

Policy Position on Water Pricing for Sustainable Household Consumption

1. Background

The Consumer Action Law Centre (**Consumer Action**) believes that access to an essential water service is a fundamental human right and that the public interest is served by the maintenance of consumers' access to essential services.

There are a range of policy tools that have been used to promote sustainable water consumption, with market based mechanisms such as price increases and alternate tariff structures increasingly being promoted as the most efficient and best options. Other policy tools available include restriction policies, water efficiency measures or the use of alternate water sources such as recycling or rainwater tanks.

In August 2011, the Productivity Commission released an inquiry report, *Australia's Urban Water Sector*.ⁱ The report finds that pricing plays an important role in providing the signals that guide behaviour on both demand and supply sides of the urban water sector. It recommends against the use of mandatory water restrictions to influence demand as they create costs for households, businesses and the community and suggests that water prices have too great a focus on addressing affordability by distorting prices. In December 2011, the Victorian Government approved a new water restriction regime for metropolitan retailers, and returned Melbourne to stage 1 water restrictions.ⁱⁱ The urban water sector regulator, the Essential Services Commission (**ESC**), has also begun consultation on the water price review for 2013 to 2018.

Consumer Action recognises that water prices are rising. However, an over-reliance on water pricing as a demand management tool will have unintended impacts for many consumers, and will particularly impact unfairly upon lower income households. Conventional economic analysis assumes that increasing water prices will result in households consuming less water. There are some fundamental problems with this assumption that must be addressed if pricing policies are to impact upon water demand.

2. Water pricing and tariff structures

Under Victorian water regulation, water prices and tariffs are set by the ESC and must reflect the cost of efficient service provision as well as provide incentives for sustainable water consumption.ⁱⁱⁱ

2.1 Costs of efficient service provision – leading to higher prices

Residential water prices are based upon the cost of harvesting and delivering water to households. During the recent period of water scarcity, investments were being made to ensure that water security is maintained. Such investments included large supply side solutions such as desalination plants and large-scale water recycling. Smaller localised measures, such as rainwater tanks, local grey-water systems or household efficiency measures have also been promoted. The challenge for Government and the water industry is to identify which options are not only the most environmentally responsible, but also the most cost efficient, as the cost of these investments flows on to residential water prices. Increasingly, the challenge is also about managing the impact of any decisions around investments. For example, the

decision to build a desalination plant for Melbourne has been made, and the question now is how we manage the costs of that investment.

The compulsory environmental contribution is also being collected and spent on projects to return water to the environment.^{iv} Increased spending by water businesses will mean that the total amount recoverable by water businesses through prices will increase. A concomitant reduction in household water consumption will mean that there is a lower base from which to recover expenditure. This is resulting in considerable pressure for higher residential water charges.

2.2 Tariff structures which aim to promote sustainable outcomes

All Victorian water businesses impose volumetric charges which mean that residential households are charged at least partly on the basis of how much water they consume. Fixed service charges also apply and amount to between 30-60% of the final bill. Some water businesses use inclining-block tariffs, which provide for higher volumetric charges once certain consumption thresholds have been reached. It is argued that this method of structuring tariffs sends a stronger price signal to households to conserve water above the threshold level.^v

3. The impact of higher water prices and ‘sustainable’ tariff structures

Consumer Action recognises the need for water prices to rise. This reflects the cost of increased investments needed to ensure the security of water supply and environmental considerations.

However, there has also been a tendency within the debate on policies to manage household water demand to advocate for higher water prices as the primary tool to reduce household water consumption. This is the message from the inquiry report of the Productivity Commission. In particular, its report promotes flexible or scarcity-based pricing. This is a price that varies in line with movements in the current and expected future demand–supply balance, and the Productivity Commission argues it has potential to allocate water more efficiently in the short run to reduce the cost of supply in the long run. The Productivity Commission also argues for more choice in tariff options.

Consumer Action believes that blanket price increases will not necessarily result in lesser household water consumption and, worse, will have an unfair and disproportionate impact on many consumers.

Our concerns are based on the following:

- **Higher water prices means that water will become more unaffordable for many consumers.** Affordability will be a particular problem for consumers who are having difficulty paying within current pricing arrangements, such as those on low or fixed incomes.
- **Higher water prices will not send a direct message to consumers to reduce water consumption at the moment they consume water.** This is because water is billed on a quarterly basis, and there is a significant lag between water consumption and any price signal.
- **High fixed service charges will dilute any price signal.** For many households, a reduction in consumption will not result in a significant reduction in their bill due to the large fixed service charge component. This is particularly the case for low consumption households. It also appears that the large fixed service charges will continue given the need to recover the cost of large infrastructure projects.
- **Households with higher water consumption levels may be able to bear higher water charges, and not respond by reducing consumption.** Numerous studies suggest that the price elasticity of

demand for water is low, which means that households reduce water usage only marginally (if at all) when price increases.^{vi}

