

South East Water response to:

**Inquiry into an Access Regime for Water and Sewerage
Infrastructure Services**

Draft Report

July 2009

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Background

South East Water has previously supported and continues to support the introduction of a State Based Third Party Access Regime. However, South East Water is of the view that the regime needs to be designed in such a way that it provides maximum benefit, at least cost. It is on the basis of this criteria that South East Water has considered the Commission's Draft Report.

In addition to addressing each of the Commission's Draft Recommendations, South East Water would like to make some more general comments in relation to the Commission's Draft Report.

Relationship with Other Reform Programs

The key driver for an access regime is to improve the efficiency of the investment in and utilisation of infrastructure and resources. There are a range of existing economic instruments and processes either established or being considered that will also deliver the same efficiency outcomes. For example water trading, grid manager development and future options like scarcity pricing. South East Water supports the implementation of a state based access regime as an integral component of a suite of measures to improve efficiency but questions whether a full, complex and costly solution based on operational separation is necessary, given these other measures.

Timing

The Commission's Draft Report proposes that water retailers prepare access commitments within six months for the Commission's approval.

There may be merit in this proposal, should there be no opportunities for access to be obtained in the interim. However, as access can currently be obtained on the basis of negotiation (for example, the arrangements in place with Topaq) and under Part IIIA of the Trade Practices Act should negotiation fail, South East Water does not see any advantage in haste.

On the other hand, there are significant disadvantages to proceeding hastily. It will be difficult for retailers to be able to make a specific and long lasting access commitment without any understanding of the costing allocation that will take place as part of the financial ringfencing (or operational or functional separation) exercise, the potential changes to the Act and Statement of Obligations, the likely licence requirements to be imposed on access seekers and the means for ensuring access seekers compliance with environmental, health and safety, emergency management and reporting obligations.

South East Water questions the added value that access commitments will provide without the following being developed prior to retailers being required to make specific access commitments:

1. Changes to legislation;
2. Changes to Statements of Obligations;
3. Introduction of a licensing regime to ensure compliance with restrictions, demand management targets, customer service standards, reporting, environment protection, health and safety requirements;
4. Retailer and network service provider of last resort arrangements; and
5. The implementation of financial ringfencing and operational and/or functional separation.

Greenfield Areas

As expressed in South East Water's response to the Commission's Issues Paper, arrangements put in place to manage access in greenfield sites need to primarily ensure that competitive neutrality between infrastructure owners and access seekers is maintained.

Arrangements should provide infrastructure owners (either existing or new) with certainty that they will earn sufficient income from these assets. That is, an inefficient solution will be reached if there is a risk that any new assets will be rendered stranded within a short period of time. Should this be the case, there will be a general

reluctance to service new areas and servicing will be based on recovery of investment over a relatively short time frame as opposed to the current long term focus.

South East Water's preferred option to resolve this issue is to exempt any party (including South East Water) investing in greenfield assets (eg large scale urban development) from a subsequent access application for a period of time. The time period involved needs to be sufficient to ensure that customers in this area are not disadvantaged by the infrastructure developer seeking to recover its costs up front.

In addition, the network service provider nominated as the provider of last resort needs to ensure that the design of the network and quality of the components in a greenfield area meet minimum standards, in case the access seeker fails to meet its financial obligations or performance standards.

South East Water proposes that developers of networks in greenfield areas be excluded from the access regime for a period of 15 years.

Metering

There are a number of issues that need to be considered when determining whether "retail" meters should be subject to access as part of the infrastructure service. Meters need to be part of the access process, to allow water to physically pass through the network to customers, however the questions of ownership and access to meter data need to be considered as well as the responsibility for undertaking the meter reading function.

Given the predominance of meters that require manual reads at present, it is more efficient for them to be read by one authority, for each geographic area. For this reason it is recommended that they be retained by the infrastructure owner. The infrastructure owner would then need to take responsibility for providing meter data to retailers, the grid manager if implemented and other parties that may require it.

Also, as meters are a capital intensive item, the recovery of their costs is better suited to a network pricing methodology (where return on assets and depreciation is

recovered through a building block approach) rather than a retail methodology that generally recovers operating margin.

South East Water recommends that “retail” or customer metering is covered by an access regime and that network service providers take responsibility for meter provision, meter reading and the provision of meter data.

