

Inquiry into an access regime for water and sewerage infrastructure services – ESC Draft Report

Melbourne Water's submission – July 2009

Table of contents

Executive summary	2
1 Staged implementation process	5
Staged implementation of an access regime	5
Access commitments	7
2 Infrastructure to be covered by an access regime	9
Criteria for services to be covered, subject to access commitments or declared	9
Water and sewerage transfer services	11
Meters	11
Large dams	12
3 Negotiation framework and dispute resolution	15
Negotiation framework	15
Arbitration	18
4 Access pricing	20
Pricing guidance / principles	20
Pricing approaches	20
Structure of access prices	22
5 Ring fencing	23
Operational separation and ring fencing	23
6 Protection of health, customers and the environment	26
Review of existing legislation	26
Licensing	27

Executive summary

Melbourne Water welcomes the opportunity to respond to the Essential Services Commission's (ESC) Draft Report on its Inquiry into an Access Regime for Water and Sewerage Infrastructure Services.

Melbourne Water supports a light handed approach to access regulation for the water industry in Victoria, particularly in the early stages of any regime's development.

Staged implementation of a state based access regime will assist in this regard. Melbourne Water considers that in the first stage it will be important for the foundations of the access regime to be developed. In particular, the following should occur to provide the necessary framework and certainty for access requests and negotiations:

- Development and implementation of a licensing regime
- Review and extension of relevant existing legislation to ensure a level playing field
- Development of relevant access criteria for assessing coverage, commitment and declaration decisions, as well as arbitrating access disputes, and the development of supporting documentation such as negotiation guidelines, pricing principles and accounting ring fencing guidelines.

Access commitments could be developed by access providers in the second stage, giving access seekers the right to negotiate access to nominated services. However, Melbourne Water considers that they should be voluntary commitments rather than mandatory. In that respect, it favours private negotiation and the development of declarations on a case by case basis only if negotiations fail. Upfront mandatory access commitments will cause regulatory costs to be incurred from the outset, before an access regime has been fully implemented, before any interest has been shown by access seekers and before private negotiations can occur.

In this regard, Melbourne Water supports an access regime based on the negotiate / arbitrate model. High level negotiation guidelines will assist in enabling negotiation to occur, but these should not be overly prescriptive recognising the potentially variable nature and complexity of the access requests that may occur. The guidelines should cover issues such as minimum information requirements, application and negotiation processes and application fees. Binding arbitration by the ESC is supported, provided

there is an independently run appeals process. Both the arbitration and appeals processes should be supported by the use of independent technical experts as appropriate.

Melbourne Water considers that water and sewerage transfer services should be subject to coverage by a state based access regime. However, it is of the view that the large dams (harvesting and seasonal storages) currently used to supply metropolitan Melbourne do not need to be covered by an access regime. This is because these services are potentially competitive and entitlements to the inflow and storage capacity in large dams have already been defined and allocated.

Access pricing is a central consideration for any access regime. Melbourne Water considers the development of pricing principles would provide guidance and a degree of certainty for access providers and access seekers. Melbourne Water supports the use of the cost of service approach for determining access prices for its infrastructure facilities that are covered by an access regime, particularly as its regulated prices are already determined on this basis. That said, Melbourne Water considers that the cost of service approach should be applied at a broad system level, rather than a specific asset level.

Accounting ring fencing, rather than operational separation, is seen to be a more cost effective means of providing the required clarity, transparency and cost information necessary to support an access regime and in particular access pricing. In this regard, it is noted that Melbourne Water's financial information is already disaggregated into product and program level, consistent with the ESC's expectations in terms of regulatory reporting. Melbourne Water also notes that operational separation is likely to come at a cost to consumers, particularly if it required businesses to be structured and operate differently to the manner that is currently considered the most efficient.

Melbourne Water supports a full and comprehensive review of existing legislation and regulation relevant to the water industry and its application to new service providers. This should include identification of any gaps in existing water industry legislation and regulation. The review should determine what changes are necessary to facilitate third party entry that results in:

- No reduction in the quality of services provided
- A level playing field for access providers and access seekers.

To further protect public health, the environment and customers in the water industry Melbourne Water supports the introduction of a licensing system. It considers that

the matters outlined by the ESC are all relevant and should be included in a licensing system. As an additional safeguard, Melbourne Water also considers that compliance with the *Environment Protection Act 1970*, the *Safe Drinking Water Act 2003* and the *Occupational Health and Safety Act 2004* should be included as licence conditions.

1 Staged implementation process

Staged implementation of an access regime

In its Draft Report the ESC recommended staged implementation of a state based access regime, recognising the extensive work program required to establish an appropriate regime. It concluded that a staged implementation process would minimise implementation costs while promoting access, innovation and competition over the intervening period. Costs would be minimised by establishing a basic framework that is refined as better information becomes available to guide further development of the regime.

During the first stage, the ESC recommended that access providers would make access commitments giving access seekers the right to negotiate access to nominated infrastructure services. The indicative implementation timetable included in the Draft Report noted that this would occur in the first 6 months. In addition, during the first stage the ESC proposed that a licensing regime be developed and implemented and a review undertaken to extend existing legislation to new service providers. This would occur over the first 12 months.

