the handling of previous investigations or references; to set out its expectations of how the Commission should conduct the corresponding aspects of future investigations or references; and to provide its views on the priority attaching to different aspects of the Commission's forward work program. By providing clarity on such matters, and reducing the need for guesswork as to the government's views and expectations, such guidance should be useful to the ICRC as well. The Commission would have an opportunity to respond to the government's statement of expectations and to consult with the Minister in preparing that response, as is required under the legislation. The end result should be a set of much clearer expectations and more common understandings than is currently the case, with consequent benefits for the operation and performance of the regulatory framework.

3.3 The role of government

As already noted, the ACT Government has many roles to play in ensuring a safe and efficient supply of water and sewerage services to the residents of the ACT. It is directly responsible for managing the policy framework relating to water security, supply and availability, and for setting the high-level objectives of water policy. In its owner and shareholder role it provides governance oversight of Icon Water Limited, as the sole supplier of water and sewerage services to the ACT. It is also responsible for providing governance oversight of the ICRC, as the independent regulator. A key responsibility is its role in appointing members to the board of Icon Water, and Commissioners to serve on the ICRC, given that the quality of these appointments will be critical to the effective performance of both bodies. The government has other important responsibilities as well, including protecting the interests of low-income consumers and funding community service obligations more generally.

Some careful balances need to be struck in performing these various roles. For example, distributional and equity objectives need to be balanced with efficiency requirements and goals. Consumer interests need to be balanced with budgetary objectives. The potential conflicts inherent in the government's multiple roles need to be recognised and managed effectively (as discussed in section 3.4 below). The government must respect the roles and authority of the Icon Water Board and the independent regulator, while holding them appropriately to account. It needs to be prepared to intervene where necessary, but guard against inappropriate intervention.

The main functions of government with respect to the operation of the regulatory framework specifically are summarised in Table 3.1 below.

**Table 3.1: Economic regulation of government-owned entities:
Some key roles of government**

- Determine the objectives, form and structure of the regulatory system. Review and amend the legislative framework as necessary.
- Put in place effective governance structures and arrangements, both for the independent regulator and the regulated entity.
- In its 'shareholder' capacity, establish a clear performance and accountability framework for the regulated entity, and monitor its performance against that framework. Set dividend policies and target rates of return. Hold the regulated entity to account for its performance.
- Establish a clear performance and accountability framework for the independent regulator, without jeopardising its statutory independence. Ensure that the regulator is suitably equipped to perform its statutory functions effectively and efficiently, but is also held to account for its performance.
- Set the high-level framework for a pricing review (via formal terms of reference), leaving the independent regulator to conduct its work within that framework.
- Support the effective operation of the regulatory system – for example, by making clear to both the regulator and the regulated entity its expectations on the importance of a constructive and professional working relationship.
- Identify and fund separately any community service obligations (CSOs) performed by the regulated entity.
- Appoint a body to conduct a review of a price direction, in the event that an application is lodged for such a review.
- Periodically review the performance of the regulatory framework, making changes as necessary to improve its efficiency and effectiveness.

The review has formed the view that there is a case for government to play a more direct and active role in supporting the operation of the regulatory system than appears to have been the case in recent times. This is broadly in line with the questions posed and suggestions made in the advice provided by Dr David Cousins to the Auditor-General:

.... This raises a couple of questions. First, could work on the (regulatory) framework (be) separated more from the work of actually determining maximum prices, which requires application of the framework? If this was possible, it might mean that price reviews could be conducted with greater certainty and more speed. Second, should it be left largely in the hands of the regulator to devise the framework which is to apply in setting prices? An alternative may be that the framework for setting prices is first largely determined by the Government, albeit after taking advice from the regulator and others.⁹⁴

The review is not suggesting any radical reshaping of the government's role in the price determination process, and certainly not that the government should resume responsibility for the setting of water and sewerage prices.⁹⁵ There is a good case, however, for the government to take a more active role in a number of respects. For example, to the extent that government is best placed to make decisions on some aspects of the high-level framework for a pricing investigation it should do so at the outset, via the terms of reference for the investigation, rather than by representation, submission or intervention in the course of the review. In addition, as argued in Chapter 4, the government should generally set the period over which a price direction is to apply, unless it sees a strong case to delegate that decision to the ICRC. Government should also set the dates by which both the draft and final reports of the ICRC are to be made available.

As discussed in the previous section, the government should also move to strengthen the governance and accountability arrangements supporting the operation of the regulatory framework. Through a statement of expectations, or similar process, it should make clear its requirements and expectations of the ICRC, without impinging on the Commission's statutory independence. It should hold both the Commission and the regulated utility to account for their performance. If the current regulatory framework is to continue, the government should also take responsibility for ensuring that the ICRC's resourcing arrangements are improved so that the Commission is better prepared and equipped to conduct its next pricing investigation. This means, among other things, that planning should be completed, administrative processes settled and 'framework' issues resolved at least several months before the terms of reference for the pricing investigation are issued.

3.4 Other governance issues

The performance audit report of the Auditor-General pointed to some conflicts of interest in the roles performed by the Treasurer in relation to the setting of water and sewerage prices in the ACT. The report noted that the Treasurer was both a voting shareholder of ACTEW and also the Minister responsible for water and sewerage price-setting policy. In the latter role, the Treasurer had set the terms of reference issued to the ICRC in October 2011 for the conduct of the Commission's water and sewerage pricing investigation, and had subsequently provided submissions to the ICRC on behalf of the ACT Government. The report noted that, while there

⁹⁴ Dr David Cousins, as quoted in ACT Auditor-General, page 70

⁹⁵ See the discussion of this issue in Chapter 6 (Option 1).

were practices that mitigated the risks involved in this situation, conflicts of interest remained. Accordingly, the report recommended that:

*The ACT Government should review the Treasurer's responsibilities and implement mechanisms to further mitigate (and if possible eliminate) conflicts in roles with respect to the water and sewerage pricing process.*⁹⁶

In responding to this recommendation, the ACT Government noted that the different responsibilities of the Treasurer in relation to the water and sewerage pricing process had been clearly defined and carried out in an appropriate manner during the process. It argued that, especially in a smaller jurisdiction such as the ACT, a Minister is often required to balance multiple interests whilst carrying out his or her various roles. It highlighted also the various strategies in place to mitigate any potential conflict of roles, suggesting that further mitigation was not required.

*As identified in the report, voting shareholders are not involved in the direct management of ACTEW, Government submissions to the ICRC are publicly available and the terms of reference is a Disallowable Instrument hence allowing the Legislative Assembly to have a voice in the process. In addition to the strategies identified in the report, the collective view of Cabinet is sought on any Government submission before provision by the Treasurer, as per normal Government practices. Lastly, it is partly in recognition of the potential for conflict of roles that the pricing process is undertaken independent of Government.*⁹⁷

The review accepts the arguments put by the ACT Government on this matter. The issue here is not so much that a potential conflict of interest exists, but rather how it is managed and mitigated. The mitigation strategies set out in the Government's response are substantive, and likely to be effective in practice. In particular, the fact that the terms of reference for a pricing investigation are a disallowable instrument, subject to potential scrutiny by the Legislative Assembly, represents a strong deterrent to any inappropriate attempt to influence the ICRC's pricing determination. The statutory independence of the Commission, and the inability of the Minister to direct the Commission in its conduct of a pricing investigation, constitute other important safeguards against inappropriate intervention in the price-setting process.

In its submission to the review the ICRC drew attention to another, if somewhat related, conflict of interest issue:

*....the Treasurer also appoints the Industry Panel members should an application for review of a price direction be received. This creates a potentially more serious problem because the Treasurer, as a shareholder of ACTEW, would clearly prefer a price direction which yields a greater profit for ACTEW over one that yielded a smaller profit. Unfortunately, this potential conflict is not mitigated by any mechanism of scrutiny by the legislature.*⁹⁸

⁹⁶ ACT Auditor-General, Recommendation 1, page 17

⁹⁷ *ibid.*

⁹⁸ ICRC 2014e, page 20

The review accepts that it would be appropriate, if the current regulatory framework is to continue, that the process of appointment of the members of an industry panel should be subject to scrutiny by the Legislative Assembly. This could be achieved by amending section 24M(3) of the ICRC Act, which currently exempts appointments to an industry panel from the requirement in the *Legislation Act 2001* (Division 19.3.3) that statutory appointments should be subject to scrutiny by the Legislative Assembly, and that the Minister must consider any recommendation made by a standing committee of the Assembly before making such an appointment. As this requirement applies to the appointment of a Commissioner to the ICRC, there would seem to be a clear case for it to apply equally to the appointment of industry panel members.

More broadly, the review considers that the current provisions of the ICRC Act in this respect are unduly restrictive, in that they assign responsibility for the conduct of a review to a single body of a particular composition (an industry panel). As argued in Chapter 4, it would be preferable if the Act were amended to give the Minister the power to establish or appoint a review body, once an application for a review had been received, but without limiting the form of that review body to the 'industry panel' option. The appointment of an existing body, such as the Australian Competition Tribunal, would substantially reduce (if not eliminate entirely) the concern raised by the ICRC about the conflict implicit in current arrangements.

3.5 Conclusions

Conclusion 3.1: *Sound governance and accountability arrangements are essential to the effective operation of a regulatory system. Many aspects of the current regulatory framework for the pricing of water and sewerage services accord with best-practice governance principles, but these are not sufficient on their own. Further changes are needed to improve the governance framework, and especially to strengthen current accountability arrangements.*

Conclusion 3.2: *A careful balance needs to be struck between respect for the statutory independence of the ICRC and an appropriate system of accountability, by which the Commission is held to account for its performance. An effective accountability framework needs to clearly define what the regulator is to be held accountable for, how it is to conduct itself and how this will be assessed. Clear expectations and common understandings are essential if such a framework is to succeed.*

Conclusion 3.3: *The ICRC is accountable to the Legislative Assembly through the responsible Minister, currently the Treasurer. It prepares an annual report on its activities, performance, finances and compliance with various legislative and whole-of-government requirements in the previous financial year. It also produces an annual Statement of Intent, co-signed with the responsible Minister, for the year ahead and the following three years. These accountability arrangements are reasonable and appropriate as far as they go, but could be*

significantly improved and strengthened. In particular, there is a strong case for the ACT Government to be more forthcoming and proactive in making clear its requirements and expectations of the ICRC, without impinging on the statutory independence of the Commission.

Conclusion 3.4: *There is a case for government to play a more direct and active role in supporting the operation of the regulatory system than appears to have been the case in recent times. To the extent that government is best placed to make decisions on some aspects of the high-level framework for a pricing investigation it should do so at the outset, via the terms of reference for the investigation, rather than by representation, submission or intervention in the course of the review. Government should generally set the period over which a price direction is to apply, unless there is good reason to the contrary. It should also set the dates by which both the draft and final reports on a pricing investigation are to be made available.*

In addition, the government should move to strengthen the governance and accountability arrangements supporting the operation of the regulatory framework (Conclusion 3.3). It should hold both the ICRC and the regulated utility to account for their performance. If the current regulatory framework is to continue, it should also take responsibility for ensuring that the ICRC's resourcing arrangements are improved so that the Commission is better prepared and equipped to conduct its future pricing investigations.

Conclusion 3.5: *While there is a potential conflict of interest in the various roles performed by the Treasurer in relation to the setting of prices for water and sewerage services, effective mitigation strategies are in place to manage this conflict and the risks attached. The fact that the terms of reference for a pricing investigation are a disallowable instrument, subject to potential scrutiny by the Legislative Assembly, represents a strong deterrent to any inappropriate attempt to influence the ICRC's pricing determination. The statutory independence of the ICRC, and the inability of the Minister to direct the Commission in its conduct of a pricing investigation, constitute other important safeguards against inappropriate intervention in the price-setting process.*

Conclusion 3.6: *There is a potential conflict of interest in connection with the Treasurer's role in appointing the members of an industry panel to conduct a review of a price direction. If the current regulatory framework is to continue, section 24M(3) of the ICRC Act should be amended to allow for the appointment of the members of an industry panel to be subject to scrutiny by the Legislative Assembly. There is also a case to broaden the options for the conduct of a review of a price direction beyond the industry panel arrangement currently prescribed in the ICRC Act.*

4 The legislative framework

4.1 Background

The terms of reference require a consideration of “all relevant legislation related to the pricing framework for regulated water and sewerage services”. The Issues Paper for the review listed the main pieces of ACT legislation which are relevant, either directly or indirectly, to the operation of the current regulatory framework for determining the prices of water and sewerage services in the ACT. These are:

- The *Independent Competition and Regulatory Commission Act 1997*;
- The *Utilities Act 2000*;
- The *Water Resources Act 2007*;
- The *Auditor-General Act 1996*;
- The *Freedom of Information Act 1989*;
- The *Public Interest Disclosure Act 2012*; and
- The *Territory Records Act 2002*.

The principal Act governing the operation of the regulatory framework is the ICRC Act, which confers upon the ICRC its powers to regulate the pricing of the services provided by ‘regulated industries’, as declared by the Minister, as well as a range of other functions as set out in section 8 of the ICRC Act. The most closely related piece of legislation is the *Utilities Act 2000* which, although not concerned with pricing as such, empowers the ICRC to license and regulate the operation of a range of defined utility services, including utilities providing water and sewerage services.

The *Water Resources Act 2007* has objectives related to the sustainable management of water resources in the ACT, rather than pricing or regulation as such. The other Acts listed above – the *Auditor-General Act 1996*, the *Freedom of Information Act 1989*, the *Public Interest Disclosure Act 2012* and the *Territory Records Act 2002* – impose various responsibilities upon the ICRC, as a statutory authority, and Icon Water Limited, as a Territory-owned corporation, similar to those applying to government departments and agencies. In addition, the staff of the ICRC must be employed under the ACT’s *Public Sector Management Act 1994* (ICRC Act, section 11), and are subject to the provisions of that Act.

As noted in Chapter 2, the ICRC Act has served the ACT well since its enactment in 1997. It provided a sound basis for establishing the ICRC, and for the Commission to exercise its statutory powers independent of ministerial direction. It established also the general framework by which price directions can be made, and the procedures to be followed in this process. Suitably, the ICRC Act is cast in flexible terms: for example, it does not prescribe the particular industries or sectors in which a price direction must be made, but rather provides the means by which an industry may be identified as subject to the price determination powers of the Commission. The trigger for commencing a particular price determination process is a reference from the responsible Minister, currently the Treasurer. This reference will specify the industry or

sector to which the price direction is to apply and may also specify, among other things, the length of the regulatory period, the date by which the price direction is to be published, the date of commencement of the regulatory period, and any matter the Minister wishes the Commission to examine or have regard to in its investigation.

