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14 January 2015

Industry Panel Secretariat
GPO Box 158
Canberra ACT 2601

Dear Sirs

**INDUSTRY PANEL – DRAFT REPORT DECEMBER 2014**

I refer to the Panel's Draft Report of December 2014.

I submit that the Panel's Draft Decision is neither correct nor preferable and violates sections 20(2) and 20(4) of the *Independent Competition and Regulatory Commission Act 1997*.

As the Panel is aware (*vide* Draft Report page 30, Table 4.1, the Act states -

*(2) In making a decision under subsection (1), the commission must have regard to—*

*(a) the protection of consumers from abuses of monopoly power in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services; and*

*(b) standards of quality, reliability and safety of the regulated services; and*

*(c) the need for greater efficiency in the provision of regulated services to reduce costs to consumers and taxpayers; and*

*(d) an appropriate rate of return on any investment in the regulated industry; and*

*(e) the cost of providing the regulated services; and*

*(f) the principles of ecologically sustainable development mentioned in subsection (5);*

*(g) the social impacts of the decision; and*

*(h) considerations of demand management and least cost planning; and*

*(i) the borrowing, capital and cash flow requirements of people providing regulated services and the need to renew or increase relevant assets in the regulated industry; and*

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*(j) the effect on general price inflation over the medium term; and*

*(k) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.*

*(3) Also, in making a decision under subsection (1), the commission must allow a declared fee to be passed on in full to consumers of the service.*

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

I deal with these seriatim.

*(a) the protection of consumers from **abuses of monopoly power** in terms of prices, pricing policies (including policies relating to the level or structure of prices for services) and standard of regulated services*

The Panel has ignored the evidence. It was pointed out that excess water charges around 1990 were 47 cents per kilolitre and are now around $5.10 per kilolitre. If this is not abuse of monopoly power what is it? How can it possibly be justified? It should be noted that ACTEW was not being subsidised by the Government in 1990 and that, until the lower Cotter project, no new storages were completed and that the lower cost Tennent Dam option was ignored (apparently for political reasons).

Further, at paragraph 3.3.2, the panel explicitly endorses the abuse of monopoly power. It states that "reduced demand necessarily leads to an increase in water prices because the costs of providing water and sewerage shipwright services are predominately fixed. That is, they don't vary directly in line with demand for these services. So as the demand for services falls, the price per unit must increase."

That statement is not only an economic absurdity but necessarily implies an endorsement of abuse of monopoly power because its logical implication is that as demand falls to zero prices must rise to infinity. There is no way any competitive industry can operate in that fashion. In competitive industries, no business is guaranteed the recovery of its fixed costs, which is why prices will be driven to short run marginal cost (SRMC).

ACTEW's financial problems have been self-manufactured by its abuse of monopoly power. As it has driven prices up and sought to suppress demand, it has cut its own throat by slashing its revenues as consumers cease to water their gardens, buy water tanks, pray for rain and have recently been blessed with it. Rather than operating as a socially useful enterprise protecting the community from water scarcity and smoothing out water supply over the seasons, ACTEW has become a monopoly profiteer, not dissimilar from the despised black marketeers of World War II. Its pricing and business model are designed to profit from scarcity rather than alleviate it. That is why it now finds itself in the absurd position of having expanded ACT water storage, yet demand is well below its historic peak.

Another example of the abuse of monopoly power which has been implicitly blessed by the panel is the failure by ACTEW to apportion costs between different classes of users. ACT water users are being charged the full cost of the construction of the lower Cotter dam when in fact there are mandated and voluntary releases of water downstream which are provided *gratis* to downstream irrigators and for environmental uses. If a dam is built and 50% of the water released from it goes to downstream users and 50% to urban water users, it is quite

wrong to impose cross subsidisation by apportioning *all* the cost to the urban water users. The ability to arbitrarily impose a price of *x* on one person and give a price of zero to another is a perfect example of abuse of monopoly power.

The Panel has simply ignored these matters.

*(b) standards of quality, reliability and safety of the regulated services*

This is a matter the Panel has not addressed but it should be noted that in recent years there was a geosmin contamination outbreak which had never previously occurred prior to ACTEW's incorporation as a Territory owned company.