During the second stage the ESC proposed that it would monitor the operation of access commitments, outcomes from access and the licensing regime (for 12 months). The third stage would involve developing and enacting the required access legislation based on the identified learnings and refinements from the previous stage and refining guidance for access providers and access seekers. This would occur over a 6 month period. The fourth stage would involve seeking certification of the regime by the Commonwealth (over a 12 month period).

In its Draft Report the ESC notes that it is possible to negotiate access at the moment but that relatively few access arrangements have been negotiated to date.¹ The ESC does not see this as indicating that there is likely to be little demand for access when a regime is in place. It considers there are a number of explanations for this, key among these reasons being lack of a clear framework to guide access negotiations.

¹ It should be noted that to date Melbourne Water has successfully negotiated one third party access arrangement already.

The limited number of access requests to date is important not because it relates to whether a state based access regime should be introduced, but rather how it should be introduced. Melbourne Water supports the introduction of an access regime and considers it should be informed by a realistic view of the costs and benefits of access to ensure the net benefits are maximised. A state based access regime should also provide sufficient certainty to ensure that all participants have a clear incentive to invest in efficient water and sewerage infrastructure services in the long term interests of consumers.

Melbourne Water supports the proposal for staged implementation of an access regime. However, it considers the ESC's proposed approach to staged implementation could be slightly modified to provide greater certainty for both access providers and access seekers (who may be making substantial capital investments in long lived assets). In particular, Melbourne Water is of the view that the following actions should occur in the first stage of the implementation process to provide both the access provider and the access seeker with the necessary framework and certainty for access requests and negotiations to occur:

- Development and implementation of a licensing regime
- Review and extension of relevant existing legislation to ensure a level playing field
- Development of relevant access criteria for assessing eligibility, coverage, access commitment and declaration decisions, as well arbitrating access disputes, and the development of supporting documentation such as broad negotiation guidelines, pricing principles and accounting ring fencing guidelines.

This stage is likely to take at least 12 months.

Only once the above steps have occurred will access providers and access seekers be well placed to understand the implications of access requests. Further, Melbourne Water considers that mandatory access commitments are not necessary or justified (see below). Access commitments should only occur in the second stage of an implementation process, once there is greater detail and certainty around their likely content and assessment. At that stage, they should be a voluntary alternative to declaration, consistent with the approach taken to access undertakings in other access regimes. Their development is likely to take at least six months. This would then be followed by subsequent stages that would involve monitoring and review, enacting of relevant access legislation and seeking certification.

Access commitments

As noted above, Melbourne Water does not consider that mandatory access commitments are necessary or justified. Rather, Melbourne Water is of the view that a state based access regime in Victoria should:

- First, clearly define the broad scope of the infrastructure services which might be covered by the access regime, i.e. which are eligible for declaration
- Secondly, provide for declarations to be determined on a case by case basis only if private negotiations around an access request have failed. Access commitments or undertakings should provide a voluntary alternative to declaration.

Access commitments should not be compulsory but instead should only be at the election of an access provider consistent with other access regimes which generally have voluntary access undertakings. Access commitments should not be confused with declaration and should remain a distinct channel for achieving access under a state based regime.

Melbourne Water considers that a case by case approach to declaration is likely to be more fit of purpose, in light of the likely costs and benefits of access.

The ESC states that access commitments would contain less detail than an access undertaking or declaration², but they would give access seekers the right to commence negotiations for access to the specified infrastructure services. The ESC considers this will ensure that water businesses are not required to incur excessive costs in developing access commitments for infrastructure facilities for which there is little or no demand for access.

While it is unclear whether mandatory access commitments would be limited in time, and subject to review once the full regime has been implemented, in practice access commitments are likely to in effect displace the need for any subsequent declarations under a fully implemented access regime. This would in effect impose significant upfront burdens on water businesses as the regulatory costs and burdens of a declaration assessment would essentially be front ended.

Costs will be incurred by access providers in deciding whether a mandatory access commitment is necessary, in formulating that commitment and in seeking approval from the ESC for the commitment (including responding to the proposed public

² The ESC notes that guidance would need to be formulated on matters that should be included in access commitments, but that they would include negotiation protocols, timeframes for various stages of negotiation processes, information that should be provided as part of those processes, dispute resolution procedures and pricing principles.

consultation process), and as a result of having to implement any further commitments required by the ESC. The costs will also be duplicated as the regime develops and the commitments are worked out in more detail.

Further, the proposed process for nominating and having access commitments imposed is unlikely to provide any certainty for water businesses. While in the first instance water businesses would be responsible for nominating specific infrastructure facilities for which access commitments would be made, it is proposed that additional infrastructure services could be imposed by the ESC during the implementation period. Additionally, access commitments could be revoked to reflect significant changes in circumstances. Water businesses will therefore be forced to develop and pay the costs relating to access commitments without any certainty as to whether an access seeker will eventually request access to those services.