While many reports and price directions have been produced under this general framework since 1997, a review of the ICRC Act is both timely and necessary on a number of grounds. Over the 17 years for which the Act has been in place, competition policy and practice have evolved and changed at least to some degree, and the balance of the Commission's activities has also shifted significantly. In 2005, for example, the Australian Energy Regulator (AER) assumed responsibility for determining network charges for the ACT's electricity and gas distribution networks, with the effect that the ICRC's objectives of promoting effective competition and ensuring non-discriminatory access (ICRC Act, sections 7(a) and 7(c)) were no longer so relevant. Further functions were transferred to the AER in 2012 as a result of which, at least under current arrangements, the most substantial ongoing function of the ICRC is its role in the determination of prices for water and sewerage services.

There are other considerations also which support a review of the ICRC Act. As the ICRC has noted, the ICRC Act has been subject to various changes over time by way of amendments consequential to changes to other Acts bearing little relation to the ICRC Act; some of these amendments, at least, do not sit well with the pre-existing provisions and schema of the ICRC Act itself.⁹⁹ In addition, the Auditor-General's report highlighted some significant areas of ambiguity or lack of clarity in the current legislation, as discussed in the following section, and further anomalies and weaknesses have become apparent in recent times. For example, the current review of the ICRC's price direction for 2013-2019, the first such review to be conducted under the current regulatory framework, has raised a number of issues about the adequacy and appropriateness of the provisions of Part 4C of the ICRC Act. These issues are examined in section 4.3 below.

For these and other reasons, it seems clear that significant changes will be needed to the ICRC Act even if the decision is taken to retain the current regulatory framework. While the current review has necessarily focussed on those provisions of the ICRC Act relating to the determination of prices for water and sewerage services, it will be essential that any broader review of the ICRC Act consider also the other functions given to the ICRC under the ICRC Act, as well as the interaction with the *Utilities Act 2000*, which assigns the Commission a range of further important functions and powers. As the ICRC argued in its submission, any change proposed in relation to a particular function, such as the determination of the prices of water and sewerage services, needs to be designed carefully so as not to compromise the Commission's capacity to carry out any of its wider range of functions.¹⁰⁰

⁹⁹ ICRC 2014e, page 32

¹⁰⁰ ICRC 2014e, page 31

Section 2.2 below examines two significant legislative issues raised in the performance audit report of the Auditor-General. Section 2.3 examines the provisions of Part 4C of the ICRC Act, relating to the review of a price direction. Section 2.4 deals briefly with a number of other legislative issues which have arisen in the course of this review. In addition, some further issues which may require legislative change are examined in Chapter 5.

4.2 *Legislative issues raised by the Auditor-General*

The period over which a price direction is to apply

The Auditor-General's report highlighted a lack of clarity about the relationship between Parts 3 and 4 of the ICRC Act in relation to decisions on the period over which a price direction is to apply (the 'regulatory period'). The key question at issue here is whether, in the absence of any reference to the regulatory period in the terms of reference for a pricing investigation, the ICRC has the power to determine the regulatory period.

The ICRC Act as currently formulated is not clear on this key point, and indeed provides some conflicting signals. Section 16(2) in Part 3 of the ICRC Act details a number of matters which the terms of reference for an investigation on an industry reference may include, but omits any mention of the time period over which a price direction is to apply. Section 20(1) of Part 4, however, refers to "the level of prices for services *in relation to the period specified in the reference*", implying that the terms of reference for a pricing investigation will (or may) specify the period over which the resultant price direction is to apply.

Different legal opinions have been expressed on whether, in the absence of a reference to the regulatory period in the terms of reference, the ICRC has the power to determine the regulatory period for a particular pricing investigation. The Government's Terms of Reference for the ICRC's investigation of water and sewerage prices for the period from 1 July 2013 did not specify a time period over which the price direction was to apply, and the ICRC subsequently determined that a six-year regulatory period should apply, from 1 July 2013 to 30 June 2019. According to some of the legal advice obtained by the Auditor-General, the ICRC was not empowered to make this decision, and its eventual price direction was invalid as a result.¹⁰¹ The ACT Government Solicitor put an alternative view, arguing that the ICRC was at liberty, within the bounds of reasonable administrative decision-making, to determine the period over which the price direction would operate.¹⁰² Subsequently, in order to remove any doubt as to the validity of the price direction made under the Terms of Reference, the ACT Legislative Assembly passed the *Independent Competition and Regulatory Commission (Water and Sewerage Price Direction) Act 2014*, which confirmed the validity of both the Terms of Reference and the ICRC's price direction.

Some part of the confusion surrounding this issue appears to derive from amendments made to the ICRC Act in 2000. The original legislation establishing the (then) Independent Pricing and

¹⁰¹ ACT Auditor-General, pages 43-49

¹⁰² *ibid.*, page 46

Regulatory Commission conferred an explicit discretion on the Commission to specify a period during which a price direction would apply, but that provision (the former section 20(4)) was repealed as part of a package of amendments passed at the time of passage of the *Utilities Act 2000*. Regardless of the history, however, the current situation is clearly unsatisfactory, and greater clarity is needed for the future.

The threshold question goes to who should make the decision regarding the period over which a price direction is to apply: the “referring authority” (i.e., the responsible Minister) or the ICRC itself.

- If the Minister is to be solely responsible for this decision (after the taking of relevant advice) the terms of reference for a price investigation will need to reflect this, and section 16(2) of the ICRC Act should be amended to stipulate this as a mandatory element of the terms of reference for a pricing investigation.
- Alternatively, if the ICRC is to be responsible for determining the regulatory period, the ICRC Act should be amended to clearly confer this power on the Commission; in addition, the current reference in section 20(1) to “the period specified in the reference” should be removed.

The review considers it appropriate that, after consultation with the ICRC and other relevant parties, the responsible Minister should generally take the decision on the appropriate length of the regulatory period and specify this period in the Government’s terms of reference for a pricing investigation. There may be circumstances, however, in which the Minister considers that a final decision on this matter would best be left to the ICRC, dependent perhaps on the findings reached by the Commission in the early stages of its investigation. To cater for this possibility, the review sees merit in a third option along the following lines:

- Amend section 16(2) of the ICRC Act to make it clear that the ‘referring authority’ (i.e., the Minister) *may* specify a regulatory period in the terms of reference for a pricing investigation.
- Make a further amendment to give the ICRC a power to determine a regulatory period in circumstances where no such period has been specified in the terms of reference.
- Amend the current reference in section 20(1) to refer to “the level of prices for services in relation to *any* period specified in the reference”.

An alternative formulation, which could achieve the same result more simply, would be to give the Minister the power to set the regulatory period but also an option to delegate that power to the ICRC.

The requirements attaching to a draft report and proposed price direction

The Auditor-General's report also drew attention to another area in which the relationship between the provisions Parts 3 and 4 of the ICRC Act is not entirely clear: namely, the requirements attaching to a draft report and proposed price direction, as set out in Part 3 of the ICRC Act, and whether these should meet the requirements of Part 4 and Part 4A of the ICRC Act, as they relate to a final report and price direction.

The requirements attached to a *draft report* on an industry reference investigation are set out in section 18 (Part 3) of the ICRC Act. The requirements relating to a *final report* on an industry reference investigation are set out in section 21 (Part 4A) of the ICRC Act. The requirements relating to a *price direction* made as a result of an industry investigation are set out in section 20 (Part 4) of the ICRC Act. These include a requirement, under section 20(4), that the Commission must indicate the extent to which it has had regard to the matters referred to in section 20(2) of the ICRC Act.

In commenting on the most recent water and sewerage pricing process, the Auditor-General concluded that there was:

... a fundamental difference in the expectations of the ICRC and ACTEW regarding the content of the Draft Report and proposed price direction, and the extent to which it needed to reflect the requirements of Part 4 and Part 4A of the ICRC Act, with respect to the Final Report and price direction. In the ICRC there was an expectation that the Draft Report and proposed price direction (February 2013) did not need to meet legislative requirements that applied to a final report and final price direction, including the matters required to be considered as part of an investigation. However, ACTEW expected that the Draft Report and proposed price direction (February 2013) would represent the ICRC's conclusions and demonstrate how legislative requirements under the ICRC Act were met.¹⁰³

This is a confusing issue, not helped by the current structure and language of the ICRC Act. The key question needing to be clarified would seem to be whether, in a proposed price direction issued in conjunction with a draft report, the Commission must indicate to what extent it has had regard to the matters listed under section 20(2) of the ICRC Act. Again, the Act provides mixed signals on this point: section 20(4), for example, does not distinguish between a draft and a final price direction, stating only that:

In a price direction, the commission must indicate to what extent it has had regard to the matters referred to in subsection (2).

On the other hand, some of the other language used in Part 4 (Price directions) could be interpreted as referring to the final price direction only; section 20(1), for example, states that:

¹⁰³ ACT Auditor-General, page 42

*At the **conclusion** of an investigation on a reference authorising the commission to make a price direction in a regulated industry, the commission must decide on the level of prices for services and give a price direction accordingly to each person providing regulated services to whom the direction applies (emphasis added).*

In practice, according to the ICRC's submission, the Commission has generally taken the view that the requirement imposed by section 20(4) of the ICRC Act should apply equally to its proposed and final price directions. Unfortunately, however, its draft report and proposed price direction published in February 2013 did not include a table of the kind published in its final report and price direction (June 2013), showing where and how it had had regard to the matters listed in section 20(2). This may have been, in part, the source of the contention and 'different expectations' highlighted by the Auditor-General. The Commission's more recent draft report and proposed price direction on retail electricity prices, by contrast, did include such a table.¹⁰⁴

Another source of some confusion in this area has stemmed from the recommendation in the performance audit report that:

*At a minimum, the principles should require that a draft report and proposed price direction must comply with, and represent, any requirements of a final report and price direction.*¹⁰⁵

The ICRC has suggested that this recommendation, interpreted literally, could have the effect of limiting the freedom of the Commission to respond to issues raised in the draft report, thereby limiting the value of the consultative process.¹⁰⁶ It is doubtful that this was the intention behind the recommendation, and it is certainly not the intention of the legislation, which states in section 18(6) that:

In preparing its final report on an investigation, the commission must take into consideration any written comments submitted in accordance with the invitation in subsection (1) in relation to the draft report of the investigation.

There should clearly be scope for changes to be made between a draft report and a final report, not least in response to issues or concerns raised in the public consultation process. That said, it is inevitable that a draft report will condition attitudes and create expectations among stakeholders, and hence that any major changes made to the proposals in a draft report are likely to produce a significant reaction, especially if the interval between the draft and final reports is short (with consequently little time for detailed consultation). The deficiencies in the ICRC's processes in these respects, in the conduct of its latest pricing investigation for water and sewerage services, were discussed in Chapter 2. As some protection against a possible recurrence of these problems, there is a reasonable case for the legislation to provide that the terms of reference for a pricing

¹⁰⁴ ICRC, *Standing offer prices for the supply of electricity to small customers, 1 July 2014 to 30 June 2017, Draft report*, February 2014, pages 172-174; and ICRC, *Standing offer prices for the supply of electricity to small customers, 1 July 2014 to 30 June 2017, Proposed price direction*, February 2014, pages 15-16

¹⁰⁵ ACT Auditor-General, Recommendation 5(a), page 54

¹⁰⁶ ICRC 2014e, pages 35-36

investigation may specify a date by which a draft report and proposed price direction are to be made available for public inspection. Such a provision would parallel the existing provision enabling a deadline to be set for submission of a final report to the referring authority (section 16(2)(a)).

In summary, the review considers that the ICRC Act should be amended to:

- clarify that the requirement imposed under section 20(4) applies equally to a proposed price direction as to a final price direction; in both cases, the Commission must indicate the extent to which it has had regard to the matters listed in section 20(2); and
- provide that the terms of reference for a pricing investigation may specify a date by which a draft report and proposed price direction are to be made available for public inspection.

4.3 Appeal and review arrangements

Part 4C of the ICRC Act provides for the review of a price direction issued by the ICRC, following an application by the responsible Minister (the 'referring authority') or by the utility providing the services. An application for review must be considered by an 'industry panel' of three members appointed by the Minister (section 24M). The panel has power to dismiss the application only if deems it to be frivolous or vexatious (section 24R).

Assuming that an application for review proceeds, the industry panel is empowered either to substitute a new price direction for the original price direction, or to confirm the original direction (section 24N). An industry panel must make a decision 'on the merits of the case' (section 24N(2)(a)), and consistent with the general requirements applying to the making of a price direction. Section 24O confers upon the industry panel the same investigative powers as the ICRC itself in considering the application for review; in effect, therefore, the panel is required to take on the role of the independent regulator and make its pricing decisions afresh, should it determine that it will not uphold the original decision of the ICRC. The ICRC for its part is required to afford the industry panel any assistance it may require and, on completion of the review, to take any action necessary to implement the panel's decision (section 24U).

The ICRC's price direction for regulated water and sewerage services over the period 2013-2019 is currently the subject of an industry panel review, following an application made by ACTEW in September 2013 under section 24K of the ICRC Act. This is the first occasion on which an industry panel review has been undertaken.

As noted in Chapter 2, the availability of an effective appeal and review mechanism is an important characteristic of a well-designed regulatory system. Such an arrangement helps to ensure that regulatory authorities exercise their authority within the scope permitted by their legal powers, exhibit procedural fairness, and have justifiable reasons for their decisions. An effective review process will also help to prevent abuse of discretionary authority by making the

regulator accountable for its decisions. The ICRC has acknowledged that, to the extent that its role in making a price direction is quasi-judicial, a review process is generally appropriate.¹⁰⁷

Notwithstanding the above, the provisions of Part 4C of the ICRC Act raise a number of significant issues which warrant consideration in the context of this review. These go to matters such as the appropriate form and type of review, having regard to considerations of proportionality and cost-effectiveness; the grounds on which an application for review may be lodged; the parties which should be able to lodge an application for review; and the body which should be responsible for conducting a review. These and other matters are considered below.

It is important to make it clear that, while activation of the provisions of Part 4C of the ICRC Act has brought to light a number of issues which have not previously been considered significant, none of the comments made below should be taken to relate in any way to the manner in which the current industry panel has gone about its task. The review is not in a position to comment, and does not wish to do so, on the conduct of the current industry panel process, except to the extent that some general issues have arisen in the course of that process which have implications for the overall regulatory framework and for possible future reviews.

