

14 April 2009

Dr Ron Ben-David
Chairperson
Essential Services Commission
Level 2, 35 Spring Street
MELBOURNE VIC 3000

Dear Dr Ben-David

Re: Inquiry into an Access Regime for Water And Sewerage Infrastructure: Issues Paper

The Victorian Water Industry Association (VicWater) is the peak industry association for water businesses in Victoria and contributes to the development and implementation of Government policies relating to water and wastewater services.

VicWater is pleased to make a submission to the *Essential Service Commission's Inquiry Into An Access Regime For Water And Sewerage Infrastructure Services: Issues Paper* (February 2009), however we note that additional submissions addressing particular issues may also be provided from our 19 industry members.

A fundamental requirement of a state-based access regime must be that it allows for flexibility to reflect the circumstances of each water service provider and does not impose administrative costs unnecessarily across the industry.

We note that current legislative and regulatory regimes provide an adequate framework for water businesses to develop access arrangements as privately negotiated contracts. Several water businesses are currently considering such arrangements for specific customers or other water businesses. By contrast, formal access arrangements in the water industry in the UK and Australia have so far failed to attract the level of competition required to justify the administrative expenses associated with developing and maintaining such substantial regimes. The lack of private sector interest may be due to limited opportunities for new source development and the relatively low margins available, and may therefore be a defining feature of the water industry.

As the evidence for developing a successful access regime is limited, any state-based regime developed for Victoria should ensure that investment in new infrastructure is not stifled and that the administrative costs for water businesses are kept to a minimum.

In this response, we address a number of questions raised in the Commission's Issues Paper in detail, however the most critical issues are summarised below.

1. **Ring fencing of functions:** VicWater would question any ring-fencing arrangements that require the separate management or operation of activities that are currently vertically integrated (e.g. separation of the retail functions from the transmission and bulkwater supply functions). Such requirements would lead to inefficiencies and reduce the integrated water management focus that has been developed by water businesses across the State and is particularly important during these times of extended drought.
2. **Methodology for access pricing:** Third party access may be sought under a range of circumstances, and it is not the case that one pricing methodology will suit all possible situations. Depending on the circumstances, the appropriate access pricing methodology may be either the cost of service method, the retail minus method or the cost to augment the system. We therefore support the use of flexible pricing guidelines, as have been adopted in the New South Wales water access legislation, with individual cases determined on an application-by-application basis. We would strongly oppose the development of prescriptive guidelines at this stage, particularly as there are only a handful of actual case studies to test them against.
3. **Access to storage dams:** The Issues Paper raises the possibility that large dams might be covered by a state-based access regime. We note that third party access should only be granted where an asset has "excess capacity", however the natural year-to-year climate fluctuations mean that additional storage in one year can be used as a buffer against lower inflows in future years. The rapid depletion of many Victorian dams over recent years has demonstrated the value of maintaining high buffer levels. Additional storage will provide security of supply against drought and climate change uncertainties and therefore should not be regarded as "excess capacity". We recommend that dams be excluded from any state-based access regime in the first instance.
4. **Accounting ring fencing:** With regard to accounting ring-fencing and coverage, we note the substantial administrative costs involved in providing ring-fencing information, including cost allocation, reporting and auditing costs. It is unclear which businesses would be required to provide this information under a State-based access regime and therefore we urge the Commission to be cognisant of the significant costs involved and to limit the ring-fencing information requirements to only those businesses that become covered by the regime after failed negotiations with an access seeker. Alternatively, it would be more appropriate to have a State-based access regime that only applies to systems or supply areas above a certain size. The size could be set to cover the area's most likely to attract applications for access (i.e. the metropolitan area) and access arrangements for areas below the nominated size would be considered on a case by case basis after an application was lodged.
5. **Merits review of decisions:** The access regime should include clear provisions to appeal access decisions on the basis of merit rather than the merely questions of law. If the Commission is to be responsible for decisions regarding declaration, implementation of the regime or arbitration, then the current grounds for appeal in the Essential Service Commission Act 2001 should be strengthened to clearly articulate a merits review process, overseen by an independent and knowledgeable third party. In this response we demonstrate the need for a merits review process by providing a number of examples in which appeals based on merit have resulted in the original access decision being overturned.
6. **Binding non-coverage declarations for new infrastructure:** As the risks associated with investing in greenfields infrastructure can be substantial, investment in new areas may be curtailed if the industry is concerned about the potential for third party access. We therefore support the concept of a period during which greenfields infrastructure will not be subject to coverage by the access regime (i.e. a binding non-coverage declaration). We understand that for binding non-