- **Low-income households have a more limited ability to respond to price signals.** Contrary to the usual experience, low-income households have a *lesser* price elasticity of demand for water compared with higher income households, primarily because of the fact that they consume less discretionary water to begin with (generally outdoor water usage).^{vii} As such, low-income households may not be able to respond to price signals to reduce water usage, and will be necessarily penalised by higher water charges. Conversely, higher income households, as stated above, may also not respond to price signals and reduce consumption because of their ability to bear higher charges.
- **Inclining block tariffs can unfairly impact upon households with larger non-discretionary consumption levels, such as large families or people living in water inefficient housing.** Large households, which have a limited ability to reduce their usage, may be forced onto higher block tariffs and thus penalised for non-discretionary use. Consumers who are not easily able to improve water efficiency of household appliances, such as tenants, may also be pushed onto higher block tariffs.

Consumer Action is also concerned that the application of 'choice' to water tariff options has the very real possibility to confuse consumers. Experience with choice in industries such as energy, telecommunications and even banking suggests that choice gives rise to complexity and, contrary to traditional economic theory, there are significant barriers to consumers making effective choices.

4. Consumer Action proposals

4.1 Policy tools that reduce demand

There are a range of non-price policy tools that impact on demand. Consumer Action believes that these policy tools can be more equitable and fair than price increases or offering choice in tariffs in achieving the desired outcome of reduced consumption:

- **Public education campaigns**—significant behaviour change has been achieved through effective social marketing campaigns that encourage consumers to modify their behaviour for the good of society.
- **Restriction policies**—mandatory restriction policies effectively limit outdoor water usage, which is largely discretionary. Effective particularly in times of water shortages, such policies are more equitable than pricing policies in that they apply to all consumers equally.
- **Subsidisation of programs aimed at adopting water efficient technologies**—water efficiency is perhaps the best policy tool available, as it reduces the ability of consumers to use water wastefully.

If price is continued to be used as a demand management tool, measures need to be implemented concurrently to mitigate against unintended unfair impacts. Targeted tariff options *may* help mitigate unfair impacts. For example, particular pricing plans which are more appropriate for certain household types (for example, large households) might overcome the inequitable impact of current “one-size-fits-all” pricing structures. However, if choice is introduced, it should not operate unrestrained to allow consumers to make poor decisions resulting in higher prices for an essential service.

4.2 Policy tools that ease affordability

We recognise that it is reasonable for water businesses to recover the cost of service provision through prices. However, where those prices mean that water becomes unaffordable for some households, it is Government's responsibility to ease this affordability problem as it is unacceptable for any consumer to have a lack of access to water due to incapacity to pay.

There are currently a range of mechanisms that are designed to assist consumers pay their water bills. These policies should be monitored and developed as water prices increase:

- **Concessions**—the Victorian Government provides a water and sewerage concession to eligible concession card holders of 50% of the bill up to a maximum of \$154 per year (in 2006/07, cap is adjusted with CPI). Other concessions are also available. These must keep pace with water price rises significantly above CPI.
- **Regulation of contractual terms**—the Victorian Water Customer Service Code requires all water businesses to offer customers the right to flexible payment options and to an instalment plan that is set at a level that takes into account the customer's capacity to pay.
- **Hardship policies**—water businesses are required to have defined hardship policies which identify how they deal with customers who are unable to pay.
- **Rebates/subsidies/incentives for water saving appliances and retrofitting, especially targeted at lower income households, including tenanted households**—increased water efficiency has dual social and environmental benefits by reducing water consumption and easing affordability (assuming lowering consumption lowers water bills).

For more information about Consumer Action and our work on water policy and other consumer issues, visit our website at www.consumeraction.org.au.

ⁱ Productivity Commission, *Australia's Urban Water Sector: Inquiry Report No55, August 2011*.

ⁱⁱ Minister for Water, *Press release— Melbourne back to stage 1 water restrictions*, 1 December 2011. See also <http://letstalkwatermelbourne.com.au>.

ⁱⁱⁱ Water Industry Regulatory Order 2003 (Vic), cl 14.

^{iv} The environmental contribution or levy adds an average of 5% to residential bills, and aims to respond, to some extent, to environmental externalities (the cost to the environment of providing water services): *Water Industry Act 1994* (Vic), Part 9.

^v Essential Services Commission, *Metropolitan Melbourne Water Price Review: Final Decision*, June 2009, p 89.

^{vi} For a review of local and international studies on price elasticity of demand for water, see Independent Pricing and Regulatory Tribunal, *Investigation into Price Structures to Reduce the Demand for Water in the Sydney Basin – Issues Paper*, December 2003, pp 15-18.

^{vii} Greg Barrett, *Residential Water Demand and Price Elasticity: A Survey of Literature*.