(a) Form of a review: the need for proportionality

One key issue goes to the appropriate form of any review, and the need for proportionality in its conduct. Any review should be fit-for-purpose: that is, the scale of the review, and the processes which it uses, should be proportional to the number, significance and complexity of the issues in contention. Where the issues raised in an application for a review are relatively simple or straightforward, the review process itself should be correspondingly limited and straightforward. Only where there is a clear and unavoidable case for a complete rework of the regulator's initial decision should a comprehensive review be undertaken.

The current provisions of Part 4C of the ICRC Act do not adequately meet this requirement. A review having been initiated, there are various provisions of the ICRC Act which serve to complicate or lengthen the process, even where the matter at issue may be relatively straightforward. For example, regardless of the grounds for the review, section 24O effectively requires an industry panel to call for public submissions and conduct public hearings, and subsequently to produce both a draft report and final report; while these procedures will be appropriate and necessary in some cases, they should not be a mandatory requirement in every case. Likewise, under section 24N, the industry panel is required to have regard to all the criteria listed at section 20(2) for price directions, even though some of these may be largely irrelevant to the subject-matter under consideration in the review. Again, the costs of an industry panel review are largely determined by the panel itself (section 24V), raising the risk that processes may be unduly elaborate and the costs unduly high. In short, both the processes and costs of a review are arguably too open-ended under current arrangements, and greater assurance is required for the future that both will be tailored to need.

¹⁰⁷ ICRC 2014c, page 7

Section 24N(2) of the ICRC Act requires that an industry panel must make a decision on an application for review “on the merits of the case”. From a legal viewpoint, this means that an industry panel review falls into the category of a *merits-based review*, with the various legal consequences (based on case law) which flow from this. In particular, while the panel should ‘stand in the shoes of the original decision-maker’, it has the power to consider all relevant matters afresh (*de novo*), if necessary; it can exercise a wide discretion in considering the relevant evidence and forming its views; and its focus needs to be on achieving the *correct or preferable decision*.¹⁰⁸ The import of the last is that if there is a wide range of potential decisions, any one of which could be considered ‘correct’, the industry panel is empowered to make that decision which it regards as not only correct but ‘preferable’ in the circumstances of the case.

Section 24N(3) of the ICRC Act places a technical limitation on the scope of the review process, providing that an industry panel may not consider any matter that was not raised on behalf of the applicant in submissions to the ICRC for purposes of the initial pricing investigation. In practice, however, this limitation may not count for much; for example, the complex interactions between different parts of the overall pricing mechanism may necessitate a wide-ranging review on the basis of a concern raised about one relatively minor issue. In these circumstances, the final judgement about the desirable and appropriate scope of the review falls, quite reasonably, to the industry panel. In some cases it may opt for a narrow review which may involve minimal change (if any) from the original decision. In other cases it might judge it necessary to conduct a far wider review, with scope for significant alteration to the initial decision.

There must clearly be scope, in certain circumstances, for a comprehensive merits-based review of a price direction decision taken by the regulator, and the ICRC Act appropriately caters for this possibility. It is appropriate also, for this reason, that the ICRC Act confers upon an industry panel a power to substitute a new price direction for the original price direction, or alternatively to confirm the original price direction (section 24N(1)). There may be other circumstances, however, in which the most appropriate and efficient course of action may be for the industry panel to make an assessment of the issues raised in an application for review and to refer the matter back to the ICRC, as the original decision-maker, with directions for the making of a fresh decision – for example, a requirement to take into account some new or additional information, or to correct an identified error. This is not an option under the current legislative framework: the industry panel is the final decision-maker in a review process, its decision cannot be appealed or reviewed, and the ICRC must take any action necessary to implement its decision (section 24(U)(3)).

This discussion leads naturally to the question, discussed below, of the grounds on which an application may be made for a review of a price direction.

¹⁰⁸ Bowen CJ and Deane J, in *Drake v Minister for Immigration and Ethnic Affairs (1979) 2 ALD 60*

(b) The grounds for an appeal

The ICRC Act currently imposes no limitations on the grounds on which an application may be lodged for the review of a price direction; either the Minister or the regulated entity may apply for a review on any grounds, subject only to lodging the application within three months after the final report on the pricing investigation is presented to the Legislative Assembly (section 24K(2)). The industry panel has power to dismiss the application only if it deems it to be frivolous or vexatious (section 24R); if this does not occur, the review process must proceed in accordance with the provisions of Part 4C.

In the opinion of this review, there is a sound case to be argued that these arrangements are unduly open-ended. As discussed in Chapter 2, the conduct of a pricing investigation is not a precise science, and ultimately depends in large measure on the exercise of experienced and well-informed judgement. Where there is reason to believe that a significant and demonstrable error has been made in the initial decision-making process (for example, an error of fact, law, or calculation), this should clearly be sufficient cause for an appeal to be lodged and a review to be conducted; in other cases, however, it is much less clear that an appeal should be allowable where the issue turns on the exercise of judgement alone. One of the subject-matter experts consulted by the Auditor-General in the context of the recent performance audit went so far as to suggest to the review that the only circumstance in which an appeal against a regulator's decision should be allowed would be in a case where it could be established that a "fundamental error" had been made in the initial decision-making process.

The review suggests that the ICRC Act be amended to provide that, in future, any application for a review must be accompanied by evidence that one or more of the following failings has occurred in the initial price determination process:

- a significant error in the application of law;
- a material error of fact;
- a material error in calculation or methodology; or
- a significant failure in due process, procedural fairness or natural justice.

It would then be for the industry panel, or other appointed review body, to assess the evidence presented in the application and determine whether a review should proceed. It would be reasonable for this purpose to require that, in assessing the evidence presented to it, the review body should provide the ICRC with an opportunity to respond to the issues and arguments raised in the application for review and provide its views on their merits. A well-informed decision should then be possible, having regard both to the evidence presented by the applicant for review and the response provided by the original decision-maker. The provisions of section 24R should be broadened accordingly to provide for an industry panel (or other review body) to dismiss an application for review if it considered that the evidence presented in the application could not be sustained, or was not sufficiently strong for a review to proceed.

(c) The circumstances in which a price direction may be varied

The ICRC has suggested that consideration be given to an arrangement under which an industry panel would be able to vary a price direction for a publicly owned utility only when the panel had concluded that the original price direction would undermine the utility's financial viability and/or its capacity to deliver safe and reliable services in accordance with its licence conditions.¹⁰⁹

The review considers that a limitation along these lines would be unduly restrictive, creating the possibility that a regulatory decision which was significantly flawed in some other respect (such as a failure in procedural fairness) would be effectively exempt from amendment. A preferable arrangement would be one in which the allowable grounds for the conduct of a review are more contained, as proposed above, but with provision made for a price direction to be varied as necessary whenever a review proceeds on one or more of these grounds. As discussed above, it would be desirable also if there were an option for an industry panel to be able to refer a matter back to the ICRC, as the original decision-maker, with directions for the making of a fresh decision.

(d) Who can make an application for a review?

Section 24K of the ICRC Act provides that the only parties eligible to apply for a review of a price direction are the Minister (as the 'referring authority') and the utility providing the regulated services. This limitation seems unduly restrictive, given the obvious interests of consumers in the pricing decisions made by the independent regulator. In practice, it is likely that any individual consumer would be deterred from making an application by reason of the requirement in section 24V of the ICRC Act that each party to a review must bear its own costs. In principle, however, it seems reasonable that an individual consumer, group of consumers or any other body with a relevant interest should be able to make application for a review of a price direction by the regulator, and the review suggests that the ICRC Act be amended to make this possible.

(e) Who should be responsible for conducting a review?

Section 24M of the ICRC Act stipulates that an application for review of a price direction must be heard by an industry panel of three members. Provisions for the constitution of the panel and for the terms of office of the panel and panel members are set out in Schedule 3 of the ICRC Act.

Again, this is an area in which the current provisions of the ICRC Act seem unduly restrictive. As there are not a large number of bodies with the requisite combination of independence, technical skills and knowledge and availability to conduct a review of a price direction, it seems unnecessary and unduly limiting to confine the options to a single body of a particular composition. As both the Productivity Commission¹¹⁰ and the ICRC¹¹¹ have suggested, a possible alternative body would be the Australian Competition Tribunal, which deals with appeals against

¹⁰⁹ ICRC 2014c, pages 8-9

¹¹⁰ Productivity Commission 2011a, page 287

¹¹¹ ICRC 2014e, pages 37-38

the decisions of Commonwealth regulatory bodies such as the Australian Energy Regulator. It has also reviewed some decisions made by the economic regulator in Western Australia. An arrangement with the Australian Competition Tribunal, or other suitable body external to the ACT, would also deal at least in part with the concern expressed by the ICRC that the Treasurer has a conflict of interest in his responsibility for appointing the members of an industry panel, in so far as the Treasurer is also a shareholder in the entity which is the subject of the price direction under review and therefore has a direct interest in the outcome of the review.¹¹²

The review suggests that the ICRC Act be amended to give the Minister the power to establish or appoint a review body, once an application for review has been submitted, but without limiting the form of that review body to the 'industry panel' option.

4.4 Other legislative issues

This section deals briefly with a number of other suggestions for legislative amendment which have been raised in the course of this review.

Objectives and functions of the ICRC

Sections 7 and 8 of the ICRC Act define the objectives and functions of the ICRC in relation to the matters covered by that legislation. Section 3 of the *Utilities Act 2000* defines the Commission's objects under that ICRC Act. There are some obvious crossovers between the two sets of objectives: for example, both refer (although in somewhat different terms) to the promotion of competition and the protection of consumer interests.

The ICRC has proposed that, given recent changes in the balance of its responsibilities, the statements of its objectives and functions in the ICRC Act should be reviewed and updated, with consideration given also to incorporating the objectives of the *Utilities Act 2000* into the ICRC Act. For example, the Commission has suggested that a suitable high-level objective would be along the lines of: "to improve the welfare of the ACT community by promoting the provision of efficient, reliable and safe infrastructure services".

These are reasonable suggestions which should be considered again and taken up, as appropriate, once the ACT Government has taken its final decisions on this review.

Timing of the terms of reference for a pricing investigation

Icon Water suggested in its submission that, to help ensure that a pricing investigation can be concluded in a timely manner, the ICRC Act be amended to require that the terms of reference for a pricing investigation be issued by the Minister a specified number of months prior to the expiry of a current price direction.¹¹³

¹¹² *ibid.*, page 37

¹¹³ Icon Water 2014b, page 9

The review sees merit, and no obvious downsides, in this suggestion, and recommends that the ICRC Act be amended accordingly.

Expenditure objectives

Icon Water also suggested that the ICRC Act should be amended to clarify the objectives (and allowable scope) of expenditure to be included in regulatory proposals.¹¹⁴ It noted that the National Electricity Rules for regulation of electricity distribution networks provide guidance on this point, and suggested that the inclusion of a similar provision in the ICRC Act would help to promote efficient investment by providing greater certainty with respect to the regulatory treatment of expenditure. Icon Water suggested that the objectives could include:

- meeting or managing expected demand for services;
- complying with all applicable regulatory (including technical) obligations;
- where no applicable obligations exist, maintaining the quality, reliability and security of supply;
- maintaining the safety of the water and sewerage system;
- complying with applicable ACT Government policies; and
- having regard to any transition required when there are material changes in obligations or expenditure levels.

The issue raised by Icon Water is an important one. While there would be little debate about the reasonableness of the items on the list above, there are issues of interpretation and judgement at the margin which have the potential to be a source of uncertainty and debate. The review is not convinced, however, that the inclusion of a set of broad expenditure objectives in the ICRC Act is the best way of dealing with this issue. For example, the list suggested by Icon Water would provide little by way of practical guidance in identifying those infrastructure projects which should be treated as community service obligations rather than projects designed primarily to meet customer needs. Where there is a particular issue surrounding the treatment of a certain item or items of expenditure in the context of a specific pricing investigation, the Minister could make reference to this issue in the terms of reference for the investigation and provide any appropriate guidance on the treatment of the issue, in terms which do not compromise the necessary independence of the ICRC.

Requirement on an industry panel to transfer its information

In the event that an industry panel is appointed to conduct a review of a price direction, the panel has the same powers as the ICRC in conducting its review. These powers include the gathering of information (Part 7 of the ICRC Act), which may include new or additional information to that collected by the Commission in its original pricing investigation.

¹¹⁴ *ibid.*, page 8

In the event that an industry panel substitutes a new price direction for the original, it will fall to the ICRC to implement and manage that new price direction once it is in place. For this purpose, it will need to have access to all relevant information on which the new price direction is based. In view of this, it seems appropriate that the ICRC Act should be amended to require an industry panel or other review body to transfer to the Commission, on completion of a review, all information it has collected or created in the course of conducting the review which may be relevant or necessary to the Commission's role in implementing and managing the substituted price direction.

Other recommended changes to the ICRC Act

Finally, it should be noted that three further substantive amendments to the ICRC Act are recommended in the next chapter (Chapter 5). One is to insert an overarching objects clause into the ICRC Act which makes it clear that the primary objective of the regulatory framework is to promote the goal of economic efficiency, while safeguarding the financial viability of the regulated entity (Recommendation 3(a)). The second is to amend the ICRC Act to require the ICRC to publish an early statement of its information requirements, and the regulated entity (and any other relevant parties) to provide the required information within a reasonable period of time (Recommendation 3(f)). The third change would give the Minister a power to establish a dispute resolution process on a procedural matter if, after receiving a written request by either party, the Minister judges this to be the most effective and efficient way of resolving the dispute (Recommendation 3(g)).

4.5 Conclusions

Conclusion 4.1: *The ICRC Act has served the ACT well since its enactment in 1997, but a review of the ICRC Act is now timely and necessary on a number of grounds. Over the 17 years for which the ICRC Act has been in place competition policy and practice have evolved and changed at least to some degree, and the balance of the Commission's activities has also shifted significantly. The Auditor-General's report highlighted some significant areas of ambiguity or lack of clarity in the legislation, and further anomalies and weaknesses have become apparent in recent times. For these and other reasons, significant changes will be needed to the ICRC Act even if the decision is taken to retain the current regulatory framework. In addition to considering the specific changes proposed in this report, any broader review of the ICRC Act should consider also the other functions assigned to the ICRC under the ICRC Act, as well as its interaction with the Utilities Act 2000.*

Conclusion 4.2: *Greater clarity is needed as to who should make the decision regarding the period over which a price direction is to apply: the responsible Minister or the ICRC itself. The review considers it appropriate that, after consultation with the ICRC and other relevant parties, the Minister should generally take this decision and specify the regulatory period in the Government's terms of reference for a pricing investigation. There may be circumstances,*

however, in which the Minister considers that a final decision on this matter would best be left to the ICRC. To cater for this possibility, the ICRC Act should be amended to confer on the Minister the power to determine the period over which a price direction is to apply, but with an option to delegate this decision to the ICRC.