coverage declarations to be included in a certified access regime, Commonwealth legislation may need to be amended (as it has been for gas). However, we believe that the importance of greenfields investment justifies pursuing such an amendment if required.

7. **Retailer of Last Resort:** Retailer of last resort arrangements are critical when developing an access regime as it provides a guarantee of supply continuity to customers in the event a retailer fails. It needs to be highlighted that there is risk exposure to the retailer that is adopted as the retailer of last resort and this risk needs to be compensated for in the access price to ensure that existing customers are not penalised.
8. **Compensation for assessing proposals:** Substantial costs may be incurred in order to determine whether an access application is technically feasible, and to calculate indicative access charges. Therefore, access seekers should be required to compensate the incumbent for the reasonable expenses incurred in assessing their application, rather than expect these costs to be recovered from the incumbent's existing customer base.
9. **Transitional arrangements:** We support the transitional approach that has been adopted in other industries, whereby access seekers are initially limited to supplying large non-residential customers, to ensure that the scheme functions correctly, protects customers and demonstrates benefits before allowing access seekers to supply residential and small commercial customers.
10. **Regional Context:** All access applications should be assessed considering the regional outcome as expressed in local government statutory planning schemes. Local developments using third party access arrangements might be optimal for that development but may not be optimal over a longer period at the regional level, especially if issues broader than water and sewerage are to be considered.
11. **Definition of an Access Regime:** The ESC's Issues Paper outlines many factors that need to be addressed when developing an access regime. However, there has been a number of questions raised suggesting that the overall definition of an access regime has not been clearly stated. This lack of clear definition leaves many uncertainties surrounding third party access and when the access regime would apply. It is suggested that a clearer definition is developed.

Questions raised in the Issues Paper

Below we respond in more detail to individual questions raised throughout the Issues Paper. Note that responses are in the order raised in the Issues Paper rather than in order of importance.

Issues Paper section: 4.1.1 Types of infrastructure services to be covered

Question: Which types of water and sewerage infrastructure services should be covered by an access regime? Consideration should be given to types of services that are expected to satisfy the criteria of being significant, not economically feasible to duplicate, and necessary to permit effective competition in related markets.

The Issues Paper notes that access to large storages may be appropriate because (amongst other things) many existing dams have excess capacity and access to the storage services provided by large dams can be provided without undue risk to human health and safety.

The variability in dam inflows over the past decade has demonstrated that historical records do not provide adequate evidence of the sufficiency (or otherwise) of dam storage capacity. “Excess” capacity in one year can quickly become a critical shortage in future years. Storage capacity can be used by water businesses as a buffer against drought and therefore provides security of supply against future years’ shortages. Maintaining greater storage capacity therefore provides customers with a higher level of service and cannot be regarded as “excess”. Therefore the capacity should not be made available under a third party access regime.

In addition, other practical complexities make the inclusion of dams in an access regime problematic. For example, the Australian Drinking Water Guidelines require a multiple barrier approach to drinking water quality that is best managed by a single agency. Any third party water supplier would need to work seamlessly with the dam owner to ensure that whole process could be managed without undue risk to human health.

Issues Paper section: 4.1.2 Specific infrastructure services to be covered

Question: Is the approach to coverage adopted in the New South Wales’ access regime— combining initial declaration of specific services with a process for case-by-case declaration of other services— appropriate for a Victorian access regime? Are there any specific water and sewerage infrastructure services that should be declared from the commencement of an access regime?