One might also note, as was pointed out, that ACTEW's policy of demand repression has contributed to a decline in service quality as sewerage drains have been clogged up by tree roots looking for water. This has resulted in a requirement for more frequent cleaning sometimes accompanied by the rather unpleasant backwash of sewage up into and overflowing from domestic toilets. I speak from personal experience. Nothing of this kind ever occurred prior to ACTEW being established as a Territory owned company.

*(c) the need for **greater efficiency** in the provision of regulated services **to reduce costs to consumers and taxpayers***

The Panel has fundamentally misconceived economic efficiency. Even the Productivity Commission, no longer noted for adherence to orthodox economic theory, continues to admit that economic theory sees efficient and competitive markets as requiring prices to be set at short run marginal cost (SRMC), see pages 143 and 144 of its report on *Public Infrastructure* dated 27 May 2014.

The PC (not a pun) does note that SRMC pricing can lead to what is called an "access deficit" where the economically optimal strategy of SRMC pricing fails to recover fixed costs.

It is therefore necessary to look at tariff structures and two-part pricing, where there is a separate charge for access to the network as opposed to a charge per unit delivered.

That is why Telstra offers different plans so that consumers are not forced to pay outrageous per minute charges if they are willing to commit to monthly fixed payments for access. That is why gas pipelines offer "take or pay" contracts to foundation shippers to ensure the pipeline owner recovers his fixed costs while not suppressing usage demand through excessive transportation costs.

That is why public utilities in this country used often to be financed by rates on the land values which are increased or sustained by potential access to infrastructure (a natural and efficient form of "value capture", see PC report pp 163-164).

By refusing to consider alternative tariff structures involving an increase to the fixed charge and its conversion to a land value rate, the Panel has guaranteed that it is fail to address the question of economic efficiency and it has equally guaranteed that it has failed to address the problem of least cost provision to consumers.

A disturbing feature of the current tariff structure of a low fixed charge and a high volumetric charge is that it necessarily exposes ACTEW to greater revenue instability in recovering its costs.

A land value rating system to recover fixed costs via fixed charges ensures that consumers are not being forced to subsidise landholders through volumetric charges above SRMC (that is, consumers are being forced pay for the fixed costs of infrastructure which adds value to the land they are renting from landholders – who pay little or nothing as such).

By failing to look at the implied cross subsidies to landholders through the provision of infrastructure being charged solely to consumers, the Panel has ensured that it is blind to a proper analysis of both economic efficiency and least cost provision of water to consumers.

*(d) an appropriate rate of return on **any investment** in the regulated industry*

The Panel has failed to consider the legal and ordinary meaning of the word "investment". In normal English, an investment relates to an actual cash outlay. It does not mean a *notional valuation*. By failing to look at actual cash investment historically made by the shareholding Ministers into ACTEW's infrastructure, the Panel has given a blessing and benediction to the corrupt policy of ACTEW (and its hidden Treasury masters) claiming a rate of return on investments never made by its shareholders (i.e. ACT Treasury).

If the Panel were serious, it would set out a table showing equity and debt advanced by the Treasury or its predecessors in title to ACTEW and which had not been recouped.

Only then would it be in a position to consider what was "any investment" made by anyone.

In fact, it could credibly be argued that the real shareholders of ACTEW ought to be regarded as the people and ratepayers of Canberra who have paid for most of the infrastructure already. ACTEW's assets are really community financed assets which have been commandeered by the ACT Treasury and treated by it as "its investment" in its wholly-owned Territory Corporation.

As for a "weighted average cost of capital" or, it is difficult to understand how one can grant a nominal weighted average cost of capital of 7.2% when one is simultaneously allowing for indexation of the regulated asset base. ICRC was surely more logical in excluding indexation of the regulated asset base and setting a nominal rate of return.

Further, when one considers that ACTEW is meant to serve the people of Canberra as its ultimate owners, a firm specific approach does not seem wrong. Indeed, it would seem logical to apply a debt cost of capital to capital from external sources and to apply an equity cost of capital for actual cash injected by the ACT government. Any equity premium in the rate of return should only be applied to cash actually injected by the ACT government and not applied to the regulatory asset base (which should not be indexed).