Conclusion 4.3: *The ICRC Act should be amended to clarify that the requirement imposed under section 20(4) applies equally to a proposed price direction as to a final price direction; in both cases, the Commission must indicate the extent to which it has had regard to the matters listed in section 20(2).*

Conclusion 4.4: *The ICRC Act should be amended to provide that the terms of reference for a pricing investigation may specify a date by which a draft report and proposed price direction are to be made available for public inspection.*

Conclusion 4.5: *Part 4C of the ICRC Act provides for the review of a price direction issued by the ICRC. The availability of an effective appeal and review mechanism is an important characteristic of a well-designed regulatory system. Such an arrangement helps to ensure that regulatory authorities exercise their authority within the scope permitted by their legal powers, exhibit procedural fairness, and have justifiable reasons for their decisions. An effective review process will also help to prevent abuse of discretionary authority by making the regulator accountable for its decisions. Notwithstanding the above, there is a strong case to review the current provisions of Part 4C of the ICRC Act, which suffer from a number of clear deficiencies.*

Conclusion 4.6: *Any review process should be fit-for-purpose: that is, the scale of the review, and the processes which it uses, should be proportional to the number, significance and complexity of the issues in contention. Where the issues raised in an application for a review are relatively simple or straightforward, the review process itself should be correspondingly limited and straightforward. Only where there is a clear and unavoidable case for a complete rework of the regulator's initial decision should a comprehensive review be undertaken.*

The current provisions of Part 4C of the ICRC Act do not adequately meet this requirement. A review having been initiated, there are various provisions of the ICRC Act which serve to complicate or lengthen the process, even where the matter at issue may be relatively straightforward. Greater assurance is needed for the future that review processes will be tailored to need, and costs contained accordingly.

Conclusion 4.7: *There must clearly be scope, in certain circumstances, for a comprehensive merits-based review of a price direction decision taken by the regulator, and the ICRC Act*

appropriately caters for this possibility. It is appropriate also, for this reason, that the ICRC Act confers upon an industry panel a power to substitute a new price direction for the original price direction, or alternatively to confirm the original price direction. There may be other circumstances, however, in which the most appropriate and efficient course of action may be for an industry panel to make an assessment of the issues raised in an application for review and to refer the matter back to the ICRC, as the original decision-maker, with directions for the making of a fresh decision. This is not an option under the current legislative framework, and the ICRC Act should be amended to make this possible.

Conclusion 4.8: *The ICRC Act currently imposes no limitations on the grounds on which an application may be lodged for the review of a price direction, and an industry panel has power to dismiss the application only if it deems it to be frivolous or vexatious. These arrangements are unduly open-ended. The conduct of a pricing investigation is not a precise science, and ultimately depends in large measure on the exercise of experienced and well-informed judgement. Where there is reason to believe that a significant and demonstrable error has been made in the initial decision-making process (for example, an error of fact, law, or calculation), this should be sufficient cause for an appeal to be lodged and a review to be conducted; in other cases, however, it is much less clear that an appeal should be allowable where the issue turns on the exercise of judgement alone.*

Conclusion 4.9: *The ICRC Act should be amended to provide that, in future, any application for a review must be accompanied by evidence that that one or more of the following failings has occurred in the initial price determination process:*

- *a significant error in the application of law;*
- *a material error of fact;*
- *a material error in calculation or methodology; or*
- *a significant failure in due process, procedural fairness or natural justice.*

The Act should also require that an industry panel (or other review body) should provide the ICRC with an opportunity to respond to the issues and arguments raised in an application for review and give its views on their merits. It would then be for the industry panel, or other review body, to assess the evidence before it and determine whether a review should proceed. The review body should be required to dismiss an application if it considered that the evidence presented in the application could not be sustained, or was not sufficiently strong for a review to proceed.

Conclusion 4.10: *The ICRC Act provides that the only parties eligible to apply for a review of a price direction are the responsible Minister and the utility providing the regulated services. This limitation is unduly restrictive, given the obvious interests of consumers in the pricing*

decisions made by the independent regulator. The ICRC Act should be amended to provide that an individual consumer, group of consumers or any other body with a relevant interest should be able to make an application for a review of a price direction by the regulator. As is currently the case, each party to a review should be required to bear its own costs.

Conclusion 4.11: *The ICRC Act stipulates that an application for review of a price direction must be heard by an industry panel of three members. Again, this is an area in which the current provisions of the ICRC Act seem unduly restrictive. There are not a large number of bodies with the requisite combination of independence, technical skills and knowledge and availability to conduct a review of a price direction; in view of this, it seems unnecessary and unduly limiting to confine the options to a single body of a particular composition. The ICRC Act should be amended to give the Minister the power to establish or appoint a review body, once an application for a review has been submitted, but without limiting the form of that review body to the 'industry panel' option.*

Conclusion 4.12: *The statements of the objectives and functions of the ICRC, as set out in the ICRC Act and the Utilities Act 2000, should be reviewed and updated as appropriate once the ACT Government has taken its final decisions on this review.*

Conclusion 4.13: *In the interests of timeliness and better planning, the ICRC Act should be amended to require that the terms of reference for a pricing investigation be issued by the Minister a specified number of months before the expiry of a current price direction.*

Conclusion 4.14: *The ICRC Act should be amended to require an industry panel, or other review body, to transfer to the ICRC, on completion of a review, all information it has collected or created in the course of conducting the review which may be relevant or necessary to the Commission's role in implementing and managing a substituted price direction.*

5 A principles-based approach?

5.1 Background

The Terms of Reference require the review to consider:

... whether the ACT would benefit from a set of principles for conducting pricing investigations for regulated water and sewerage services, and outline the principles to be included.

This element of the terms of reference stems largely from Recommendation 5 of the Auditor-General's report, which proposed that:

The ACT Government, in consultation with key stakeholders, should develop a set of principles for the conduct of water and sewerage pricing investigations in the ACT. The principles should include:

- a) a requirement to clearly identify the nature and purpose of stakeholder consultation documents prepared by the ICRC. At a minimum, the principles should require that a draft report and proposed price direction must comply with, and represent, any requirements of a final report and final price direction;*
- b) guidance with respect to the prioritisation of objectives that are sought from the water and sewerage pricing investigation;*
- c) guidance with respect to administrative processes to be conducted as part of the investigation, in order to facilitate open and timely communication of key issues, findings and conclusions at early stages of the process;*
- d) protocols for the provision of information required, including outlining the type and nature of information to be provided by ACTEW as the regulated entity; and*
- e) protocols for the resolution of disputes between the regulator and the utility being regulated during a water and sewerage price investigation, specifically with respect to disputes in relation to administrative processes associated with the investigation.*

The various matters listed in the Auditor-General's recommendation go mainly to administrative and procedural issues: that is, to the processes used by the ICRC in conducting its pricing investigations for water and sewerage services. Separately, there is also an issue of whether the ACT would benefit from the adoption of more formal *pricing principles* to guide the price determination process itself. This issue is examined in section 5.3 below.

Some general comments should be made at the outset. Firstly, there is no shortage of statements of regulatory principles. The recent Frontier Economics report, for example, distilled a set of nine high-level principles which are commonly seen as reflecting key features

of best-practice economic regulatory regimes.¹¹⁵ The nine suggested principles, or best-practice characteristics, were:

- Clarity of objectives/focus;
- Efficiency/cost-effectiveness;
- Consistency/predictability;
- Accountability;
- Transparency;
- Adaptability/flexibility;
- Independence;
- Capability; and
- Coherence.

Similarly, Icon Water argued in its submission that the ICRC Act should be amended to incorporate a set of principles relating to the ICRC's exercise of its regulatory powers. It submitted that these principles should provide direction to ensure that:

- the process incorporates the principles of procedural fairness and natural justice;
- the regulatory process is transparent;
- the regulator is accessible to stakeholders;
- the process is cost effective; and
- there is no retrospective application of decisions nor expropriation that might undermine incentives for efficient investment in long lived assets.¹¹⁶

At the international level, the OECD has suggested eight broad principles which make for good regulation. These are that an effective regulatory system should:

- serve clearly identified policy goals, and be effective in achieving those goals;
- have a sound legal and empirical basis;
- produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account;
- minimise costs and market distortions;
- promote innovation through market incentives and goal-based approaches;
- be clear, simple and practical for users;
- be consistent with other regulations and policies; and
- be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.¹¹⁷

There would be little argument about the importance of these requirements or of the general attributes listed above, but the main issue for consideration here is whether codifying such attributes into a statement of high-level principles is likely to have any significant influence on

¹¹⁵ Frontier Economics, pages 17-20

¹¹⁶ Icon Water Limited 2014b, page 7

¹¹⁷ OECD (2005), *OECD Guiding Principles for Regulatory Quality and Performance*, www.oecd.org/fr/reformereg/34976533.pdf

behaviours or outcomes in a given institutional setting. Just as no regulator will disown a commitment to transparency or procedural fairness, so no statement of principles can guarantee that these and other key attributes will always be met. As the Frontier Economics report commented:

*While (these are) useful guiding principles for an effective regulatory regime, there is a need to translate them into what they mean for specific practical elements of economic regulation in order to identify a 'best practice' regulatory model for urban water in Australia.*¹¹⁸

The alternative to reliance on a statement of principles is to target directly any areas of perceived deficiency or concern, or areas where greater clarity and assurance is needed, and take specific measures to address those concerns in a reasonable and cost-effective way. An important conclusion arising from the analysis in Chapter 2, for example, was the need for better planning and clearer guidance at an earlier stage of a pricing investigation, especially with regard to key matters such as the information required to be provided by the regulated entity. The best means of ensuring that this requirement can be met in the future will be to tackle directly the issues which have caused problems in the past; for example, by dealing with the resourcing issues which have restricted the ICRC's planning for previous pricing investigations, and by introducing a new provision into the ICRC Act requiring the Commission to issue a statement of its information requirements soon after receiving its terms of reference for a pricing investigation (as discussed below).

Accountability is also an important consideration here. Chapter 3 proposed that the ACT Government should take a more active role in making clear its reasonable requirements and expectations of the ICRC, which the Commission would then reflect in its Statement of Intent. In the review's judgement, this mechanism would offer a surer and more transparent means of holding the Commission to account than any reliance on a statement of high-level principles. Among other benefits, it would allow the Government to make clear to the ICRC the particular requirements it expects the Commission to meet in conducting its work program for any given year.

Finally, a closely related issue goes to the balance between prescription and discretion: in other words, to what extent the regulatory role performed by the ICRC should be bound by government prescriptions or guidelines, and to what extent decisions should be left to the regulator's best judgement and discretion. The statutory independence of the ICRC is obviously one important consideration here, but there are other considerations as well. Even if it respects the need for regulatory independence, any system of detailed prescription is likely to introduce a number of costs and unintended consequences; for example, it would run the risk of limiting necessary flexibility over time, and there could be significant costs in updating and maintaining the regulatory 'rules'.¹¹⁹ Ultimately it is a matter of judgement as to

¹¹⁸ Frontier Economics, page 18

¹¹⁹ For example, the latest edition of the National Electricity Rules is Version 66, and runs to nearly 1,500 pages.

where the balance between prescription and discretion should lie; in general, however, if government sees a particular requirement as sufficiently important as to be deemed essential and ongoing, it should aim to reflect that requirement in the legislation governing the operation of the regulatory framework.

Within the general framework just discussed, the next section examines the particular issues raised by Recommendation 5 of the Auditor-General's report.

5.2 *Administrative and procedural issues*

The nature and purpose of stakeholder consultation documents

Administrative processes in a pricing investigation

It is efficient to consider these two issues jointly, as both raise similar issues about the need to plan effectively for the conduct of a pricing investigation and to meet the requirements of good process in undertaking that investigation.

The Auditor-General's report drew attention to the different expectations of the ICRC and ACTEW with regard to the status of the ICRC's draft report and proposed price direction (February 2013). As discussed in Chapter 4, a contributing factor in this regard was the ambiguity in the ICRC Act as currently drafted in relation to the status of, and requirements to be met in, a draft report and proposed price direction. Assuming that the current regulatory framework is to continue, legislative changes are needed to remove this ambiguity, in particular by clarifying the relationship between Parts 3 and 4 of the ICRC Act (see Recommendation 3(c)).

More generally, the Auditor-General's report proposed that there should be a "requirement to clearly identify the nature and purpose of stakeholder consultation documents prepared by the ICRC" for purposes of a pricing investigation.¹²⁰ The only documents which the ICRC is required to produce under current legislation are a draft report and a final report. It is fairly standard regulatory practice, however, and has been the ICRC's practice in the conduct of its own pricing investigations, to issue a range of earlier papers on particular issues or aspects of an investigation, such as a background paper, issues papers, technical papers or working conclusion documents.¹²¹ Such documents serve a useful purpose in informing interested parties of the Commission's intended approach and methods, and subsequently the conclusions emerging from its work. They can also serve as a basis for consultation and reaction, in advance of the production of a draft report. The issue here, therefore, is whether a requirement to produce such papers, and to identify their nature and purpose, should be

¹²⁰ ACT Auditor-General, Recommendation 5(a), page 53

¹²¹ For purposes of its latest investigation of water and sewerage prices the ICRC released a context paper (November 2011) and an issues paper (21 February 2012). A 'working conclusions report' was also planned for release in May 2012, but this did not occur.

prescribed by legislation or other means, or whether decisions on these matters are best left to the discretion and good judgement of the ICRC itself.