Cost/Benefit

The Commission’s Draft Report states that an access regime will contribute to the broader reform program by, “promoting the economically efficient operation of, use of and investment in water and sewerage infrastructure.....”. However, this can only occur should:

- a. there be interest from potential access seekers; and
- b. a regime is put in place that reflects the level of interest.

In order to develop the least costly regime that can meet the needs of access seekers that come forward, the Commission needs to proceed in an incremental fashion.

More specifically, the Commission’s Draft Report proposes functional separation (and in some cases operational separation although this is not defined) of the retailers.

South East Water questions the added value that this will provide should there not be plans to progress to full retail contestability in the short term. In fact, it is likely that this degree of separation will add costs to the business as a result of requirements to ringfence the billing system and duplication of management and other services such as human resources and accounting and finance.

The Commission has also proposed that businesses be required to implement ring fencing within three months of the asset becoming subject to access. South East Water is of the view that:

- An access commitment will not be able to be made with respect to a specific asset without understanding the ringfenced costs; and
- Ring fencing will take more than three months to implement (given potential business process and system changes required).

South East Water proposes that a third party access regime be introduced on the basis of financial ringfencing, at least in the first instance until the decision is made to proceed with full retail contestability.

South East Water also supports the introduction of third party access incrementally, so that interest from access seekers can be ascertained.

Pricing

South East Water in its response to the Commission's Issues Paper supported a "retail minus" pricing methodology as:

- It preserves the current postage stamp pricing methodology which ensures that all customers in a particular category are charged the same tariff regardless of the cost to serve;
- Does not preclude the gradual removal of pricing anomalies over time;
- Discourages new entrants from "cherry picking" customers; and
- Is consistent with the ACCC determination in the Services Sydney case and forms the basis of NSW's state based access scheme pricing.

South East Water supports the Commission's conclusion that a retail minus approach to pricing is used where a regulated retail price exists (including retail prices established under regulated pricing principles). This access price must be adjusted as the retail price is adjusted from time to time.

Retailer of Last Resort

In order to ensure that customers are provided with an uninterrupted service regardless of the service provider they choose, retailer and network service provider of last resort arrangements need to be in place prior to access occurring.

For example, if an access seeker develops a network in a greenfield area, then an existing network service provider should be nominated to take this network over should the access seeker fail to meet service standards, become insolvent or have their licence revoked. Rules also need to be established in advance to ensure that the network service provider can recover their costs.

Also, if contestability occurs, and a retailer subsequently fails financially or has their licence revoked then arrangements need to be in place for another retailer to take over this retailer's customers and recover their reasonable costs.

South East Water is of the view that appropriate retailer and network service provider of last resort arrangements should be put in place prior to access proceeding.

Dispute Resolution

The Commission has proposed that it becomes the third party access regulator, the arbitrator of access disputes and the issuer of licenses under the proposed licensing scheme.

South East Water remains of the view that while the Commission is best placed to become the issuer of licenses and the third party access regulator, arbitration of disputes should be undertaken by an independent party. That is, there should be a distinction between the Commission in their role as "rule maker" and the party nominated as "rule enforcer".

If the Commission is appointed as the regulator of third party access and the issuer of licenses, an independent party should be nominated as the arbiter of disputes.

Cost Recovery

As the recent four year price determination did not include any allowance for the costs associated with:

- Establishing the access regime;
- Negotiating with access seekers; or

- Ongoing changes to business systems and processes,

South East Water expects that there will be an opportunity to recover costs from access seekers. This is expected to take the form of a standard one off fee for initial information provision and a means of determining cost recovery for additional information provision.

Licensing

South East Water supports the establishment of a licensing system for new entrants to ensure that infrastructure design standards and customer service, environment protection, water quality and health and safety requirements apply to new entrants, on a functional basis. South East Water recommends that the requirement to obtain a license is relaxed in a very limited set of circumstances. For example, while a large water user who does not intend to on-sell any water, may not be required to obtain a retailer license, they should still be subject to a set of requirements that enforce environment protection and health and safety standards.

South East Water is also concerned that where a new entrant obtains a licence, that licence is not transferable on either sale of the entity that is licensed or sale of the assets to which the licence relates. The potential purchaser of a licensed business would need to apply to the licensing authority for a license prior to taking over control of any licensed business operation. This may require standards of both technical capability and/or credit worthiness to be met.

South East Water supports the establishment of a licensing system for new entrants to protect customer service, environment and health and safety standards. These license should not be transferable should a licensed business be sold.