The evidence from other industries suggests that it is not a straightforward matter to determine whether a specific service should be declared. In addition, the process of testing specific services against the declaration criteria can be time consuming and resource intensive. Therefore, we do not support the declaration of specific services until/unless a third party applies for those services to become declared. A state-based access regime should indicate only the types of services to be covered, and should include the criteria by which declaration of specific services will be assessed on a case-by-case basis.

Issues Paper section: 4.1.3 Greenfields investment

Question: What features should be incorporated into a Victorian access regime to ensure sufficient investment is made in new (greenfields) investments in water and sewerage infrastructure facilities?

As noted in the Issues Paper, new (greenfields) investment can involve substantial expenditure and risk, with one of the greatest uncertainties being the take-up rate of new services. The Issues Paper refers to other regimes that have included “binding non-coverage declaration” period for greenfields investment (that is, a period during which greenfields infrastructure will not be subject to coverage by the access regime). These arrangements assist to promote certainty and therefore support efficient investment in new areas.

We understand that the National Competition Council has questioned the inclusion of binding non-coverage declarations in the New South Wales access legislation. However, we believe that the inclusion of a non-coverage period for greenfields investment is sufficiently important that all measures should be undertaken, including the development of national legislation if required, to ensure that binding non-coverage declarations can be applied in any state-based regime developed for Victoria.

Issues Paper section: 4.1.5 transitional arrangements

Question: Should an access regime include transitional arrangements? If so, what type of arrangements should be included, what would be their purpose and how long would they need to be in place? Are there any implementation issues that should be resolved during a transition period?

VicWater supports the inclusion of transitional arrangements – in particular that, in the first instance, the access regime should apply only to large non-residential customers or third parties seeking to supply large non-residential customers. This will ensure that the access regime can be assessed and refined in more detail before it is applied to residential and smaller commercial customers.

Issues Paper section: 4.3 Dispute resolution

Question: Are the existing merits review provisions under the Essential Services Commission Act 2001 sufficient for reviewing access-related decisions?

Although rarely utilised by government-owned businesses, the ability to appeal an arbitrator's decision is a critical element of the dispute resolution process. We note that there are numerous examples of successful appeals against access determinations, including those based on a merits review. Cases include: the declaration of the Sydney Water sewerage network; the access arrangements for the Moomba-Sydney Pipeline; the declaration of domestic air services at Sydney Airport; and the estimation of Capital Asset Pricing Model parameters in the determination of GasNet's reference tariff. These and other examples demonstrate the benefits of a robust, independent appeals process.

Therefore, the limited merits review provisions under the Essential Services Commission Act 2001 are considered insufficient, and a clear and comprehensive avenue for merits reviews should be incorporated into any state-based access regime for water and sewerage, as it has been in other industries.

Issues Paper section: 5.1.1 Certification criteria relating to access pricing

Question: Should an access regime include regulatory guidance on prices, such as indicative tariffs or reasonable price boundaries, to provide a framework for access negotiations between infrastructure operators and access seekers?

The Victorian water industry canvasses a wide range of diverse circumstances. Access prices will be specific not only to each scheme, but also to each specific location within the scheme. Providing an indicative access tariff across an entire reticulated water or wastewater system will typically be uninformative for third parties seeking access at a particular location. By contrast, developing an indicative tariff for each potential nodal location that could be accessed by a third party would involve a substantial administrative expense that would far outweigh the benefits of providing the indicative tariffs.

Consequently, it is assumed that regulatory guidance would relate to the type of tariff and the method of calculation to be used.

Therefore, we do not support the inclusion of regulatory guidance on prices, only guidance on tariff types and calculation methods.

Issues Paper section: 5.1.3 Comparison of access pricing methodologies

Question: What issues should be considered in determining access prices? What is the most appropriate methodology for determining access prices for the Victorian water industry—cost of service or retail minus?