Icon Water argued in its submission that price inquiry processes would be improved if the legislation were amended to require an Approach Paper (specific to the price inquiry) early in the process, in addition to the existing requirement for a draft report.¹²² It suggested that a draft Approach Paper could be prepared as the basis for a public forum and submissions from stakeholders prior to finalisation, well in advance of the regulatory proposal from the regulated utility, with the content of the paper to include:

- the proposed control mechanism (for example, a price cap or a revenue cap mechanism);
- the information that must be provided by the utility in its regulatory proposal;
- the formulae proposed to give effect to the control mechanism;
- the proposed length of the regulatory period;
- the planned timetable for the review;
- proposed arrangements for consultation, submissions and public forums; and
- a budget for the review.¹²³

Icon Water argued that arrangements along these lines, similar to the ‘framework and approach paper’ required under the National Electricity Rules, would:

*... enhance procedural fairness in relation to fundamental constituent decisions and provide all stakeholders with a better understanding of the responsibilities of the respective parties at the outset of the process.*¹²⁴

Perhaps not surprisingly, the ICRC took a different view in its submission:

It is questionable whether mandating that the ICRC produce issues, technical papers and other guidelines will mean a better outcome for the ACT community. Every investigation is different and there is no guarantee that an approach that is effective for one investigation will be as effective in another. The Commission notes that the National Electricity Rules require the Australian Energy Regulatory (AER) to produce guidelines in relation to how it will apply the rules. The ICRC also notes that the AER is a national regulator and guidelines are intended to assist a large number of businesses each of whom may have a different view on how a rule should be applied given their particular circumstance. In the case of the ACT water utility, the ICRC is only dealing with one entity.

¹²² Icon Water Limited 2014b, page 9

¹²³ *ibid.*

¹²⁴ *ibid.*

*That does not mean that the ICRC does not see merit in producing these types of documents. In our view, there is likely to be value in the Commission producing guidelines and technical papers, but, in many cases, these documents will need to be produced before the price investigation commences. Moreover, their value comes from confirming practices and procedures and thereby allowing a future investigation to be undertaken on a more streamlined and cost effective basis. Consideration needs to be given to how the Commission might resource these activities outside of the formal investigation process.*¹²⁵

The review sees merit in both sets of arguments. There is clearly a strong case, as argued elsewhere in this report, for greater clarity and better guidance from the ICRC at an earlier stage of a pricing investigation. In turn, that argues for better planning and communication processes so that, as Icon Water states, all stakeholders are better informed of the ICRC's plans and of their own responsibilities at the outset of the process. On the other hand, there is also substance in the ICRC's contention that each investigation is different, at least potentially, and that the best approach in one case may not be so effective in the next. As noted above, the risk here is that a highly prescriptive approach, embedded in legislation, may lead to a loss of necessary flexibility over time.

While there is a good case for the early release of an 'approach paper' or similar, along the lines suggested by Icon Water, the review is not convinced that such a requirement should be built into legislation, especially if it were accompanied by a prescriptive list of matters to be covered in the paper. A workable alternative, more consistent with the need for flexibility over time, would be for the responsible Minister to build a requirement of this kind into the terms of reference for a particular pricing investigation if that were judged useful or necessary in the circumstances at the time. Better still, the ICRC could anticipate this requirement and implement it on its own initiative, as part of its commitment to institute better planning procedures.

Similar issues arise in relation to the Auditor-General's comments on deficiencies in the administrative processes used by the ICRC in its latest pricing investigation. Among other criticisms, the performance audit report noted: the lack of detailed procedural guidance within the ICRC itself on the conduct of its latest pricing investigation; perceived weaknesses in the ICRC's communication and consultation processes, reflecting in part the inadequacy of procedural guidance on these matters; and the absence of detailed project planning documentation for the conduct of the investigation (notwithstanding the existence of a draft project plan).¹²⁶ Accordingly, the audit report recommended that, for all future water and sewerage pricing investigations, the ICRC should develop and implement:

¹²⁵ ICRC 2014e, page 27

¹²⁶ ACT Auditor-General, pages 77-79

- a) *detailed internal procedural guidance. This should include guidance on communication and consultation processes with stakeholders, including ACTEW; and*
- b) *rigorous project planning, monitoring and reporting procedures.*¹²⁷

The ICRC agreed in part with this recommendation. It noted that, following the release of its draft report on water and sewerage services, the Commission had reviewed its internal processes for producing that report and instituted changes to improve the management of the production of the final report. It had also continued to develop and document its project management procedures for the efficient and effective operation of the Commission.¹²⁸

The issue for this review is whether specific principles or requirements should be introduced to provide greater assurance that the Commission's future administrative processes will meet the high standards to be expected in the conduct of a pricing investigation. For reasons similar to those argued above, the review does not see a strong case to build such requirements into legislation. Apart from other considerations, it would be difficult to devise a set of legislative conditions or requirements in this area which do other than state the fairly obvious. It would be open to the Minister, in approving the terms of reference for a pricing investigation, to stipulate any particular administrative requirements or processes which were judged to be important to the conduct of the investigation (unusual though such an approach would be). Ultimately, however, it must be the responsibility of the Commission itself to ensure that its administrative processes and related project planning, monitoring and reporting procedures meet the necessary high standards advocated by the Auditor-General. The ICRC should be held to account in these respects under the governance and accountability arrangements proposed in Chapter 3.

The prioritisation of objectives

An important issue raised by the Auditor-General's report concerns the prioritisation of the various objectives which are sought from the conduct of a pricing investigation. The performance audit report quoted the Productivity Commission in this regard:

*To ensure decisions about where the 'public interest' lies continue to be made by elected representatives, and not by regulators determining which objectives take priority, governments should avoid having conflicting objectives in regulatory acts. Where conflicting objectives are considered unavoidable, regulators should be given clear guidance by government on how to prioritise objectives.*¹²⁹

As noted in Chapter 2, section 20(2) of the ICRC Act lists a number of considerations to which the Commission must have regard in making a price direction in a regulated industry. Broadly speaking, these cover issues relating to the protection of consumer interests, economic

¹²⁷ *ibid.*, Recommendation 6, page 79

¹²⁸ *ibid.*, page 21

¹²⁹ Productivity Commission 2011a, page 268 (quoted by ACT Auditor-General, page 65)

efficiency, the financial viability of the regulated entity and environmental protection objectives. As the Auditor-General noted, there are elements of potential conflict between the considerations listed in this section, meaning that balances need to be struck and trade-offs made by the ICRC. The issue here is whether, in its role of policy maker, the Government should provide clearer guidance to the Commission on how to balance these various objectives, and which particular objectives (if any) should take priority. As ACTEW Corporation argued in its submission to the Productivity Commission inquiry in 2011:

*The current framework for water regulation in the ACT provides a broad range of factors to be balanced by the regulator. This is a very difficult assignment that effectively results in considerable discretion to the regulator and significant levels of regulatory risk for the utility.*¹³⁰

There is now a broad consensus (if not universal agreement) that the promotion of economic efficiency should be the overarching objective of economic regulation. This was the conclusion reached in the recent reviews of regulatory arrangements in both Queensland¹³¹ and Victoria¹³². It was also the conclusion reached in the Productivity Commission's inquiry of 2011, which recommended that an overarching objects clause be inserted into regulatory acts along the lines of the National Electricity Objective set out in the National Electricity Law:

... promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –

- (a) price, quality, safety, reliability and security of supply of electricity; and*
- (b) the reliability, safety and security of the national electricity system.*¹³³

Significantly, also, the submissions of both the ICRC and Icon Water endorsed an economic efficiency objective along these lines. Icon Water commented, for example:

*The objectives (in s20 of the ICRC Act) should be clarified in legislation to give primacy to key objectives such as economic efficiency, a sustainable return for the utility service and the promotion of the long term interest of consumers.*¹³⁴

The ICRC commented, in broadly similar vein:

It may be helpful to those looking for such guidance if the Act were amended to require the Commission, when making a price direction for water and sewerage services, to set prices such as to provide reasonable assurance that the expected efficient costs of the

¹³⁰ Productivity Commission 2011a, page 268

¹³¹ Queensland Competition Authority, page 30

¹³² Independent Review of economic regulation, governance and efficiency in the Victorian water sector (draft report), pages 34-37

¹³³ *National Electricity (South Australia) Act 1996*, Schedule, National Electricity Law, part 1, section 7

¹³⁴ Icon Water Limited 2014b, page 7

utility will be recovered, provided that setting prices in this way does not put the financial viability of the regulated entity at risk.

*The Commission might also be required to explain how it concluded that the prices set meet the required criterion and, if it concluded that prices meeting the criterion would put the financial viability of the regulated entity at risk, how it reached that conclusion and the variations it introduced in the price direction it would otherwise have brought to deal with that situation.*¹³⁵

A common concern which is raised in relation to the pursuit of economic efficiency as a primary objective is that this will in some way conflict with equity or distributional objectives, or with the pursuit of 'fairness'. As argued in the recent report of the Queensland Competition Authority, however, the goal of economic efficiency will generally best serve the overall public interest, provided that social and equity objectives are addressed by governments in other ways.¹³⁶ Community Service Obligations (CSOs) are the means most commonly used to target social and equity concerns and, given the ready availability and transparency of this mechanism, efficiency goals should usually take precedence over fairness goals where a government has chosen not to establish a CSO. Governments also need to be mindful of the limitations of regulatory tools to meet multiple objectives.¹³⁷

For the reasons just discussed, the review considers that there is a strong case to insert an overarching objects clause into the ICRC Act, broadly along the lines of the National Electricity Objective set out in the National Electricity Law. While the various considerations listed in section 20(2) of the ICRC Act could remain in place, a high-level objects clause along these lines should provide useful guidance to the ICRC in balancing these considerations and making the necessary trade-offs. An explicit reference to the importance of safeguarding the financial viability of the regulated entity would also deal with some of the concerns expressed by Icon Water (and previously, ACTEW Corporation).

Protocols for the provision of information required

In support of its recommendation in this area, the Auditor-General noted the different expectations of the ICRC and ACTEW with respect to the nature of the information to be provided by ACTEW as part of the ICRC's most recent water and sewerage pricing investigation.

It is apparent that the ICRC sought information from ACTEW and that, for various reasons, ACTEW did not wish to provide this information to the ICRC. This difference in expectations was never satisfactorily resolved between the ICRC and ACTEW. Other

¹³⁵ ICRC 2014e, pages 33-34

¹³⁶ Queensland Competition Authority, page 30

¹³⁷ *ibid.*, page v

*issues, including assumptions underpinning the different entities' expectations and understanding of the process, were never effectively communicated.*¹³⁸

The Auditor-General also pointed out that:

*.... the ICRC Act does not, with the exception of section 41 in Part 7, provide the ICRC with authority to compel the provision of information as part of a price investigation process. That is, the ICRC Act does not allow the ICRC to compel a party (including ACTEW) to provide a submission, nor does it allow the ICRC to identify the nature and type of information to be provided in the submission. Section 41 of the ICRC Act does provide the ICRC with authority to compel the provision of information, but only 'if the commission has reason to believe that a person has information or a document that may assist it in exercising its functions.' Section 41 does not provide the ICRC with the authority to compel an entity (including ACTEW) to bring into existence any document or information.*¹³⁹

The review considers that the deficiencies identified in the paragraph just quoted represent a major flaw in the ICRC Act as currently formulated. Access to high-quality information is a *sine qua non* of a regulator's work, and the regulator must be confident that it can obtain the information it needs in an assured and timely way. The only mechanisms currently available to the ICRC for this purpose, apart from reliance on the co-operation of the regulated utility, are the options of a section 41 demand or the use of a reset principle in a previous price direction. The latter is an awkward mechanism, inappropriate as basis for seeking the information needed to make a price determination for a future period. A section 41 notice suffers not only from the limitation noted by the Auditor-General, that it can be applied only to require the production of a document that the Commission has reason to believe already exists, but also represents a heavy-handed and legalistic approach, likely to raise the stakes in any dispute. The penalty for failing to comply with a section 41 notice, for example, is 100 penalty units, one year of imprisonment, or both.

Better arrangements are needed for the future, requiring both the ICRC to publish an early statement of its information requirements and the regulated entity (and any other relevant parties) to provide the requisite information within a reasonable period of time. Accordingly, the review suggests that, if the current regulatory framework is to continue, the ICRC Act be amended as follows:

- to require that, within a specified period (no more than one month) after receipt of the terms of reference for a pricing investigation, the ICRC must publish a statement specifying the information it requires to be supplied for purposes of undertaking its investigation, the party or parties responsible for providing that information, and the time period within which the information is to be supplied; and

¹³⁸ ACT Auditor-General, page 122

¹³⁹ *ibid.*

- to require the regulated entity, and any other party to whom the statement of information requirements applies, to supply the information required by the ICRC within the time period specified in the statement.

Arrangements along these lines would meet a number of objectives. They would help to provide some early clarity about the ICRC's intended framework for the conduct of a pricing investigation. They would provide the Commission with assured access to the information it needs for the conduct of its investigation, and for the making of its price direction. In addition, to the extent that the provision of information has been a source of contention and dispute in the past, they should reduce the risk that similar disputes will arise again in the future.

That said, no legislative provisions can replace the need for goodwill and due process in dealings on matters such as this. For example, the time period specified in the Commission's statement of requirements should be set only after a process of effective consultation with Icon Water Limited and any other parties responsible for supplying the information required. Likewise, it should be the responsibility of the Board of Icon Water to consider and approve the information to be provided in response to the regulator's request, given the significance of that information to the price determination process (and hence to the future operations and performance of the company). The ICRC noted in its submission to the review that the information it had required from Icon Water for purposes of its recent biennial recalibration process had been clearly explained at the outset and subject to an appropriate process of consultation. Subsequently, Icon Water had provided the required information on time and without issue.¹⁴⁰

Arrangements for dispute resolution

In recommending that protocols be developed for the resolution of disputes between the regulator and the regulated utility, the Auditor-General commented as follows:

*There is merit in putting in place a process for mediation or dispute resolution in water and sewerage pricing processes. This is likely to assist in resolving differences early and removing the risk of an inefficient and ineffective process, which has occurred in this instance.*¹⁴¹

In their responses to the Issues Paper for this review, which sought comment on this proposal, neither the ICRC nor Icon Water expressed support for a formal dispute resolution process. Icon Water doubted the practicability of such an arrangement:

Icon Water does not believe that mediation by external party is workable, particularly where the ultimate decision on matters in dispute necessarily remains with the regulator and the legislation prevents interference with the regulator once a reference

¹⁴⁰ ICRC 2014e, pages 28-29

¹⁴¹ ACT Auditor-General, paragraph 5.117, page 129

is issued. Similarly mediation by the Minister is fraught with political and sovereign risk given the Minister's role as owner and policy maker.