2 Infrastructure to be covered by an access regime

Criteria for services to be covered, subject to access commitments or declared

The ESC's Draft Report notes that, in designing an access regime for water and sewerage infrastructure, the types of infrastructure services covered by the regime must be clearly defined to provide certainty and clarity to industry participants and potential new entrants. Coverage defines the scope of the regime and enables the identification of particular infrastructure facilities that fall within the regime's scope and satisfy the criteria for access. The process of confirming that a particular infrastructure facility satisfies those criteria is known as declaration.

The Draft Report sets out the declaration criteria used for determining the infrastructure facilities to be included in access regimes under the National Competition Policy. Specifically that the infrastructure must be:

- Significant – which can be measured in relation to the nation, State or a particular region
- Not economically feasible to duplicate – that is, which satisfy the definition of a natural monopoly
- Necessary to permit effective competition in related markets – these can be upstream or downstream markets
- Able to be used safely by an access seeker at an economically feasible cost – that is safety requirements can be met at reasonable costs.

While noting these criteria, the Draft Report does not clearly state how they might be used in a state based access regime. In particular, it is unclear whether the National Competition Policy criteria would be used to determine which services are covered by the regime, which services should be subject to access commitments and/or which eligible services are declared.

The Draft Report is also not entirely clear in relation to the criteria to be used by water businesses to determine the specific infrastructure for which access commitments should be made and the basis for the assessment. The Draft Report notes the following:

- That in the staged implementation of an access regime, the major infrastructure services satisfying the 'criteria for access' would be subject to access commitments³
- That access commitments would be submitted to the ESC for approval to ensure they are reasonable and consistent with both the national access provisions, the specific circumstances of the Victorian water industry and Government objectives⁴
- That guidance would need to be provided on identifying specific infrastructure services for which access commitments should be made. The infrastructure subject to access commitments would have to meet the criteria of being provided by significant monopoly infrastructure facilities and of being needed to promote competition in related markets⁵
- That in broad terms the following should be taken into account in assessing whether to nominate a particular infrastructure service for an access commitment (i) whether the service falls within the geographic scope and generic types of services caught by the regime and (ii) whether the service meets the criteria of significance at a state or regional level.⁶

The ESC does not clearly state which of these criteria might apply to mandatory access commitments. The above issues encompass a wide range of matters that would need to be considered by access providers and publicly consulted on by the ESC. This includes consistency with national access provisions (this appears to be suggesting the declaration criteria under the National Competition Policy), circumstances of the water industry in Victoria and Government objectives. More clarity around these criteria would be required to inform the development and assessment of access commitments, as these would appear to be broader than the issues that would be taken into account under the declaration criteria (see below).

In terms of declaration criteria the Draft Report notes that the ESC sees value in declaring specific infrastructure services from the outset. These would be services that satisfy the National Competition Policy declaration criteria and which are expected to be most likely to be subject to access requests. It is unclear how the ESC would assess evidence of the likelihood of access requests; it may take a broad approach in an attempt to encourage access seekers to come forward. Further guidance would be required on this matter.

³ The ESC's Draft Report, pg 3.

⁴ The ESC's Draft Report, pg 44 – 45.

⁵ The ESC's Draft Report, pg 45.

⁶ The ESC's Draft Report, pg 61.

As discussed above, Melbourne Water does not consider that there is any justification for mandatory access commitments or upfront declaration. Declaration based on the National Competition Policy criteria should be determined on a case by case basis in the second stage of implementation of the regime and in response to actual demand from access seekers that cannot be met via private negotiations.

Water and sewerage transfer services

In its Draft Report, the ESC recommended that the water and sewerage transfer services provided by water industry infrastructure be covered by a state based access regime. Further, that the definition of such infrastructure include services such as storage services that are subsidiary but inseparable to providing transport services but exclude the filtering, treating or processing of water or sewage except to the extent that these services are an inseparable part of providing transport services.

Melbourne Water supports the coverage of these services by an access regime. Further, as noted in Melbourne Water's earlier submission, in the case of its water transfer network many of its service reservoirs and smaller treatment plants (e.g. chlorination facilities) are an integrated part of the transfer network. The same applies in relation to its sewerage transfer network where there are subsidiary services that are inseparable from the network such as odour control treatment plants and ventilation stacks.

Meters

In its Draft Report, the ESC also recommended that metering devices that are an integral part of water and sewerage transfer service be covered by a state-based access regime. It considers that headworks meters and in-system meters are integral to the water and sewerage transfer services and should be provided by an access provider. Headworks meters are described as those at the headworks which measure the quantities of bulk water supplied to wholesale customers and in-system meters are those which measure water and sewage flows within the networks at various interconnection points.

Melbourne Water considers that meters which are a part of the water and sewerage transfer services should be subject to coverage by an access regime. In much the same way as other services (e.g. smaller treatment plants) are an integrated part of the water and sewerage transfer networks, so too are meters.

Melbourne Water does not consider it useful to distinguish between headworks and in-system meters. Rather, it considers that coverage should relate to those meters which are integral to the water and sewerage transfer service.