The Issues Paper notes that two common methods of pricing for access are the cost of service approach and the retail minus approach. We note that a further option is a charge based on the incremental cost of providing the service.

Each access pricing methodology has advantages and disadvantages, and each may be applicable under different circumstances (as discussed below). We therefore strongly encourage the Commission to adopt relatively broad pricing guidelines, such as those included in the NSW access legislation for water, to provide a flexible approach that can be adapted to individual circumstances.

Some of the advantages and disadvantages of each approach include:

- ◆ access charges based on the cost of service (e.g. the Building Block approach) will be largely driven by the cost of sunk investments and therefore will not send a signal to access seekers regarding the incremental or avoided costs faced by the incumbent. Where the cost of upgrading the system is significantly higher than the replacement cost of the system, the price to existing customers may need to increase to pay for the higher cost of augmenting the system. In addition, where uniform retail prices occur across a region, the cost of service approach may result in “cherry-picking”. That is, retail customers in low cost areas may be encouraged to apply for an access price to avoid paying the (higher) retail tariff. In this case, there will be no efficiency gains, only a windfall profit to the access seeker;
- ◆ access charges based on incremental costs (e.g. the Long Run Marginal Cost) would send an accurate pricing signal regarding the incremental cost to supply a service and would therefore promote economic efficiency. However, these charges could be significantly different to the existing retail tariff and may therefore also encourage “cherry-picking” in low cost areas. In addition, if access were to become widespread, charges based on incremental cost will limit the service provider’s ability to recover sunk and fixed costs across the scheme; and
- ◆ “retail minus” charges are based on the existing retail tariff plus (or minus) the costs (or avoided costs) incurred by adding the access seeker to the incumbent’s system. Therefore, the retail minus avoids cherry-picking by charging the access seeker the same retail price as the customer, but reducing that price by the value of the avoided costs to the incumbent (for example, the incumbent might avoid having to purchase additional bulkwater). However, the retail minus approach can only be applied when a retail price for the service actually exists. For example, the retail minus approach could not be applied for water supplied during periods of water restrictions, or for bulkwater charges between water authorities. In addition, as the retail minus approach is typically based on a uniform price across the system, this method will not send an accurate pricing signal about the marginal cost of adding the access seeker to the system.

Although it is not possible to canvass every situation in this response, the retail minus approach will typically be appropriate whenever the potential for “cherry-picking” exists - in particular, where the incumbent has uniform retail prices (commonly referred to as “postage stamp prices”). We note that all regulators of water infrastructure access in Australia and the UK to date have endorsed some version of the retail minus methodology (including the ACCC determination regarding access to Sydney Water’s

sewerage network, the ERA's review of competition in the water industry in Western Australia and Ofwat's "Cost Principle"). Any access regime that allowed cherry-picking would immediately undermine uniform retail prices. We note that most water businesses have adopted, or are moving toward, uniform pricing for similar products and services.

Where cherry-picking is not a concern, the cost of service approach may be appropriate as it aligns with other regulated pricing approaches for water, is usually equitable and is relatively straightforward to calculate. The cost of service approach is therefore likely to be appropriate in most circumstances in which a retail price does not currently exist.

The discussion above assumes that the access seeker can be accommodated at no additional expense to existing customers. However, where the incremental cost of supplying an access seeker is materially greater than the existing cost of supply, an access charge based on the (existing) cost of service would require the service provider to recover the additional costs from existing customers. Therefore, in cases where the incremental cost is greater than the existing cost of service, an access charge based on the incremental cost (plus some contribution toward shared costs) would be more appropriate.

The incumbent will neither gain nor lose from any of these approaches to access pricing, provided the method for setting regulated water prices is adjusted to remove the revenue received from access seeker.

In addition, there may be some cases in which the access seeker could self supply at a cost below the access price. The incumbent may therefore be warranted in offering the access seeker a lower price (down to, but no lower than, the incremental cost of providing the service). Both the access regime and the approach to setting regulated retail tariffs, should therefore be flexible enough to allow the water business to offer "prudent discounts" where warranted, such as those allowed under the national gas access regime.