*(e) the cost of providing the regulated services; and*

As with the word investment, the panel has failed to adhere to the meaning of "cost". In ordinary English, cost means an amount of money actually expended. It does not mean a

notional or inflated or hypothetical replacement or indexed cost. It is interesting to note that the United States Supreme Court in the *Southwestern Bell Tel. Co. v. Public Svc. Comm'n, 262 U.S. 276 (1923)*and *FPC v. Hope Nat. Gas Co., 320 U.S. 591 (1944)* cases long ago saw through the manipulation of "replacement cost" by monopolists claiming tariff charges to recover bogus inflated costs. The Panel is slavishly following an unsound methodology which has no foundation in the ordinary legal meaning of the word "cost" and which has been long since rejected in the country which spawned the idea that privatized monopolies could be regulated.

*(f) the principles of ecologically sustainable development mentioned in subsection (5);*

The Panel seems to have given no consideration to this aspect but it should be noted that the overcharging of urban water consumers by ACTEW and the cross subsidisation of downstream users by free outflows from the dams built by ACT water consumers necessarily has adverse ecological effects.

Urban amenity is adversely affected as people abandon the business of planting and watering trees and shrubs. The replacement of greenery by gravel and concrete leads to heat sink effects which in turn require the installation of domestic air-conditioning, leading to unnecessary use of resources. The subsidisation of downstream water use represents a misallocation of resources where that downstream use has not been paid for. Unless the capital cost of the lower Cotter catchment is properly apportioned between ACT and downstream users, this continuing misallocation of environmental resources will be promoted by the Panel's decision. A sensible approach would seem to be to treat the downstream outflows as a mandated community service obligation to be borne by the ACT government which has mandated the outflows and prorate the capital cost of the Lower Cotter Dam accordingly.

*(g) the social impacts of the decision; and*

The Panel does not seem to have given much attention to the social impacts of the decision but it is worth noting that a water price which has risen from 47 cents per kilolitre around 1990 to $5.10 today has had a pervasive effect on society. Having a nice garden was once the pastime of pensioners. Today it is the status symbol of millionaires. Many elderly pensioners, faced with the cost of water, are now condemned to give themselves back injuries while lugging buckets of recycled shower water around the garden. School playgrounds and sports grounds become harder as they are less well watered and more injuries result to children. The social impact of a water pricing policy which inevitably promotes more injuries to the young and old must surely be questioned. Personally I am unaware that Royal Canberra Hospital is really in desperate need of more clientele.

*(h) considerations of demand management and least cost planning; and*

"Demand management" is an undefined phrase. One might have thought that if it has any rational meaning, it is that no expansion of capacity should be undertaken to create storage at a cost which is less than the value added to the community, including the sustained and enhanced land values of lands able to connect to the reticulation system. But to use the phrase "demand management" as code for a policy of demand repression is fundamentally to pervert economics.

As a *reductio ad absurdum*, taken to its logical conclusion, the best method of managing demand and securing least cost planning would be to do nothing. Demand would be suppressed and costs would be minimised at the point where the whole system has fallen into desuetude, serves no one and costs nothing.

Given that such an interpretation is absurd, the Panel has to revert to a concept of effectual demand for product where the demand of landholders and consumers for the provision of infrastructure and its volumetric use can together cover both the short run marginal cost of delivering water and the fixed costs of maintaining the infrastructure in place to service the land.

*(i) the borrowing, capital and cash flow requirements of people providing regulated services and the need to renew or increase relevant assets in the regulated industry; and*

It is wrong to give a retrospective benediction to policies of gearing up debt on an inflated asset base. Where, for example, a utility is gone into debt to pay a dividend to its owners, that can hardly be treated as a borrowing, capital and cash flow requirement incurred "*in providing regulated services*". It is my understanding of the financial history of ACTEW that, since the establishment of the Territory owned corporation, a policy of revaluing assets, borrowing against them and paying dividends has been at times undertaken. A proper review of the price direction would go back through the history and strike out any allowance for borrowings incurred to pay dividends.

*(j) the effect on general price inflation over the medium term; and*

Clearly, a policy of allowing perpetual revaluation of the regulated asset base must lead to inflation of charges over time which in turn feeds into the general level of prices.

*(k) any arrangements that a person providing regulated services has entered into for the exercise of its functions by some other person.……*

No comment.

Yours sincerely

Terence Dwyer