Large dams

In its Draft Report, the ESC also recommended that storage services provided by large infrastructure facilities like dams be covered by a state based regime. It considers that access seekers may need access to such services to be able to supply water efficiently to their customers. The ESC also notes that if storages such as dams were not covered by a state based access regime but met the requirements for declaration under the *Trade Practices Act 1974*, the access seeker could apply for access under the *Trade Practices Act 1974*.

The ESC notes the important role of dam capacity in contributing to security of water supply, but argues that there may be scope to use spare capacity to provide short term storage services. It considers that as the water businesses undertake extensive forecasting of seasonal supplies and demands, guided by longer range inflow forecasts, this would provide them with the information needed to manage the risks involved in allowing access to storage infrastructure.

Further, the ESC notes that tradable entitlements to the storage capacity of large dams could be created which would allow businesses entering the water sector to purchase access to storage facilities, either on a permanent or temporary basis. While the ESC acknowledge that if such arrangements were developed then the primary need to negotiate access would not exist, access is still seen to be necessary to:

- Provide an option for obtaining access where the tradable entitlements regime contains any gaps
- Improve certainty for access providers about how any access requests would be assessed.

As noted in Melbourne Water's previous submission, the primary role of its harvesting storages is to 'produce' water. At the same time, they also play a storage role. Seasonal water storages also have dual roles. They are difficult to separate from the harvesting function because of their role in enabling the maximisation of system yield (i.e. in maximising water 'production'). Melbourne Water does not consider that the large dams (harvesting and seasonal storages) currently used to supply metropolitan Melbourne need to be covered by an access regime. The reasons for this are set out

below. It is noted that the storage services provided by dams are not covered by the access regime in New South Wales.

Potentially competitive

As noted in Melbourne Water's previous submission, the services provided water harvesting and seasonal storages (i.e. water 'production') are potentially competitive. This is illustrated by the fact that in the future, Melbourne's water production will be provided by a number of other facilities (e.g. a desalination plant or water from other catchments). Accordingly, coverage and declaration of water harvesting and seasonal storage infrastructure is unnecessary as access will not enhance competition in any upstream or downstream market. These services are in fact a part of the upstream market which is potentially competitive.

Entitlements

Consistent with the above, entitlements to the inflow and storage capacity of Melbourne's harvesting and seasonal storage have already been defined and allocated.⁷ These have been defined by establishing bulk entitlements to the water resource and shares in storage capacity, including for seasonal storages. The need for third party access under these entitlements is therefore not clear.

The issuing of entitlements, together with the Storage Management Rules and the Annual Operating Plans that are in place, provide the regulatory framework under which water businesses hold and make use of the water resources and storage capacity. This framework may evolve to further facilitate the development of wholesale competition (i.e. to make the entitlements more tradeable).⁸

In these circumstances, it is not obvious what purpose providing access to the storages to promote upstream competition would serve, as any spare capacity could be traded to ensure its highest valued use. To the extent that any framework does contain 'gaps' as the ESC has noted, the more appropriate course of action is to rectify these gaps, rather than creating another form of regulation to address them.

The ESC's proposed approach risks attenuating these entitlements by creating overlapping rules around whether or not any 'spare' capacity can be used. This is

⁷ Bulk entitlements are primarily held by the three metropolitan retailers (as a pool). In the case of Thomson reservoir a small amount of storage capacity has been allocated for Southern Rural Water's irrigation requirements and additional storage capacity for the environmental flow requirements of the Thomson River.

⁸ The issue of wholesale competition in Victoria's water sector was considered in the recent Victorian Competition and Efficiency Commission's (VCEC) inquiry 'Water Ways: Inquiry into the reform of the Metropolitan Retail Water Sector'. The two options considered in relation to wholesale competition in this report were competitive sourcing and the development of an urban water market.

because these overlapping rules are likely to be inconsistent and create uncertainty regarding which rules take precedence. Providing access to storage facilities risks stifling the upstream competition that any tradeable entitlements are designed to facilitate.

The ESC should be aware that the Department of Sustainability and Environment (DSE) is currently examining issues to facilitate more upstream competition. Melbourne Water encourages the ESC to communicate with DSE before making any decision whether to include storages in an access regime.

Spare capacity

Although there is currently spare storage capacity within some of Melbourne Water's large dams (i.e. its harvesting and seasonal storage system) this will be impacted by normal future seasonal variability in supply and demand as well as the completion of the new water supply augmentation projects for Melbourne. While modelling is undertaken to understand and project potential volumes in the harvesting and seasonal storage system, this is subject to significant uncertainty in the inputs which limits the ability to estimate and manage excess capacity within the system. For example, the catchment inflows to these storages depend on the quantity, extent and intensity of rainfall over Melbourne's water supply catchments.