Comments on Specific Recommendations

Draft recommendation 3.1

That a Victorian water industry access regime is developed and refined over a staged implementation period.

South East Water supports the development of the regime and would prefer a staged approach to implementation. This approach will allow the degree of interest from access seekers to be ascertained before significant cost is incurred in developing the access regime. South East Water does not support the Commission's proposed approach as it requires "access commitments" to be made in advance of necessary amendments to legislation, Statements of Obligations, a licensing regime and the development of retailer and network service provider of last resort requirements.

Draft recommendation 3.2

That the Government requires the water businesses to prepare 'access commitments' giving access seekers the right to negotiate access to nominated infrastructure facilities during the implementation period.

Access seekers have the right to negotiate access to infrastructure facilities now. Not only do these rights exist under Part IIIA of the Trade Practices Act, but there have been several examples of negotiated access occurring by mutual agreement. South East Water does not believe that an "access commitment" will change current practice.

South East Water considers it essential that the requirements for licensing, compliance with environmental, health and safety regulations and changes to the Act are finalised before further steps are taken to formalise "access commitments"

Draft recommendation 3.3

That the Government develops and enacts new legislation and regulations, or amends existing legislation and regulations, to establish the legal framework for the access regime during an implementation period.

South East Water recognises that changes to legislation and regulations will be necessary. South East Water would like to participate in the change process and considers it necessary that this process conclude prior to access arrangements commencing.

Draft recommendation 3.4

That a Victorian water industry access regime be reviewed not less than five years, and not more than ten years, after the legislative and regulatory amendments required to establish the legal framework for the access regime have been implemented.

South East Water agrees with the proposed review timeframe.

Draft recommendation 4.1

That the entire State of Victoria be covered by a state-based access regime.

While the whole state may be subject to the access regime, the assets to be subject to third party access need to be specified.

Draft recommendation 4.2

That water and sewerage transport services provided by water industry infrastructure be covered by a state-based access regime. The definition of water and sewerage transport services would include services, such as storage services, that are subsidiary but inseparable to providing transport services. It would exclude: the filtering, treating or processing of water or sewage; the use of a production process; the use of intellectual property; and the supply of goods, including the supply of water or sewage; except to the extent that these services are an inseparable part of providing transport services.

South East Water agrees that assets such as water treatment facilities will need to be included where they form an integral part of the transport service, however it must be stipulated that access to these assets will always be subject to capacity constraints.

Draft recommendation 4.3

That metering devices that are an integral part of water and sewerage transport infrastructure be covered by a state-based access regime.

Significant additional work needs to be undertaken to develop an approach to metering. While South East Water recognises that physical access to water and sewer infrastructure may require access to meters to allow flows to occur, further thought needs to be given to meter ownership, responsibility for meter reading and rights to access meter data. South East Water proposes that the most efficient solution is for the network service provider to maintain ownership of meters and responsibility for meter reading and provision of meter data.

Draft recommendation 4.4

That the storage services provided by large infrastructure facilities like dams be covered by a state-based access regime.

South East Water is of the view that potential impacts on security of supply need to be taken into account in order to determine whether storage services should be subject to access. In addition, potential changes to bulk entitlements and trading may provide access seekers with storage rights should they proceed.

Draft recommendation 4.5

That rural water transport services be covered by a state-based access regime.

South East Water agrees with this recommendation.

Draft recommendation 4.6

That the Government requires the water businesses to nominate, within a six month timeframe, specific infrastructure facilities for which access commitments would be made. The businesses should assess whether the services meet the declaration criteria, taking into account guidance provided by the Commission. Provision should

be made for making additional access commitments in respect of specific infrastructure facilities subsequently identified as meeting the declaration criteria.

As noted above, South East Water considers that this should be done once the necessary legislative, regulatory and licensing changes have been implemented.

Draft recommendation 4.7

That the Government requires the water businesses to apply for the Commission's approval of access commitments.

South East Water expects that a change to the statement of obligations will be necessary for this to occur.

Draft recommendation 4.8

That a process is established to provide for case-by-case review of coverage declarations. The process should allow for revocation of declarations where the declared infrastructure services no longer satisfy the declaration criteria and to declare services provided by new or existing infrastructure that meet the declaration criteria. During the implementation period for the regime, similar processes should be established for access commitments by the businesses.

South East Water agrees with this recommendation.