Negotiation between the regulator and the regulated party on the basis of goodwill is the only reasonable option available, subject to recognition that the process rests on the quality of the relationship between the parties. From the perspective of recent experience there are challenges associated with making this option work effectively, but in Icon Water's view it is still the best approach and achievable, particularly where supported by principles such as goodwill, reasonableness and participation in good faith.

The ICRC's reasons for opposing the proposal were broadly similar, although cast in somewhat different terms:

....the performance audit report also raised the possibility of introducing a third party dispute resolution process. This suggestion has two major drawbacks: it adds an unnecessary complexity to the process of making a determination of the prices of water and sewerage services and would therefore likely increase the cost of the determination, and it is incompatible with the quasi-judicial nature of the determination process.¹⁴²

Elaborating on the second of these points, the ICRC commented:

Since the issuing of a price direction is a quasi-judicial process, with the Commission in the role of decision maker, it would be difficult to introduce a third party into the process to resolve disputes without undermining the authority of the Commission as decision maker in the process. Disputes about procedure, like the one described in the performance audit report, are best handled by the Commission making sure, at the outset of the investigation, that there is no doubt about the procedure to be followed. Disputes about the content of a price direction or a conclusion reached in a report, which are the far more common kind, are precisely those matters that the Commission exists to determine. Introduction of a third party into a dispute of that kind would undermine the foundations of the regulatory price setting process.¹⁴³

The review accepts the argument that a dispute resolution process would not be appropriate to handle any issues relating to the content of a price direction, or a substantive conclusion reached in an ICRC report. It also supports Icon Water's comments on the critical importance of goodwill and good faith, as well as the ICRC's contention that disputes about procedure should be reduced, or contained, by doing more at the outset of an investigation to make clear the procedures to be followed. A clear statement of information requirements at the

¹⁴² ICRC 2014e, page 28

¹⁴³ *ibid.*, page 29

beginning of a pricing investigation, in particular, should serve to limit the scope for subsequent disputes in this area.

The possibility remains, however, that another dispute on a procedural matter could arise in the future which, if not resolved quickly, could once again lead to delays, additional costs and, perhaps most seriously, a breakdown in relationships. Undesirable and unlikely though a further dispute of this kind may be, it would be prudent to cater for the risk by giving the Minister a power to establish a dispute resolution process on a procedural matter if, after receiving a written request by either party, the Minister judges that this is likely to be the most effective and efficient way of resolving the dispute. Such an arrangement should not put at risk the independence or the authority of the ICRC as the ultimate decision-maker; rather, it would be an option to be invoked as a last resort if best efforts by the parties to reach an agreement had failed and an impasse had been reached. The review suggests that, when the ICRC Act is amended, a provision along these lines be introduced into the legislation, in terms which leave to the Minister's discretion the appropriate form of any dispute resolution mechanism in the circumstances of a particular dispute.

5.3 Pricing principles

The Issues Paper for the review posed the question of whether there would be benefit to the ACT from the introduction of more formal pricing principles, in relation to the price determination process itself. It raised as issues for consideration the level of detail in which any such principles would be cast; by whom the principles would be determined; possible implications for the independence of the ICRC; and whether any principles would be codified in legislation, or issued in the context of a particular pricing investigation.¹⁴⁴

Perhaps the first matter to be noted is that the ACT is already a signatory to some national water pricing principles. Under the National Water Initiative (NWI) negotiated in 2004, all Australian governments made commitments to best practice water pricing. A stocktake of approaches to water charging was prepared by a Steering Group on Water Charges in 2007, leading to a revised set of pricing principles endorsed by all jurisdictions in 2010. These principles were agreed by governments as the basis for setting water prices and charges in their respective jurisdictions and on the understanding that, if a decision were made not to apply these principles in a particular case, the reasons for this would be tabled in parliament.¹⁴⁵

The NWI pricing principles comprise four main elements, dealing with the recovery of capital expenditure; urban water tariffs; water planning and management costs; and recycled water

¹⁴⁴ *Review of the ACT's Water and Sewerage Pricing Framework: Issues Paper*, November 2014, pages 12-14

¹⁴⁵ *National Water Initiative Pricing Principles*, April 2010, paragraph 10, page 3

and stormwater reuse. The principles were due for review by the end of 2014, but that review has not yet taken place.¹⁴⁶

In its report on its urban water inquiry in 2011 the Productivity Commission identified a number of shortcomings in the NWI pricing principles, arguing that they were not consistent with a commitment to efficient pricing.¹⁴⁷ The National Water Commission supported this view, while also expressing concerns over a lack of commitment to pricing reform in some jurisdictions, a 'lowest common denominator' approach to pricing reform, and indications that some actions required under the NWI had been diluted or altered during implementation.¹⁴⁸ The ACT Government will need to consider its position on these matters when the review of the NWI pricing principles finally takes place. In the meantime, it needs to consider whether there is a case to implement any pricing principles (separately from, or in addition to, the NWI principles) in its own domain.

Icon Water proposed in its submission that the ICRC Act be amended to require the regulator to make and publish standing guidelines in relation to the methodology for key constituent decisions in the price-setting process. The regulator would then need to provide reasons for departing from its guidelines when making price determinations. It argued that the existence of such guidelines would promote greater confidence in the consistency, reliability and procedural fairness of the price-setting process.¹⁴⁹

Icon Water proposed that the guidelines could cover matters such as information templates and the requirements of regulatory proposals; the roll-forward and revenue building block models; rate of return; expenditure forecast assessment; incentive schemes; and arrangements for consumer engagement. It suggested that the guidelines would need to be set in accordance with the objectives and principles in the legislation and reviewed by the regulator in consultation with stakeholders on a regular basis, but not during a price review process.¹⁵⁰

The ICRC submission noted that "there is a trend to specify matters regulators must address when making pricing or network charges determinations".¹⁵¹ It suggested that it was a matter for judgement as to whether these were likely to be necessary or cost-effective in setting the prices of water and sewerage services, given the matters to which the Commission must already have regard in making a price determination (as listed in section 20(2) of the ICRC Act). The ICRC acknowledged, however, that a specification in guidelines or pricing principles of how economic efficiency should be assessed could serve to address concerns about the

¹⁴⁶ Standing Committee on Environment and Water, *Next Steps in National Water Reform: Preparation for the Future*, Report to the Council of Australian Governments, 2013

¹⁴⁷ Productivity Commission 2011a, pages 177-179

¹⁴⁸ National Water Commission 2011, page xiv

¹⁴⁹ Icon Water Limited 2014b, pages 8-9

¹⁵⁰ *ibid.*

¹⁵¹ ICRC 2014e, page 29

predictability of the Commission's approach, while also assisting to streamline the regulatory process.¹⁵²

More specifically, the ICRC suggested that the assessment of economic efficiency should have regard to the following factors:

- the value of past investments in the water and sewerage business which were prudent and efficient;
- the need for future investment in the utility to meet licence obligations, regulatory requirements and ACT water policies;
- accounting and economic depreciation;
- efficient operating costs;
- debt servicing obligations, interest costs and financing charges; and
- a return on equity appropriate for a government owned entity.¹⁵³

Consistent with this emphasis on technical efficiency, the ICRC suggested that its future pricing investigations could focus on addressing:

- the efficiency of ACTEW's operating costs;
- the effectiveness of ACTEW capital planning and delivery practices;
- Icon Water's financial viability; and
- the ACT's water security outlook, and the supply side and demand side measures needed to maintain water security while addressing the community's expectations about water availability and environmental amenity.¹⁵⁴

The ICRC noted that, while the factors just listed are essentially the building blocks already used by the ICRC and other Australian regulators to assess the efficient costs of network utilities, a specification of these principles would serve to formalise the requirement to consider these matters when assessing the regulated utility's efficient costs.¹⁵⁵

As in relation to administrative processes, discussed above, the review is wary of the merits of any approach which would seek to build a set of detailed or highly prescriptive pricing principles into legislation. For the reasons already argued, this approach could reduce the level of desirable regulatory discretion, limit necessary flexibility over time, and potentially entail additional costs in refining or updating the principles as needs or circumstances change. The review is also mindful of the cautions sounded by Dr David Cousins in his advice to the Auditor-General:

¹⁵² *ibid.*, pages 29-30

¹⁵³ *ibid.*, page 29

¹⁵⁴ *ibid.*, pages 29-30

¹⁵⁵ *ibid.*, page 30

*Whilst there has been a clear evolution to a relatively common model in Australia, as well as the UK and USA, there is no reason why experimentation with other approaches should not occur. Indeed, it is desirable that such experimentation does occur. Further, different methodological approaches should not be seen as ends in themselves, but rather as means to inform regulators as to the decisions on prices they have to make. Price regulation is, or should be seen as, an art just as much as a science. Regulators need to take many factors into account and these factors need to be balanced by informed and wise judgement.*¹⁵⁶

The approach suggested in the ICRC's submission, however, would avoid the trap of undue prescription, while at the same time going some way to providing Icon Water with a more certain basis on which it could make the operating, investment and financing decisions necessary to run an efficient water and sewerage business.¹⁵⁷ The review suggests that, in line with the more active role for government proposed in Chapter 3, a set of guidelines modelled on this approach should be incorporated into the terms of reference for the next pricing investigation for water and sewerage services, assuming that the current regulatory framework is to continue. The relationship between these guidelines and the factors listed in section 20(2) of the ICRC Act would need to be made clear.

A final comment should also be made on the issue of pricing methodology and regulatory approach. The Auditor-General's performance audit report noted that there had been "minimal opportunities" during the ICRC's most recent pricing investigation for external peer review and evaluation of the technical approach that underpinned the price direction.¹⁵⁸

*In this respect, the ICRC did not engage, or seek assistance from, an external body or expert with respect to its proposed technical approach. The ICRC advised the Audit Office that external peer review is not a requirement of the ICRC Act.*¹⁵⁹

While it is true that external peer review is not a requirement of the ICRC Act the review considers that, resources permitting, it would be prudent for the ICRC to adopt the practice of some other regulatory bodies and engage a regulator from another jurisdiction to conduct a peer review of its price investigation methodologies and processes. Such an arrangement would add confidence to the integrity of the overall pricing process and, among other benefits, could serve to limit the scope for an appeal against a price determination. The ICRC is not well placed to implement a peer review process currently, given that the costs of such a process would probably fall outside the reasonable limits of its cost-recovery arrangements. If that is the case, however, there is stronger argument for an increase in the level of budget funding for the ICRC, as proposed in Recommendation 4, so that the Commission and the

¹⁵⁶ Quoted by ACT Auditor-General, page 70

¹⁵⁷ Icon Water Limited 2014b, page 9

¹⁵⁸ ACT Auditor-General, paragraph 4.54, page 77

¹⁵⁹ *ibid.*

wider community can benefit from the additional assurance which a peer review process would afford.

5.4 Conclusions

Conclusion 5.1: *There is broad agreement on the general principles which should guide the work of a regulator, and the attributes which characterise a best-practice regulatory regime. These include qualities such as independence, transparency, accessibility, predictability, cost-effectiveness, adaptability and procedural fairness. It is not clear, however, that codifying such attributes into a statement of formal requirements would have a significant influence on behaviours or outcomes in any given institutional setting. A preferable alternative is to target directly any areas of perceived deficiency or concern, or areas where greater clarity and assurance is needed, and take specific measures to address those concerns in a reasonable and cost-effective way. The regulator should then be held to account for its performance in these areas.*

Conclusion 5.2: *A careful balance needs to be struck between prescription and discretion: that is, the extent to which the regulatory role performed by the ICRC should be bound by government prescriptions or guidelines, or alternatively left to the regulator's best judgement and discretion. Any system of detailed prescription has the potential to undermine the necessary independence of the regulator; it also runs the risk of limiting necessary flexibility over time, and imposing additional costs in updating and maintaining the regulatory 'rules'. Ultimately it is a matter for judgement as to where the balance between prescription and discretion should lie; in general, however, if government sees a particular requirement as sufficiently important as to be deemed essential and ongoing, it should aim to reflect that requirement in the legislation governing the operation of the regulatory framework.*

Conclusion 5.3: *Better planning processes and administrative arrangements will be important for the future if the current regulatory framework is to continue. A key objective should be to provide greater clarity at an earlier stage of a pricing investigation so that all stakeholders are better informed at the outset of the ICRC's plans and their own responsibilities.*

In line with that objective, there is a good case for the ICRC to issue a range of early papers detailing its general approach to the investigation and addressing particular issues which will need to be examined. It is not clear, however, that such a requirement should be built into legislation, as this may lead to a loss of necessary flexibility over time. An alternative would be for the responsible Minister to stipulate a requirement along these lines in the terms of reference for a pricing investigation, if that were judged useful or necessary in the circumstances at the time. Better still, the ICRC could anticipate this requirement and implement it on its own initiative, as part of its commitment to better planning procedures.

Conclusion 5.4: *The ICRC has acknowledged that the administrative processes and project management arrangements it used in its last pricing investigation were deficient in a number of respects, and has taken some remedial action on its own account. Ultimately, it must be the responsibility of the Commission itself to ensure that its administrative processes and related project planning, monitoring and reporting procedures meet the necessary high standards. The ICRC should be held to account in these respects under the governance and accountability arrangements proposed in Chapter 3.*

Conclusion 5.5: *There is a strong case to insert an overarching objects clause into the ICRC Act which makes it clear that the primary objective of the regulatory framework is to promote the goal of economic efficiency, while safeguarding the financial viability of the regulated entity. This would provide useful guidance to the ICRC in balancing the multiple considerations listed in section 20(2) of the ICRC Act, and making the necessary trade-offs. A primary emphasis on economic efficiency can be expected to best serve the overall public interest, provided that social and equity objectives are addressed by governments in other ways.*

Conclusion 5.6: *Access to high-quality information is a sine qua non of a regulator's work, and the regulator must be confident that it can obtain the information it needs for a pricing investigation in an assured and timely way. The current provisions of the ICRC Act do not provide that assurance. If the current regulatory framework is to continue, amendments are needed to the ICRC Act to require the ICRC to publish an early statement of its information requirements, and the regulated entity (and any other relevant parties) to provide the required information within a reasonable period of time.*

Conclusion 5.7: *Any dispute resolution process needs to respect the statutory independence of the ICRC and its authority as the ultimate decision-maker in a price determination process. For that reason, a dispute resolution process should not apply to a dispute involving issues related to the content of a price direction, or a substantive conclusion reached in an ICRC report on a pricing investigation. In the case of disputes on procedural matters, however, such issues should not arise.*

If the current regulatory framework is to continue, an amendment should be made to the ICRC Act to give the Minister a power to establish a dispute resolution process on a procedural matter if, after receiving a written request from either party, the Minister judges this to be the most effective and efficient way of resolving the dispute. The Minister would have the discretion to determine the appropriate form of any dispute resolution mechanism in the circumstances of a particular dispute. Such an arrangement should be invoked only as a last resort, when best efforts by the parties to reach an agreement have failed.