Further, in the future there is likely to be reduced spare capacity in Melbourne Water's seasonal storages (e.g. Silvan, Cardinia, Sugarloaf and Greenvale reservoirs) as a result of the water that will be received from the new supply augmentations. Also, the water from the new augmentations will require Melbourne Water to operate the system in a new way that involves more balancing of the water available across the seasonal storage system. Prior to the augmentations coming on line, water has been harvested to the east of Melbourne (in the Yarra and Thomson catchments) and distributed by gravity. In the future, desalinated water will be supplied from the south-east via Cardinia reservoir and Goulburn water will be supplied from the north via Sugarloaf reservoir. These changes will make management of water transfers through the system a more dynamic process and hence defining available storage capacity is likely to become more difficult.

3 Negotiation framework and dispute resolution

Negotiation framework

In its Draft Report, the ESC concluded that negotiation protocols should be included in the negotiation framework of an access regime. It notes that flexibility could be provided by allowing water businesses and access seekers to vary the negotiation protocols to suit the particular circumstances of an access request where both parties agree.

The Draft Report recommended that negotiation protocols be developed by the ESC and included by water businesses in their access commitments. These protocols would include minimum information requirements, i.e. the information that must be made available by access providers and access seekers, as well as a process for access applications and negotiations, including timeframes. Application fees and charges would also be detailed and the ESC notes that fees should reflect costs and not form an unreasonable barrier to access requests.

In this regard, it appears the ESC is of the view that an access regime requires reasonably prescriptive negotiation protocols.

As noted in its previous submission, Melbourne Water supports an access regime which encourages private negotiation of access terms and conditions. Melbourne Water has successfully negotiated such an agreement in the past and would enter into any future negotiations in good faith, with the intent of achieving a negotiated outcome on reasonable terms. It considers that a flexible good faith framework should be the underlying basis of all negotiations. Accordingly, it considers there is a need only for minimal regulatory requirements, if any, around negotiation protocols and procedures.

Melbourne Water considers that only high level guidelines are required to enable negotiation to occur. Guidelines will ensure there is sufficient flexibility and that compliance costs are minimised. This includes allowing the parties to agree to deviate and follow an alternative approach (or timeline) for negotiations.

The following should be considered to ensure that negotiation guidelines are well designed. Going forward, Melbourne Water welcomes the opportunity to be involved in developing negotiation guidelines.

Minimum information requirements

Guidance should be provided as to the type of information that will initially be required from both the access provider and the access seeker to assist in facilitating an efficient process. From the access provider's perspective, this will include all information necessary to assess the feasibility, potential impacts / risks, and costs involved in providing access. In addition, information that enables the access provider to determine whether the access seeker is viable would be useful.

The minimum information required of both parties should also not impose an undue cost burden. Should the access seeker require more information than the agreed minimum, the access provider should be able to recover the cost of providing that information. The cost of providing additional information would be determined on a case by case basis.

Application and negotiation processes

Guidance should be provided as to the processes and reasonable timeframes for application and negotiation processes. This should reflect the potentially varying nature and complexity of the access requests being considered. For example, there will be access requests where there are public health and environmental considerations and / or where the access provider's compliance with existing contractual obligations may be impacted.

In relation to public health considerations, Melbourne Water notes that existing national and State guidance on drinking water quality management was generally not designed taking into account water quality issues associated with alternative sources such as recycled water, roof water, stormwater and groundwater. Therefore, if access requests relate to water from these sources, they could take longer to assess and ultimately negotiate than if they relate to water from traditional sources.

Melbourne Water considers that to facilitate access requests and negotiations it may be beneficial to establish water quality Codes of Practice. Codes of Practice could include:

- Base assumptions regarding source water quality and variability
- Typical treatment trains
- Typical risk management requirements

- Emergency and Chemical Quality Assurance requirements

In order to develop the water quality Codes of Practice, a technical group comprising of representatives from regulators (Department of Human Services and EPA Victoria) and water businesses could be established during the implementation stage of the access regime. The technical group would establish minimum standards for each alternative source of water, potentially starting with the most likely alternative water source to be involved in access applications.

This approach will ensure State wide consistency in water quality requirements from the water industry for different sources of water. It will also assist access providers in assessing and negotiating access requests more quickly than if there were no standards and provide greater clarity around reasonable timeframes for negotiation.

Establishing similar Codes of Practice for sewage will be more difficult given the variable nature of sewage and the various issues that could arise from an access request. While the ISO system that is in place for integrated sewage quality management will be useful, in many cases access requests are likely to be site / catchment specific. As noted in Melbourne Water's previous submission reduced flows in the sewerage transfer infrastructure and to the treatment plants could:

- Increase the sewage concentration in the sewers and lead to health and safety risks when maintenance is being undertaken
- Increase the sewage concentration and impact on treatment plant performance, heightening the risk that legislative, regulatory and contractual requirements are not met and increasing the cost of treatment
- Increase the sewage concentration, consequentially altering the properties of the biosolids and potentially increasing the risk that reuse targets are not met
- Make it difficult to meet the RAMSAR wetland requirements at the Western Treatment Plant
- Impact on the achievement of recycling objectives and meeting recycled water contractual commitments.

Increased flows in parts of the transfer infrastructure could also lead to greater blockages, bursts, leaks, corrosion and these could result in additional maintenance.

Odour emissions from the transfer infrastructure could also be affected as a result of third party access which increases concentration or reduces flow.