Draft recommendation 5.1

That the Government establishes minimum requirements for the type of information that infrastructure operators must make available to access seekers and that access seekers must provide to infrastructure operators.

The initial information to be provided to potential access seekers needs to be relatively general in nature, so that it can be made available to all access seekers, without the need to incur additional costs or disclose potentially sensitive information. Should it be the case that an access seeker requires more specialised information then, if that information is not commercially sensitive, it can be provided on a cost recovery basis.

Draft recommendation 5.2

That the Government requires the water businesses to include the negotiation protocols developed by the Commission in their access commitments. The water businesses would be required to comply with the negotiation protocols in responding to requests for information from access seekers and to access applications.

While South East Water is prepared to comply with the negotiation protocols developed by the Commission, the trade off between degree of detail and cost needs to be recognised. The more detailed the requirements and the shorter the timeframes to respond, the greater number of resources South East Water will need to have in place to respond to access inquiries. These costs should be borne by the access seeker.

Draft recommendation 5.3

That the Government establishes a dispute resolution mechanism, including binding arbitration by an independent arbitrator and appeals provisions. Arbitration decisions should be subject to judicial review and limited merits review.

South East Water agrees that a dispute resolution mechanism, including appeals provisions needs to be put in place. However, in order for this appeals mechanism to be independent, an arbiter other than the Commission needs to be appointed.

Given the Commission's role in developing and implementing the access regime, the incumbent service provider and the access seeker should have recourse to an independent party to determine whether the access requirements have been met.

Draft recommendation 6.1

That the cost of service approach is used to determine access prices in respect of infrastructure where the costs associated with providing an infrastructure service can be easily identified.

This is not expected to affect many South East Water assets.

Draft recommendation 6.2

That the retail minus approach is used to determine access prices in respect of infrastructure where a regulated retail price exists and the infrastructure operator provides services in the regulated retail market.

South East Water agrees with this recommendation, however it must be recognised that in some cases there may be additional costs such as connection costs.

Draft recommendation 6.3

That the Government requires the water businesses to identify in their access commitments which pricing methodology will be applied to calculate access prices for the services provided by the infrastructure facility and note that prices will be calculated in accordance with the relevant pricing principles developed by the Commission.

South East Water supports the concept of openly declaring its proposed pricing methodology.

Draft recommendation 6.4

That the Government reviews the Water Industry Regulatory Order 2003 to determine whether amendments are required to ensure an access regime can be effectively regulated.

Agreed, however this must occur before third party access is implemented.

Draft recommendation 7.1

That the Government requires the four metropolitan Melbourne businesses and nominated regional water businesses to commence, within six months, the process of implementing operational separation of their water sourcing, water and sewerage distribution, and retail customer service functions.

Operational separation is an onerous and costly requirement and will require

structural change as well as changes to South East Water's business systems and processes. For example, the billing system will either need to be duplicated or additional security put in place to only allow certain individuals to access some parts of the system and some customer's records.

South East Water is of the view that the intended outcome can be achieved through the implementation of financial ringfencing at a much lesser cost and in a shorter time frame. This would allow access to progress incrementally and the potential levels of interest from access seekers to be gauged.

Regardless of whether operational separation, functional separation or financial ringfencing is to occur it must be completed before access commitments are made in order to allow the incumbent service providers to obtain an understanding of the costs involved in the various aspects of their businesses.

Draft recommendation 7.2

That the Government requires the water businesses to implement ring fencing of infrastructure facilities that are subject to access within three months of becoming subject to access. Ring fencing should be implemented in accordance with ring fencing guidelines to be formulated by the Commission.

Before financial ringfencing can commence, agreement needs to be reached on what are the monopoly aspects of the business and the rules for cost allocation. Financial ring fencing will therefore take some time to implement and once implemented, some actual data will be required to be able to adequately respond to access requests.

Therefore, financial ringfencing is a prerequisite to access and access cannot commence prior to its completion.

Draft recommendation 8.1

That the Government conducts a comprehensive review of the legislation and regulations relating to health and safety, drinking water quality, customer protection and environmental protection in the water industry as soon as possible. The review should identify amendments or additional measures required to extend existing

obligations in regard to these matters to new water and sewerage service providers and to ensure that the relevant regulator has sufficient powers to require compliance with these obligations by all service providers.

South East Water agrees with this recommendation, however this review must be undertaken prior to access commencing. Until new entrants can be compelled to meet these legislative requirements, access cannot proceed.