Conclusion 5.8: *There would be dangers in building any detailed or highly prescriptive pricing principles into legislation. Among other risks, this approach could reduce the level of desirable regulatory discretion, limit necessary flexibility over time, and involve additional costs in refining or updating the principles as needs or circumstances change. It is important also to recognise that price regulation is not an exact science, but requires the exercise of wise and well-informed judgement. Consistent with this, there should be scope for experimentation and change over time in regulatory approaches and pricing methodologies.*

Conclusion 5.9: *Notwithstanding Conclusion 5.8 above, some high-level principles providing guidance on how economic efficiency should be assessed could be useful in addressing concerns about the predictability of the ICRC's price investigation processes, while also assisting to streamline the regulatory process more generally. These would also go some way to providing Icon Water with a more certain basis on which it could make its operating, investment and financing decisions in the future. A set of guidelines for this purpose should be incorporated into the terms of reference for the next pricing investigation for water and sewerage services, assuming that the current regulatory framework is to continue.*

Conclusion 5.10: *Resources permitting, it would be prudent for the ICRC to adopt the practice of some other regulatory bodies by engaging a regulator from another jurisdiction to conduct an external peer review of its price investigation methodologies and processes. Such an arrangement would add confidence to the integrity of the overall pricing process and, among other benefits, could serve to limit the scope for an appeal against a price determination. Assuming that peer review does not fall within the allowable scope of its cost-recovery arrangements, budget funding for the ICRC should cater for this and the range of other necessary functions of the Commission for which cost-recovery is either inapplicable or inappropriate.*

6 Possible alternative frameworks

6.1 Possible alternatives to the current regulatory framework

This chapter responds to the requirement in the Terms of Reference that the review consider “other possible frameworks for the determination of water and sewerage prices in the Territory”: that is, frameworks other than the regulatory model currently in place.

Several points should be made at the outset. Firstly, as noted in Chapter 2, no method of price determination can be considered ‘ideal’ in every circumstance: each possible arrangement will have its particular advantages and disadvantages, and present its own set of risks and challenges. Ultimately, the key judgement required will be which of the various options best meets the tests of cost-effectiveness and practicability.

Secondly, the arrangements which will best serve a particular jurisdiction may vary over time. In supporting a move from price regulation to price monitoring, for example, the Productivity Commission argued that the efficiency benefits of regulatory price determination are likely to be heavily concentrated in the early years of regulation, with limited gains thereafter.¹⁶⁰ Along somewhat similar lines, Icon Water commented in its submission:

*“... the policy aspiration should be to transition from the current price setting model to a more light handed approach, such as price monitoring or surveillance. Such a transition would normally be appropriate following consistent application of incentive-based price regulation over a period of 15 to 20 years. Although the current independent price regulation model has been in place for more than 15 years in the ACT, the impacts of the millennium drought and recent changes in regulatory approach may mean that a further period of regulatory price control is required in order to achieve the appropriate level of maturity for a successful transition to price monitoring or surveillance.”*¹⁶¹

Thirdly, it is important to recognise that each of the options potentially available would carry implications and consequences that would need to be managed. Under any of the possible alternatives to the current regulatory framework, for example, a clear strategy would need to be developed for managing the associated risks (as discussed below). Likewise, if the decision were taken to maintain the existing framework, it would be important to move swiftly to rectify the various weaknesses and vulnerabilities identified in this report.

Finally, when it comes to comparing the merits of the various possible alternatives with the current regulatory framework, the most reasonable comparison to make is between the assessed costs and cost-effectiveness of the possible alternatives with those of the current framework after necessary improvements have been made.¹⁶²

¹⁶⁰ Productivity Commission 2011a, page 306

¹⁶¹ Icon Water Limited 2014b, page 4

¹⁶² ICRC 2014e, pages 7-9

The review has identified five broad alternatives to the current arrangement involving independent price regulation by the ICRC. Each of these alternatives has its possible refinements and variants, but these are not discussed in detail here. There are also some other possible longer-term options which are not examined in this chapter; for example, while a 'market-based' approach to water pricing has a number of theoretical attractions, it does not yet meet the practical requirements which would make it a viable option in the short term.¹⁶³

The five possible alternative frameworks examined below are:

- **Option 1:** The ACT Government to set future prices for water and sewerage services.
- **Option 2:** The ACT Government to contract a regulator from one of the larger jurisdictions to undertake independent pricing regulation on behalf of the ACT.
- **Option 3:** The ICRC to contract a regulator from one of the larger jurisdictions to undertake the detailed work required for a pricing investigation on its behalf, while retaining ultimate decision-making power over the determination of prices.
- **Option 4:** The regulated utility (Icon Water) to set the prices of water and sewerage services, subject to a 'light-handed' price monitoring regime, as recommended in the Productivity Commission's inquiry report on *Australia's Urban Water Sector* (August 2011).
- **Option 5:** In the context of a possible new national water agreement, the ACT Government to transfer its powers of determination of water and sewerage prices to a new national regulator, as suggested in the *Draft Report of the Competition Policy Review* (September 2014).

Independent price regulation would continue to apply under Options 2, 3 and 5, but under different arrangements from those currently in place. Options 1 and 4, by contrast, would represent a more radical move away from the model of independent price regulation which has operated in the ACT for the past 17 years.

6.2 Assessment of the options

Option 1: Government to set the prices of water and sewerage services

While this option could easily be characterised as a retreat to the past, it should probably not be dismissed out of hand. Final prices are set by government in a number of other jurisdictions, notwithstanding national agreements to the contrary, and it is useful at least to consider the implications which would flow if a system of government-determined prices were to be adopted in the ACT. The ICRC effectively acknowledged this as an option to be considered when it commented in its submission:

¹⁶³ See the ICRC Senior Commissioner's comments in ICRC 2008, pages vii -xxiii

The question of whether the Territory should have the prices of water and sewerage services set by an entity that is independent of government is not one to be passed over lightly. Although this is the approach that has been taken in the ACT since the incorporation of ACTEW in 1995, it is by no means the only approach that can be taken. There may be circumstances in which the policy adopted is to subsidise the price of water and sewerage services, with the quantum of the subsidy being set on a year by year basis in the budget process. Alternatively, the government may take the view that the profits made from supplying water and sewerage services is a legitimate source of revenue and the rate of profit should be determined along with other tax rates in setting taxation policy.¹⁶⁴

The main potential **advantages** of this option are that it would be easy and cheap to implement and could be relatively simple in its design; for example, prices could be adjusted each year in the annual Budget process in line with the movement in the CPI or other price index, and there would be none of the complexity involved in the ICRC's current methodology. Uncertainty would be reduced as a result, and some cost savings made (at least in the short run). From a budgetary perspective, also, by virtue of the control it would exercise over the price-setting process, the ACT Government could more easily ensure that decisions on the prices of water and sewerage services formed part of its overall budgetary strategy.

Despite these superficially attractive features, this option also suffers from a number of significant **disadvantages**. A key drawback is that, by definition, it would put government back in the business of determining the prices of water and sewerage services, and thereby increase the risk of 'politicisation' of pricing decisions. As noted in Chapter 2, high levels of government involvement in these decisions in earlier times often meant that prices were set inappropriately: either well below cost recovery levels or, in some cases, at higher than efficient levels. A key reason for the introduction of independent price regulation was precisely to offer some protection against pricing decisions of this kind, and to ensure that prices charged would reflect the prudent and efficient costs of delivering water and sewerage services to the community. It is fair to note also that, whatever the potential attractions of increased control over prices, there are significant risks to government itself from direct involvement in the price-setting process; in this sense, the existence of an independent regulator offers a measure of protection to government as well as to consumers.

There are other disadvantages of this option as well. An arrangement in which the ACT Government set the prices of water and sewerage services would raise some clear conflict of interest issues, given that the Government is the sole owner of Icon Water Limited and the recipient of any profits it makes. In addition, a reversion to price-setting by government itself would be in clear conflict with the spirit and letter of the ACT's commitments under various national agreements: most obviously, with the commitment made under the *National Water Initiative* that:

¹⁶⁴ ICRC 2014e, page 3

*The Parties agree to use independent bodies to.... set or review prices, or price-setting processes, for water storage and delivery by government water service providers*¹⁶⁵

For the various reasons just discussed, the review does not favour this option, and considers that it would represent a retrograde step. Its fundamental defect is that, over the longer term, it could offer no guarantee, or reasonable level of assurance, that the prices charged by government would reflect the prudent and efficient costs of delivering water and sewerage services in the ACT.

Option 2: Keep independent price regulation, but contract out the price-setting task

Under this option, independent price regulation would be retained but the ICRC would no longer be responsible for the determination of prices: instead, the ACT Government would contract a regulator from one of the larger jurisdictions to undertake independent pricing regulation on behalf of the ACT.

The primary argument in support of this option relates to considerations of cost and cost-effectiveness: to the extent that the regulators in some other jurisdictions are judged to have processes which are superior in efficiency and effectiveness to those of the ICRC, there is a *prima facie* case to consider the option of contracting out.

Potential **advantages** of this option would include:

- the potential for lower net costs and greater efficiency in price determination processes, with ultimate benefits for the customers of water and sewerage services;
- the ability to select a pricing regulator (e.g., via a limited tender process) on the basis of certain specified criteria, including price; and
- the potential economies of scale which could result from having the ACT's price determination processes conducted by a regulator from a larger jurisdiction, with well-established processes already in place and a reputation for quality and efficiency within its own domain.

On the other hand, potential **disadvantages and risks** associated with this option include:

- a potential loss of 'sovereignty' involved in the contracting of price-setting responsibilities to a regulator from another jurisdiction;
- the risk that a contractual arrangement with a regulator from another jurisdiction might not offer the same assurance of regulatory independence as the current reliance on the ICRC as an independent statutory authority;
- a risk that the ACT could attract 'second-billing' status in the priorities of a regulator from another jurisdiction;

¹⁶⁵ COAG 2004, paragraph 77

- the transitional costs involved in making such a change, including the costs of changes to legislation and to current institutional arrangements; and
- uncertainty as to the likely level of interest from suitable regulatory bodies in other jurisdictions.

In relation to the first two entries in the list above, the ICRC's submission commented in the following terms:

*Any such (contracting out) arrangement would need to be structured very carefully to ensure that, in discharging the function, the entity was and was seen to be operating independently of the ACT government. For example, if IPART in NSW were contracted to perform the function, the fact that IPART might be considered to operate independently of the NSW government in performing its functions in NSW would offer no guarantees that it would operate independently of the ACT government when discharging a function under a contract with the ACT government. Such an arrangement may result in unintentional jurisdictional and territorial power issues, with the ACT government in effect ceding power to a state. It might well prove challenging to construct a contracting out arrangement that offered the same assurance of independence as a properly constructed, independent statutory authority in the ACT.*¹⁶⁶

The review accepts the ICRC's comment that any arrangement along these lines would need to be structured carefully, particularly with a view to ensuring that sovereignty was preserved and regulatory independence protected. In practical terms, the sovereignty consideration would probably mean that the contracted regulator would make recommendations on pricing to the ACT Government, rather than a final price determination as such; final decisions (and hence sovereignty) would then rest with the ACT Government, which would nevertheless commit publicly in advance to implement in full the recommendations it received from the external regulator.

The review considers that the various risks identified above, while by no means trivial, could probably be managed if this option were to be pursued. Clear communication processes would be needed to explain the reasons for the change in arrangements, with an emphasis on the benefits expected to accrue to the customers of water and sewerage services in the ACT. Likewise, the key requirements and expectations of the ACT Government would need to be clearly specified in the relevant tender documentation, and reflected also in the terms of any contract negotiated with a successful tenderer. Specific provisions would need to be included to protect the independence of the contracted regulator.

The review suggests that the ACT Government retain this as an option to be weighed against a continuation of the current regulatory framework, on the assumption that improvements will be made to the efficiency and effectiveness of the ICRC's current processes.

¹⁶⁶ ICRC 2014e, pages 7-8

Option 3: Keep independent price regulation and maintain the ICRC, but contract out the detailed work required for a pricing investigation

In many respects this option is similar to Option 2, and would have many of the same advantages, disadvantages and risks attached. The key differences are that the ICRC would remain in place, and that the Commission (rather than the ACT Government) would contract a regulator from one of the larger jurisdictions to undertake the detailed work required for a pricing investigation on its behalf. Having completed this work, the contracted regulator would make its recommendations on pricing to the ICRC, which would then make the final price determination.

An arrangement along these lines was used in the very early years of the ICRC's operations, when the ICRC engaged the New South Wales regulator, IPART, to undertake the detailed work required for a pricing investigation on its behalf. Subsequently, once the ICRC had recruited its own staff and developed its own methods and procedures, this arrangement with IPART was terminated.

Given that the conduct of pricing investigations is now the principal activity of the ICRC, an obvious consequence of this option would be to reduce the number of staff required by the Commission for the performance of its functions. The key requirement would be for one or more Commissioners to be available to examine and evaluate the detailed work undertaken by the contracted regulator, and subsequently to make a final price determination. A small complement of staff would be needed to support the Commission in this role and to undertake the other functions assigned to the ICRC under the ICRC Act and the *Utilities Act 2000*. As discussed in Chapter 2, the ICRC is already a very small agency, especially by comparison to its counterpart bodies in other jurisdictions, and while any move in this direction would reduce the problem of undue cyclicity in its workload, it would also be likely to call into question the ongoing viability of the Commission unless some other functions were added to its remit.

As with Option 2, the review suggests that the ACT Government retain this as an option to be weighed against a continuation of the current regulatory framework, on the assumption that improvements will be made to the efficiency and effectiveness of the ICRC's current processes.