In summary, the access pricing guidelines for a Victorian state-based access regime should be sufficiently flexibility to:

- ◆ allow the service provider to fully recover efficiently incurred costs;
- ◆ protect uniform retail prices where they exist;
- ◆ protect against 'cherry-picking';
- ◆ not increase prices to existing customers;
- ◆ include some contribution toward shared costs;
- ◆ allow flexibility to negotiate "prudent discounts"; and
- ◆ send a signal about the cost of service.

Issues Paper section: 5.2 Accounting ring fencing methodology

Question: How should ring fencing be implemented in the Victorian water industry? What information should be included in ring fencing guidelines? Should Victorian infrastructure service providers be required to prepare cost allocation manuals and/or reports on compliance with the ring fencing guidelines? Should a more prescriptive regulatory framework apply to infrastructure service providers that are vertically integrated?

The Issues Paper notes that certification of a state-based regime may require the segregation of access-related functions and alternative staffing arrangements for vertically integrated businesses. VicWater would question any ring-fencing arrangements that require the separate management or operation of activities that are currently integrated. We note that the opportunity for competition in the water industry appears limited. As a consequence, any separate management or operational requirements would lead to inefficiencies and produce a splintered service that might jeopardise the integrated water management service that is currently provided by water businesses and is particularly important during these times of drought.

With regard to accounting ring fencing, VicWater represents 19 water organisations that provide service to hundreds of individual water and wastewater schemes. It is likely that the majority of these organisations will never be subject to a third party access application. The framework recommended by the Commission should, therefore, be cognisant of the substantial costs involved in accounting ring-fencing and reporting when determining the coverage of the scheme and the requirements for information provision. Accounting ring-fencing requirements should be strictly limited to those services that are covered by the scheme following a failure to negotiate the terms and conditions of access. Alternatively, it would be more appropriate to have a State-based access regime that only applies to systems or supply areas above a certain size. The size could be set to cover the area's most likely to attract applications for access (i.e. the metropolitan area) and access arrangements for areas below the nominated size would be considered on a case by case basis after an application was lodged.

Issues Paper section: 6.2.2 Customer protection framework

Question: Should the existing customer protection framework be extended to cover new entrants to the water industry? Should new entrants providing retail services be required to participate in the Energy and Water Ombudsman of Victoria (EWOV) scheme relating to water and sewerage services?

To protect customers and the environment, and to ensure that all water businesses operate under competitively neutral terms, all customer service, environmental and health obligations of existing service providers should be extended to cover new entrants that will be providing a similar service.

Issues Paper section: 6.2.2 Customer protection framework

Question: Should retailer of last resort arrangements be established in conjunction with the development of an access regime to protect customers in the event of that access seekers start to provide retail water or sewerage services? If so, what factors should be taken into account in designing appropriate retailer of last resort arrangements?

Retailer of last resort arrangements should ensure that the retailer of last resort has sufficient capacity to absorb an access seeker's business and that the retailer is adequately compensated by the access seeker for this additional expense. Under no circumstances should a water business's existing customer base be required to meet the costs associated with meeting retailer of last resort obligations for an access seeker.

Issues Paper section: 6.2.3 Protecting public health and water quality

Question: Will any changes to existing water quality regulatory arrangements be required to ensure that public health, safety and water quality standards are not compromised by allowing access seekers to enter the water industry?

To meet the commitments to water quality and the requirements of the Australian Drinking Water Guidelines, water businesses are required to ensure that water quality risks are managed throughout the water supply system. The current guidelines specify a multiple barrier approach to water quality protection and therefore organisations seeking access to the water supply system will need to coordinate carefully with the infrastructure operator.

The infrastructure operator will require a substantial amount of information from the access seeker and this information must be a formal requirement of access. The type of information that must be provided by the access seeker should be developed through significant consultation across the industry. The information requirements must also be flexible enough to accommodate case-by-case requirements for each location, process and technology involved.