Hydraulic and network management issues could also occur as a result of changes to flow/pressure due to third party access. This could affect the level of safety in transferring sewage to the treatment plants.

As a result, assessment of sewerage infrastructure access requests are likely to be complex and vary for each case, with many being site / catchment specific. This will necessitate guidance on the process and timeframes for assessing and negotiating these requests rather than a prescriptive approach.

Before finalising negotiations, Melbourne Water considers that the negotiation process should include demonstration by the access seeker that they have satisfied the relevant licensing requirements. This will confirm the ability of the access seeker to comply with its broader obligations.

Application fees and charges

Guidance should be provided as to the principles for setting application fees and charges. This should allow the access provider to recover the costs associated with assessing an access request. As noted earlier, should the access seeker require more information than the agreed minimum, the access provider should be able to recover the cost of providing that information.

Arbitration

The ESC's Draft Report notes that it is important for an access regime to be supported by a dispute resolution mechanism when negotiations are unsuccessful. The ESC considers that dispute resolution mechanisms should encourage parties to try to resolve the dispute themselves through higher level negotiations and mediation before seeking arbitration. The Draft Report recommended that a dispute resolution mechanism be established, including binding arbitration by an independent arbitrator and appeals provisions. Further, that arbitration decisions should be subject to judicial review and limited merits review.

Melbourne Water supports the establishment of a dispute resolution mechanism and appeal provisions. It considers that the appeal provisions should also apply to decisions made by the ESC in relation to coverage of the access regime and declaration of specific infrastructure services.

As noted in its earlier submission, Melbourne Water supports arbitration of disputes by the ESC. It considers that the ESC is generally well placed to make access decisions

and has water industry experience as well as experience in implementation of other industry access regimes in Victoria. That said, independent technical experts would likely have a role to play in assisting the ESC on issues relating to water / sewage quality and network management. Further, ESC arbitration should occur within a clearly defined process and the regime should establish upfront the criteria to be used by the ESC in its arbitration.

Melbourne Water considers that arbitration decisions should be subject to judicial review and limited merits based review. Limited merits review is in line with the provisions in the *Essential Services Commission Act 2001* and should apply to decisions about whether or not to grant a declaration and in relation to arbitration of an access dispute. Melbourne Water considers that the *Essential Services Commission Act 2001* contains an adequate framework for a review mechanism that allows parties to effectively test the adequacy of the decision, without undermining the authority of the regulator as the key decision-maker, or certainty for access seekers and access providers (and any other affected third parties).

Under the *Essential Services Commission Act 2001*, appeals of ESC determinations are heard by an appeal body which is established by the Victorian Civil and Administration Tribunal. In practice, therefore, appeals of ESC determinations are independent of the ESC. Melbourne Water understands the appeal body must be made up of one member with a knowledge of administrative law, or the law of evidence and procedure, and best endeavours must be used to ensure that one member has technical or industry experience or knowledge relevant to the appeal.

Given the very specialised nature of any appeals in relation to access declarations or arbitration determinations, Melbourne Water recommends that the appeals process include a requirement to ensure that one member of the panel has relevant technical or industry experience. Alternatively, the appeal panel would need to have the ability to seek advice from independent technical experts in examining the matter under appeal.

4 Access pricing

Pricing guidance / principles

The ESC's Draft Report notes that regulatory guidance on access prices may be needed to facilitate effective negotiations between access providers and access seekers and to provide a level of certainty to market participants on the method for calculating access prices.

In the early stages of an access regime the ESC recommended that general guidance should be provided by way of pricing principles and methods for calculating access prices (rather than reference tariffs). It considers this would promote effective negotiations between access providers and access seekers and provide flexibility to calculate prices on a case by case basis.

Melbourne Water supports the provision of pricing guidance. Given the uncertainties about the nature and regularity of any future access request, the development of pricing guidance provides a balanced approach for both access providers and access seekers that should facilitate pricing negotiations.

Pricing approaches

In the Draft Report two pricing approaches are discussed, the cost of service approach and the retail minus approach. Under the cost of service approach access prices are determined by estimating the amount of revenue required to provide the service subject to access. The ESC also currently uses this approach to regulate prices for water and sewerage services. Under the retail minus approach the access price is determined by taking the approved retail price for a bundled service and applying a discount to account for the services the access seeker does not require from the access provider. The discount reflects the costs avoided by the access provider in not having to provide those services. This approach has generally been used where the retail price is regulated.

In the Draft Report the ESC recommended 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. Further, that the retail

minus approach be used where a regulated retail price exists and the access provider supplies services in the regulated retail market.

The Draft Report notes that the cost of service approach will apply in two types of circumstances. Firstly where charges for the services provided by an infrastructure facility are already calculated e.g. for Melbourne Water's water and sewerage pipelines. Secondly, where access is provided to a discrete infrastructure facility and the costs associated with this infrastructure can be readily identified e.g. the Sugarloaf Pipeline.

Melbourne Water supports the use of the cost of service approach for determining access prices for its infrastructure facilities that are covered by an access regime, particularly as its regulated prices are already determined on this basis.