Draft recommendation 8.2

That the Government takes appropriate measures to ensure that new water and sewerage service providers are subject to the *Environment Protection Act 1970*, the *Safe Drinking Water Act 2003*, and the *Occupational Health and Safety Act 2004*.

South East Water agrees with this recommendation, however these measures must be undertaken prior to access commencing. Until new entrants can be compelled to meet these requirements, access cannot proceed.

Draft recommendation 8.3

That the Government establishes a functional licensing system for new water and sewerage service providers.

South East Water agrees with this recommendation, however this licensing system must be established prior to access commencing.

Draft recommendation 8.4

That the Commission is responsible for granting licences and monitoring compliance with licence conditions.

South East Water agrees with this recommendation.

Draft recommendation 8.5

That the Government incorporates provisions for granting exemptions within the functional licensing system.

South East Water is of the view that a basic licence should be required in all circumstances. While exemptions to some licence components may be justified in some circumstances, these will be uncommon. For example, even if an access seeker is planning to supply themselves only, there will need to be minimum requirements for environmental protection and reporting in place.

Draft recommendation 9.1

That the Commission is appointed the regulator of an access regime for the Victorian water industry. The Commission's regulatory role would include arbitrating in access disputes.

As noted on page 8 above, if the Commission is appointed as the regulator of the access regime then they should be precluded from arbitrating access disputes. This role should be undertaken by an independent body.

Draft recommendation 10.1

That the Government investigates whether the constitutional provision in respect of public ownership in the Victorian water industry would prevent opportunities for private provision of water or sewerage services.

This investigation needs to be undertaken prior to access being introduced. The design of the access regime may be substantially different and less extensive if private provision of water or sewerage services is prohibited.

Draft recommendation 10.2

That the Government reviews the *Water Act 1989* with the aim of permitting businesses other than the existing water businesses to hold and trade water entitlements and to extend the definition of water to which entitlements apply to include new and innovative sources of water.

This review should be done in conjunction with the transition to the Water Act for South East Water and the metropolitan water retailers, and the work that is currently

underway in relation to the establishment of markets and the introduction of a grid manager.

While this review is not a prerequisite for access, it should be finalised prior to access being introduced.

Draft recommendation 10.3

That the Government investigates extending the existing trading arrangements for water entitlements.

This investigation should be done in conjunction with the transition to the Water Act for South East Water and the metropolitan water retailers, and the work that is currently underway in relation to the establishment of markets and the introduction of a grid manager.

While this investigation is not a prerequisite for access, it should be finalised prior to access being introduced.

Draft recommendation 10.4

That the Government amend the *Water Industry Act 1994* and the *Water Act 1989* to remove provisions that limit a water business to only servicing customers within a specified geographic area.

This change appears aimed at facilitating the introduction of retail competition between the existing retailers or potentially competition in Greenfield areas, and if so, should be finalised prior to access being introduced. However, the wording of this change needs to be carefully considered in order to ensure that it only applies to the retail function of the current retailers.

As it is currently drafted, it would allow the existing water businesses to extend their infrastructure into locations adjacent to their existing service areas. This would result in the inefficient duplication of infrastructure and potential network competition on the basis of the retailer's current average price which includes cross subsidies.

Draft recommendation 10.5

That the Government reviews its bulk water procurement processes to improve opportunities for development of low-cost new water sources.

This review should be done in conjunction with the transition to the Water Act for South East Water and the metropolitan water retailers, and the work that is currently underway in relation to the establishment of markets and the introduction of a grid manager.

While this review is not a prerequisite for access, it should be finalised prior to access being introduced.

Draft recommendation 10.6

That the Government reviews the adequacy and timeliness of publicly available information related to resource planning.

South East Water supports a review of the adequacy of publicly available information related to resource planning however, information that may prove disadvantageous to any party in a future competitive market should not be disclosed.


Draft recommendation 10.7

That until such time as the Government completes its review of network management arrangements, Melbourne Water and the regional businesses provide water supply coordination and management functions in their service areas.

This review should be undertaken promptly and should incorporate consideration of the appointment of an independent grid manager.

Draft recommendation 10.8

That appropriate arrangements are developed for: network balancing; interconnections into infrastructure facilities; network operation, maintenance and expansion; and emergency management.



South East Water agrees with this recommendation. These arrangements should include both planning and funding requirements and need to be implemented prior to access commencing.