After agreeing with the infrastructure operator on appropriate minimum requirements, the information to be provided by the access seeker may include, but is not limited to:

- ◆ information about water quality levels and potential fluctuations, including water source protection plans and catchment management strategies;
- ◆ treatment methods;
- ◆ risk assessment information;
- ◆ regime for routine monitoring, inspection and reporting of critical control points and barrier performance;
- ◆ regime for routine monitoring and reporting of water quality indicators;
- ◆ triggers for action and response plans based on the results of routine monitoring;
- ◆ coordinated and agreed incident management plans;
- ◆ a clear framework for water quality accountabilities between the infrastructure provider and the access seeker;
- ◆ coordinated asset maintenance plans;
- ◆ compatibility of monitoring and telemetry systems;
- ◆ demonstration that other water system integrity requirements are met, including backflow prevention, elimination of contamination risk and storage requirements.

Issues Paper section: 6.2.5 Regulatory instruments

Question: Should a licensing system be developed for the water industry? If a licensing system is not used, what alternative approaches could be considered for regulating service quality and customer protection in the water industry? Who should be responsible for assessing licence applications (or applications for registration) and for making decisions on the issue of licences?

The development of new licensing systems must consider the administrative cost imposed on existing water businesses and any technical codes should be developed in close consultation with industry representatives, taking into account the diversity of circumstances across Victoria

Issues Paper section: 6.4 Information and reporting requirements

Question: What types of information would access seekers need to be able to assess the viability of proposals to provide water and sewerage services and to be able to negotiate effectively with infrastructure service providers?

Access seekers will require information regarding the nature of services that can be provided, terms and conditions of access and pricing information. To provide this information, the infrastructure operator will need to determine the technical feasibility of each access proposal, the water quality and quantity requirements, and the impact of the proposal on the existing system. The cost of undertaking these investigations will be substantial. Therefore, the access seeker should be required to compensate the incumbent for the time and resources required to assess their application rather than expect these costs to be recovered from the incumbent's existing customer base. The appropriate level of compensation may be determined by an independent body such as the Commission.

Charging access seekers for this service will:

- ◆ send an appropriate signal regarding the cost of assessing an application;
- ◆ ensure that only non-frivolous and well researched proposals are considered; and
- ◆ compensate the incumbent for the cost of assessing the proposal and therefore the cost will not be passed on to the incumbent's existing customer base.

Issues Paper section: 6.6 Sustainable urban planning objectives

Question: What provisions should be included in an access regime to facilitate the development of innovative local solutions to water supply, consistent with broader sustainable urban planning objectives and not inconsistent with the certification criteria?

Access seekers may request the use of an incumbent's facilities to provide customers with a different level of service than is currently provided by the incumbent. Changes in the minimum level of service will typically require authorisation by the government department responsible for health or environmental protection. However, some service levels are not mandated by regulators, but are either informally required by government or self imposed by the water business. Access seekers could

potentially provide a service that opposes the water supply objectives of government, particularly in the short-term, before informal arrangements could be converted into regulation.

It is therefore recommended that any access applications be required to pass a public interest test and that the arbitrator for access disputes is required to consider factors including as a minimum:

- ◆ security of supply and the impact on the likelihood of water restrictions across the system, including a consideration of how the proposal fits within the portfolio of existing water sources;
- ◆ the sustainable development of new water sources;
- ◆ water efficiency and water conservation targets determined by the State government.

Conclusion

VicWater would ask that the ESC consult widely with the water sector to resolve the issues raised in this submission. Further consultation is required so that the needs of all members of the industry are met. Ideally those further discussions would be in the form of workshops which would allow detailed consideration of all of the issues raised in the Issues Paper.

VicWater would like to thank the Essential Services Commission for the opportunity to present the issues highlighted in this submission and would welcome further discussion in the future.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Steve Bird', written in a cursive style.

Steve Bird
Chief Executive Officer