That said, Melbourne Water considers that the cost of service approach should be applied at a broad system level, rather than a specific asset level, resulting in average access price for those of its services covered by an access regime. This is considered appropriate for the reasons set out below.

Integrated network

Melbourne Water operates most of its infrastructure facilities as integrated networks, rather than separate assets.

For example its water and sewerage transfer infrastructure (which in Melbourne Water's view are likely to services covered by an access regime) are operated as an integrated whole. Therefore, although access may be sought to particular assets in Melbourne Water's water transfer infrastructure, operational and capacity issues may mean that to take water from point A to point B those particular assets are not necessarily used. This could occur for a variety of reasons. For example, drought, seasonal variation within a year or management of maintenance requirements. These factors could mean that the system is operated in a different manner and that water is transferred through the system from point A to point B using different transfer assets to those requested by an access seeker.

This means that while an access request might only 'use' certain assets most of the time, the access seeker is likely to be deriving value (e.g. in terms of the security of supply) from other parts of the system. As a result, Melbourne Water considers that an average access price would typically be more appropriate rather than access prices for specific assets.

Cost of determining access prices

As noted by the ESC, the cost of service approach is generally regarded as being more information intensive and therefore more costly to implement than the retail minus approach. This will be exacerbated to the extent that access prices and therefore costs and revenues need to be identified for specific assets that make up the infrastructure service the subject of an access request. Determining access prices for specific assets is likely to raise considerable challenges, particularly in terms of establishing asset values and allocating other costs and volumes at a disaggregated asset level.

Melbourne Water considers the administration costs of determining access prices at a highly disaggregated asset level should be carefully considered as well as the risks associated with what may be rather arbitrary cost allocation to determine such prices. Determination of average access prices will provide broadly cost reflective pricing signals that do not impose overly excessive cost burdens, particularly in an environment where the nature and regularity of access requests are largely unknown.

Cherry picking

As noted in the ESC's Draft Report, a potential disadvantage of the cost of service approach is the risk of cherry picking when regulated retail prices do not accurately reflect the costs of servicing different customer groups. This can occur, for example, when the retail price is uniform across the customer base even though the costs of providing services vary across different groups of customers. It could also occur if the wholesale price faced by access seekers differs to that faced by the retailers.

Structure of access prices

The ESC's Draft Report notes that under the Competition Principles Agreement, in addition to providing access providers with sufficient revenue to cover the efficient costs of providing access, prices must also allow multi-part pricing and price discrimination. Current water and sewerage prices are generally two part tariffs consisting of a variable price and a fixed service price. The ESC states that where the cost of service approach is adopted a two part tariff structure is likely to be preferred as this would ensure that access prices reflect the cost of providing access while ensuring the access provider can recover the full costs of providing access.

Melbourne Water supports the continued use of two part tariffs comprising variable and fixed prices as the basis for the pricing guidance provided.

5 Ring fencing

Operational separation and ring fencing

In its Draft Report the ESC concluded that a staged approach to implementing ring fencing should be adopted during the regime's implementation period. In particular, that there would be value in undertaking operational separation of the water businesses' infrastructure facilities that are most likely to be subject to access requests. Operational separation is seen as a means of facilitating broader participation in the water sector by promoting clarity and transparency in allocating costs between business units and therefore in determining access prices. It was also noted that ring fencing could still be necessary for functionally separated business units that operated more than one infrastructure facility.

The Draft Report recommended that the four metropolitan Melbourne businesses, and nominated regional water businesses commence, within six months, the process of implementing operational separation of their water sourcing, water and sewerage distribution and retail customer service functions. That is, to separate the natural monopoly infrastructure functions from the potentially competitive functions. Further, that water businesses implement ring fencing of infrastructure facilities that are subject to access within three months of becoming subject to access.

Melbourne Water considers that accounting ring fencing, rather than operational separation, is a more cost effective means of providing the required clarity, transparency and cost information for access pricing.

In this regard, it is noted that Melbourne Water's financial information is already disaggregated into product and program level, consistent with the ESC's expectations in terms of regulatory reporting. That is, Melbourne Water has already implemented accounting ring fencing for its water production, treatment and transfer services, as well as its sewage treatment and transfer services.

Melbourne Water is of the view that operational separation should only be considered if accounting ring fencing fails to deliver the required clarity, transparency and cost information that the ESC is looking for.

In any event, it is not clear to Melbourne Water how operational separation as recommended in the Draft Report would apply to its business. As detailed by the ESC it has recommended the process of implementing operational separation of water sourcing, water and sewerage distribution and retail customer service functions. In terms of its bulk water and sewerage services, Melbourne Water does not have a retail / end customer function. Preliminary discussions with the ESC have indicated that they are concerned to separate Melbourne Water's bulk water and sewerage business from its waterways business, which has a retail / end customer function. Melbourne Water notes that this separation has largely already been effected through ring fencing and cost allocation.