Option 4: Icon Water to set prices, subject to price monitoring

In the 2011 report on its major inquiry into the urban water sector the Productivity Commission recommended that:

*State and Territory Governments should move away from regulatory price setting to a price monitoring regime (where some form of prices oversight is considered necessary). Independent regulatory price setting should only be applied where it can be demonstrated that price monitoring and appropriate governance arrangements are unlikely to prevent misuse of market power.*¹⁶⁷

¹⁶⁷ Productivity Commission 2011a, Recommendation 11.1, page 323

In support of this recommendation the Productivity Commission argued that regulatory price-setting is the most 'heavy-handed' form of price determination, with the largest informational requirements and the highest compliance costs. More 'light-handed' alternatives such as price monitoring, by contrast, should impose fewer costs and informational requirements and be less intrusive, leaving water utilities with greater scope for innovation and more discretion over the structure of prices, in line with customer needs. The Commission argued that price monitoring was likely to be more appropriate than price setting where the scope for abuse of market power was fairly limited, but where some concerns still remained about the potential for monopoly pricing.¹⁶⁸

It is important to note that the Productivity Commission tied its recommendation for a shift to a price monitoring regime to separate proposals for reforms to the governance of government-owned urban water utilities (such as Icon Water). It argued that further reforms of governance arrangements were needed to ensure the independence of water utilities, to clarify their responsibilities and to ensure that they were held to account for their performance against the government's objectives. Accordingly, it recommended that State and Territory Governments should introduce 'charters' for urban water utilities, incorporating best-practice governance arrangements.¹⁶⁹

The Productivity Commission argued that, in the long run, the establishment of strong governance arrangements for government-owned utilities would prove a more effective means of promoting efficiency, and ensuring full cost recovery, than a reliance on regulatory price-setting alone.¹⁷⁰ It suggested also that, if regulatory price controls were to continue to operate, these should be effectively aligned with governance arrangements.¹⁷¹

The ACT Government currently has under consideration a commissioned report prepared by Dr Bruce Cohen on the institutional and governance arrangements for Icon Water (ACTEW Corporation Limited).¹⁷² Given the close connections between governance issues and regulatory arrangements, especially in terms of the purposes they are designed to serve, there is a good case for the ACT Government to consider the findings and recommendations arising from this review alongside the recommendations made in Dr Cohen's report.

To date, no jurisdiction has acted upon the Productivity Commission's recommendation to move away from regulatory price-setting in the direction of a price monitoring regime. In the ACT environment, the key judgement required in assessing this option is whether a system of price monitoring would provide adequate assurance of efficiency in Icon Water's operations, and provide adequate protection for customers against the possible misuse of monopoly powers. To illustrate with a hypothetical example, it is useful to consider what protections (or sanctions) would be available if, under a price monitoring regime, Icon Water were to raise water prices to a

¹⁶⁸ *ibid.*, Chapter 11, pages 295-323

¹⁶⁹ Productivity Commission 2011a, Chapter 10

¹⁷⁰ *ibid.*, page 321

¹⁷¹ *ibid.*, page 308

¹⁷² Cohen, B, *Review of Institutional Arrangements for ACTEW Corporation Limited (ACTEW)*, December 2013

level consistent with the total revenue it proposed in its 2012 submission to the ICRC (Table 2.4), implying an increase in water prices of well over 20 per cent. Unlikely as that outcome might be in practice, the possibility exists and the risk needs to be weighed.

Indeed, a major issue for consideration in the design of any price monitoring regime relates to the action which should occur if the monitoring authority detects some problem with the prices being charged: for example, that they exceed some pre-determined benchmark. As the Productivity Commission noted in its 2011 review of the economic regulation of Australian airport services:

*Fundamental to the effectiveness of the light-handed approach is the credible threat of sanction for airports that abuse their market power.*¹⁷³

The Productivity Commission concluded from its review that a credible threat of sanction did not exist at that time in the way that the Australian Competition and Consumer Commission monitored the performance of Australia's major airports.¹⁷⁴

For the reasons discussed above, the review considers that a move to a price monitoring regime would represent a high-risk option, at least in current circumstances, and should not be pursued at this time. Rather than discarding the option altogether, however, it suggests that the ACT Government retain the option for possible future consideration, once reforms to Icon Water's governance arrangements have been implemented and bedded down and there is a higher level of assurance of ongoing efficiency in its operations.

Option 5: Transfer of price-setting powers to a national regulator

The recent draft report of the Competition Policy Review (September 2013) proposed that all Australian governments should re-commit to reform in the water sector, with a view to creating a national framework. The report suggested that a new intergovernmental agreement should cover both the urban and rural water sectors, with a focus on promoting consistent economic regulation of the sector and the potential for a national regulator. It also proposed that governments should "re-commit to introducing efficient and cost-reflective pricing in water as far as it is practical to do so".¹⁷⁵ The final report of the Competition Policy Review is expected to be delivered to the Commonwealth Government in March this year.

There are sound arguments for greater national consistency in the regulatory framework governing the urban water sector, as well as for some nationally consistent principles in relation to competition and private sector participation in the water market. The merits of having a national regulator for the water sector would probably be more keenly debated, with the potential efficiency benefits of such an arrangement likely to be set against concerns about 'special circumstances' and the need to have due regard to the variety of jurisdictional interests and local

¹⁷³ Productivity Commission 2011b, page xxxv

¹⁷⁴ *ibid.*, Overview, pages xxxiv-xlv

¹⁷⁵ Competition Policy Review, pages 36-37 and 127-128

conditions.¹⁷⁶ There is also an argument that the diversity inherent in current arrangements, whereby each jurisdiction has its own regulatory body employing its own techniques and approaches, is a source of strength rather than weakness.

It is premature to speculate about the possible outcomes of the Competition Policy Review, particularly as they might apply to the pricing of water and sewerage services, and the review suggests that the ACT Government should keep its options open on the issues raised in the draft report. Experience gained with the operation of the national energy framework and the recent work of the Australian Energy Regulator may suggest some lessons to be learned, or pitfalls to be avoided, in the event that a new intergovernmental agreement is proposed on national reform of the water sector.

In short, this option should be kept in reserve and evaluated more fully when further details become available.

6.3 *Other considerations*

The regulatory period covered by the ICRC's current price direction extends to 30 June 2019; alternatively, the draft report of the Industry Panel has proposed a five-year regulatory period expiring on 30 June 2018. Whichever of these regulatory periods is ultimately confirmed, there is a considerable lead-time for the ACT Government to weigh its options as to the future pricing framework which will best meet the long-term interests of the ACT community. For reasons of certainty, however, and to assist in forward planning, the review suggests that an in-principle decision should be made by no later than 30 June 2016, and preferably earlier. As noted above, it would be desirable for the recommendations arising from this review to be considered alongside the recommendations made in the report prepared by Dr Bruce Cohen on the institutional and governance arrangements for Icon Water (ACTEW Corporation Limited).

Allowing for the various uncertainties and risks attached to the alternative arrangements considered above, the review considers that the safest option for the time being would be to retain the current regulatory framework while pursuing the various changes and improvements recommended elsewhere in this report. It suggests also, however, that the ACT Government retain a 'contracting out' arrangement (Option 2 or Option 3) as a live option in the event that it is not satisfied with the adequacy or speed of progress made in implementing any agreed changes. The options of a price monitoring regime (Option 4) and the transfer of price-setting powers to a new national regulator (Option 5) should be reserved for more detailed evaluation in the longer term, when conditions require or are appropriate.

Under each of the alternative arrangements discussed above there would be questions as to whether the residual elements of the ICRC's role would be sufficient to warrant the retention of the Commission in its current form; and if not, the means by which its other functions, such as

¹⁷⁶ See Productivity Commission 2011a (pages 324-326) for a more detailed discussion of the potential advantages and disadvantages of a national economic regulator.

price determinations for retail electricity or the handling of competitive neutrality complaints, should be performed in the future. If the ACT Government were inclined to favour one of these alternatives, a consideration of this matter should form part of its overall decision-making process.

6.4 Conclusions

Conclusion 6.1: *No method of price determination will be optimal in every circumstance: each possible arrangement will have its particular advantages and disadvantages, and present its own set of risks and challenges which need to be managed. Ultimately, the key judgement required will be which of the various options best meets the tests of cost-effectiveness and practicability.*

Conclusion 6.2: *A reversion to a system in which government sets the prices of water and sewerage services would be a retrograde step, and should not be considered further. Such an arrangement would risk the 'politicisation' of pricing decisions, raise significant conflict of interest issues, and be in clear conflict with the ACT's commitments under various national agreements. More fundamentally, it would offer no guarantee, or reasonable level of assurance, that prices charged would reflect the prudent and efficient costs of delivering water and sewerage services in the ACT.*

Conclusion 6.3: *There is potential merit in an arrangement under which the ACT Government would contract a regulator from one of the larger jurisdictions to undertake independent pricing regulation on behalf of the ACT. While this option offers some scope for efficiency benefits relative to the current framework, any arrangement along these lines would need to be carefully structured to ensure that sovereignty was preserved and regulatory independence protected. The ACT Government should retain this as an option to be weighed against a continuation of the current regulatory framework, on the assumption that improvements will be made to the efficiency and effectiveness of the ICRC's current processes.*

Conclusion 6.4: *There is potential merit also in an arrangement under which the ICRC would remain in place but the Commission, instead of conducting its own pricing investigations, would contract a regulator from one of the larger jurisdictions to undertake the detailed work required for a pricing investigation on its behalf. Having completed this work, the contracted regulator would make its recommendations on pricing to the ICRC, which would then make the final price determination.*

An arrangement along these lines would reduce the problem of undue cyclicity in the current workload of the ICRC; however, it would also be likely to call into question the ongoing viability of the Commission unless some other functions were added to its remit. Again, the ACT Government should retain this as an option to be weighed against a

continuation of the current regulatory framework, on the assumption that improvements will be made to the efficiency and effectiveness of the ICRC's current processes.

Conclusion 6.5: *A move away from regulatory price-setting to a price monitoring regime, as recommended by the Productivity Commission, would represent a high-risk option, at least in current circumstances, and should not be pursued at this time. However, the ACT Government should retain this as an option for possible future consideration, once reforms to Icon Water's governance arrangements have been implemented and there is a higher level of assurance of ongoing efficiency in its operations.*

Conclusion 6.6: *There is a strong connection between the governance arrangements for government-owned utilities and the operation of the regulatory system. Both have an important role to play in promoting efficiency, ensuring full cost-recovery, and protecting the interests of customers. On these grounds, there is a good case for the ACT Government to consider the findings and recommendations arising from this review alongside the recommendations made in the report prepared by Dr Bruce Cohen on the institutional and governance arrangements for Icon Water (ACTEW Corporation Limited).*

Conclusion 6.7: *There are arguments both for and against the option of a national regulator for the water sector, as canvassed in the recent draft report of the Competition Policy Review. The ACT Government should keep its options open on the issues raised in the draft report, evaluating the proposals more fully when further details become available.*

Conclusion 6.8: *Under each of the alternative arrangements considered in this chapter there would be questions as to whether the residual elements of the ICRC's role would be sufficient to warrant the retention of the Commission in its current form; and if not, the means by which its functions other than price determinations for water and sewerage services should be performed in the future. If the ACT Government were inclined to favour one of these alternatives, a consideration of this matter should form part of its overall decision-making process.*

Appendix A: Terms of Reference

As part of the Government's response to the ACT Auditor-General's Performance Audit Report titled *The Water and Sewerage Pricing Process, Report No. 2/2014*, the Government committed to introduce improvements to the independent pricing framework for regulated water and sewerage services in the Territory.

The Government is commissioning a review of the ACT's price regulation framework for water and sewerage services, in order to inform the Government's consideration of options for achieving an improved framework.

The review will examine the current framework for water and sewerage pricing in the ACT and within this context, provide comments and recommendations on:

- the governance and administrative arrangements for the provision of independent pricing for regulated water and sewerage services in the Territory, including consideration of both the current model and other potential options;
- all relevant legislation related to the pricing framework for regulated water and sewerage services, in particular the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act);
- whether the ACT would benefit from a set of principles for conducting pricing investigations for regulated water and sewerage services, and outline the principles to be included; and
- any other matters considered relevant to improving the pricing framework.

The review will also consider other possible frameworks for the determination of water and sewerage prices in the Territory.

Consultation: The review should seek the views of key stakeholders and other interested parties in the community. A public call for submissions, as well as ongoing consultation with key stakeholders, would facilitate this outcome.

Appendix B: Consultations held and submissions received

Consultations held

Independent Competition and Regulatory Commission

Malcolm R Gray	Senior Commissioner
Mike Buckley	Commissioner
Ranjini Nayager	Chief Executive Officer
Ian Phillips	Legal, Regulatory and Consumer Affairs Adviser

Icon Water Limited

John Knox	Managing Director
Sam Sachse	General Manager, Finance
Ben McNair	Principal Economist
David Graham	Director, Regulatory Affairs and Pricing
Alison Pratt	Manager, Legal Services

Chief Minister, Treasury and Economic Development Directorate

David Nicol	Under-Treasurer
Karen Doran	Executive Director, Economic and Financial Group
Tony Hays	Senior Manager, Government Business Enterprise Unit, Expenditure Review Division
Phil Liddicoat	Manager, Government Business Enterprise Unit, Expenditure Review Division

Environment and Planning Directorate

Stewart Chapman	Senior Manager, Water Policy
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Auditor-General's Office

Maxine Cooper	Auditor-General
Brett Stanton	Director, Performance Audits

Industry Panel

Maryanne Hartley QC	President
Sally Farrier	Member
Claire Thomas PSM	Member

ACT Parliamentary Counsel's Office

David Metcalf	Deputy Parliamentary Counsel
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Individuals

Paul Baxter	Former Senior Commissioner, Independent Competition and Regulatory Commission
David Cousins AM	Adjunct Professor, Centre for Regulatory Studies, Monash University
Ted Matthews PSM	Chair, Audit and Risk Management Committee, ActewAGL

Submissions received (a)

Icon Water Limited

Independent Competition and Regulatory Commission

Dr David Denman AM

(a) Submissions can be accessed on the website www.act.gov.au/frameworkreview

Appendix C: Reference documents

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Independent Competition and Regulatory Commission (ICRC)

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- 2011, *Review of pricing reform in the Australian water sector*, 2011
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Productivity Commission

- 2011a, *Australia's Urban Water Sector*, Report No. 55, Final Inquiry Report, Canberra, 31 August 2011
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Queensland Competition Authority, *Statement of Regulatory Pricing Principles*, August 2013

Service Level Agreement *between the ACT Chief Minister, Treasury and Economic Development Directorate and the Independent Competition and Regulatory Commission for the Provision of Certain Services under the Independent Competition and Regulatory Commission Act 1997 for the Period 1 July 2014 to 30 June 2015*