Melbourne Water also notes that operational separation is likely to come at a cost to consumers, particularly if it requires businesses to be structured and operate differently to the manner that is currently considered the most efficient. This would particularly be the case if, as noted in the ESC's Draft Report, it involves physical separation of the infrastructure operator unit from other units of the business, separate staffing, separate operational support systems and information management systems and limits on information exchanges between the infrastructure operator unit and the other units.

For example, Melbourne Water is currently structured on functional lines rather than product lines. In other words, it has groups that address strategic planning, asset planning, capital delivery and operations and maintenance needs across both water and sewerage services. The Waterways business is held in a different division because of the very different nature of that service.

Melbourne Water is structured this way because it believes it is the most efficient way to deliver the water and sewerage services it is required to provide. Initially, post disaggregation of the industry in 1995, Melbourne Water was structured along product lines, but found that structure separated key business capabilities in a way which meant that many of the synergies between products were not captured. It also increased costs by duplicating capabilities across products. This is particularly relevant in the environment that increasingly requires an integrated approach to water resource management and where there is a significant focus on cost effective, timely delivery of major capital projects.

If the ESC chooses to impose operational separation, it is likely that Melbourne Water would need to alter its business structure. This would seem to be an odd outcome if regulation imposed a business structure that the business itself has determined to be lacking in synergies and inefficient. Such a decision should only be made in light of a clear view of the benefits that access is likely to provide.

The ESC has also proposed that accounting ring fencing guidelines would be developed in consultation with businesses during the implementation period. Melbourne Water supports the development of any ring fencing guidelines by the ESC in consultation with water businesses.

6 Protection of health, customers and the environment

Review of existing legislation

In the Draft Report the ESC recommended 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 the relevant regulators have sufficient powers to require compliance with these obligations by all service providers.

The ESC has also recommended that the Government takes appropriate measures to ensure that new service providers are subject to the *Environment Protection Act 1970*, the *Safe Drinking Water Act 2003* and the *Occupational Health and Safety Act 2004*.

Melbourne Water supports a full and comprehensive review of existing legislation and regulations relevant to the water industry and their application to new service providers. This should include identification of any gaps in existing water industry legislation and regulation. The review should determine what changes are necessary to facilitate third party entry that results in:

- No reduction in the quality of services provided
- A level playing field for access providers and access seekers.

In particular, Melbourne Water considers that new service providers should be subject to the requirements of the *Environment Protection Act 1970* and the *Occupational Health and Safety Act 2004*.

Melbourne Water also notes the ESC's view that new providers should be declared as 'water suppliers' under the *Safe Drinking Water Regulations 2005* to ensure they comply with the *Safe Drinking Water Act 2003*. The ESC considers this would ensure that compliance with the drinking water standards would be monitored by the Department of Human Services. Combined with Melbourne Water's recommended approach to licensing, which is outlined below and includes requiring compliance with the *Safe Drinking Water Act 2003*, and the role Melbourne Water would play in

assessing individual third party access arrangements to ensure they do not pose an unacceptable risk to the water supplied to its existing consumers, these arrangements should mean there is no reduction in the quality of water supplied to consumers.

Licensing

The ESC's Draft Report recommended that the Government establishes a functional licensing system for new service providers. It notes that licences typically set out matters such as:

- The services or activities the licensee is able to perform
- The duration of the licence
- The requirement to comply with customer, technical or operational codes or agreements. This includes ensuring that there are adequate risk management plans and emergency management plans.
- Information collection, reporting and auditing necessary to enable the ESC as the regulator to perform its functions
- Requirements to comply with relevant laws, such as the *Environment Protection Act 1970* and the *Safe Drinking Water Act 2003*
- Communication protocols.

The ESC also notes that licences for infrastructure operators would need to contain requirements for licensees to prepare detailed infrastructure operating plans covering design, construction, operation and maintenance. This will ensure that facilities are properly designed and constructed, operated in a safe and reliable manner and maintained in proper condition.

Further, that in order to obtain a licence, access seekers would be required to demonstrate that they have sufficient capacity to carry out the activity and comply with the licence obligations. The ESC recommended that financial capacity be a consideration in granting licences to ensure the long term financial viability of the Victorian water industry.

The ESC has also recommended that it is responsible for the granting of licences and monitoring compliance with licence conditions.

Melbourne Water supports the introduction of a licensing system in order to ensure the protection of public health, the environment and customers. It considers that the matters outlined by the ESC are all relevant and should all be included in a licensing system. As an additional safeguard, Melbourne Water also considers that compliance

with the *Environment Protection Act 1970*, the *Safe Drinking Water Act 2003* and the *Occupational Health and Safety Act 2004* should be included as licence conditions.

Melbourne Water considers that rather than the ESC being responsible for the granting of licences, the decision should be made by the Minister for Water based on recommendations by the ESC. The Minister for Water is responsible for water and environmental policy issues and imposes obligations on water businesses in relation to these issues. As a result, the Minister is best placed to make licensing decisions. In making recommendations to the Minister, the ESC could be the co-ordinating agency and reflect the assessments of other Government departments that have expertise in relation to specific matters that need to be assessed in licence applications. This would include the views of DSE, the Environment Protection Authority and the Department of Human Services.