

27 July 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: Draft Report

The Victorian Water Industry Association (VicWater) is pleased to make this second submission to the Essential Service Commission's *Inquiry Into An Access Regime For Water And Sewerage Infrastructure Services*. This submission relates to the Commission's Draft Report dated June 2009. We note that additional submissions addressing particular issues may also be provided from our 19 industry members.

VicWater would like to reiterate the position presented in our original submission, that current legislative and regulatory arrangements provide an adequate framework for water businesses to develop access arrangements as privately negotiated contracts. However, within the context of the Commission's Terms of Reference, VicWater would like to complement the Commission on a broad ranging investigation that included careful consideration of a number of important issues including:

- ◆ that an access regime for the Victorian water industry should be implemented in stages, including the initial development of access commitments followed by a period of monitoring before legislation is established and regulatory guidance is finalised;
- ◆ the exclusion of certain processes from a state based access regime including 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;
- ◆ the strong emphasis on negotiation as a starting point for determining the terms and conditions of access, with well clear dispute resolution and arbitration protocols should the parties fail to reach agreement;
- ◆ the extension of existing health, safety, environmental, customer service and other water industry legislation to also cover new entrants; and
- ◆ the commitment to ongoing consultation with water businesses throughout the implementation stages.

We note that many other issues will be finalised during the implementation stage, including guidance on the content of access commitments, the development of negotiation and arbitration protocols and a more comprehensive review of legislation and regulations. Detailed and ongoing consultation with water businesses will be critical throughout this stage.

The remainder of this submission focuses on specific areas of concern in the Draft Report. The most significant of these relates to the Commission's recommendations regarding ring fencing, the access pricing methodology and access to storage in dams. We also comment on the Draft Report's discussion of procurement processes and the establishment of a functional licensing regime.

Each of these issues is outlined in more detail below.

Ring Fencing

Recommendation 7.1 of the Draft Report is *"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."*

The Commission indicates that the separation of business functions would involve physical separation of the infrastructure operator unit from the 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. The Draft Report suggests that functional separation would facilitate broader participation in the water sector by promoting clarity and transparency in allocating costs between business units and ensuring that infrastructure services are made available to all market participants on an equal basis.

The Commission recommends functional separation of the metropolitan businesses and other "nominated" regional businesses. The Draft Report does not specify which regional businesses would be nominated, other than stating that functional separation may not be justified for smaller businesses that do not expect access applications in the near future.

VicWater strongly opposes this recommendation. The operational separation of water business functions would be an expensive exercise that would have significant ramifications for customer service and the ability of water businesses to co-ordinate between business units. This recommendation would impose substantial additional costs associated with operational separation including duplicated administrative, technical, operational and construction costs. In addition, the integration of planning, communications and day-to-day operations between business units will be severely hampered.

The additional cost and the operational impact would be unnecessarily onerous, particularly for an industry that is expected to face very limited competition. Unlike the electricity and gas industries, the water sector has had very few third party access applications in those jurisdictions that have already established third party access regimes (such as the UK and NSW). The situation in Victoria is likely to be similar, apart from several access arrangements that are being considered within or between existing State-owned water businesses. We do not believe that the substantial costs associated with operational separation would be warranted to cater for these situations, nor would the changes be supported by the businesses seeking access.

We consider that in the first instance, accounting separation would be sufficient to provide clarity and transparency in cost allocation between business units. In addition, the regulator could be provided powers to investigate and act on claims that an infrastructure operator was supplying services on a discriminatory basis. Combined, these alternatives would achieve the same objectives but would be far less costly to implement than operational separation.

We recommend that the Commission consider the costs of operational separation carefully and consult widely with industry before making a final recommendation on this serious and far-reaching issue.

Access Pricing

The Draft Report makes two recommendations regarding access pricing:

- ◆ “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.” (Draft Recommendation 6.1)
- ◆ “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.” (Draft recommendation 6.2)

VicWater is concerned that the cost of service approach has been recommended where infrastructure can be “easily identified”, regardless of whether that infrastructure will be used to supply regulated retail customers. As noted in the Draft Report and in submissions from water businesses, the cost of service approach could potentially allow for “cherry picking” in low cost areas if the incumbent has uniform retail prices. That is, a competitor could gain an inefficient and inequitable advantage over the incumbent by only servicing customers in low cost areas and undercutting the incumbent, who would be required to charge the uniform, regulated prices determined by the Commission.

The fact that certain elements of the incumbent’s infrastructure may be “easily identified” does not alter the ability of competitors to use that infrastructure to cherry pick low cost areas from the incumbent. For example, where the incumbent has an “easily identified” bulk water pipeline, potential competitors could target customers that were supplied immediately after the pipeline, thereby avoiding the need for distribution infrastructure. In this case, the incumbent would be at a competitive disadvantage as it would be required to share the cost of distribution assets across its entire customer base, including to those customers that made little or no use of those assets.

Therefore, VicWater supports the use of the retail minus approach in any situation in which the customers supplied by an access seeker would otherwise be subject to regulated retail prices. This approach would ensure that neither the incumbent nor the access seeker would have an artificial competitive advantage.

The cost of service approach could be used in those cases in which retail prices did not apply. This could include, for example, the use of infrastructure to transport water to customers that would not otherwise have been supplied by the incumbent.

We agree with the Commission's finding that variable charges for access should be based on the incremental cost, with any remaining costs recovered through fixed charges. To avoid confusion, we recommend that the Commission clarifies that access seekers will be required to meet all incremental costs of providing access to the incumbent's infrastructure plus an equitable contribution to shared costs and sunk assets that are utilised by the access seeker.

Finally, we also note the interaction between access prices and regulated retail tariffs. Where infrastructure is used to supply both an access seeker and regulated retail customers, we would expect the revenue from both groups should sum to the total revenue required for that infrastructure. Where the cost of service approach is used, it may be possible to allocate retail customers the "remaining" cost that was not apportioned to the access seeker. However when the retail minus approach has been adopted, it may be difficult to apportion specific asset costs to each customer group. Therefore it may be more appropriate to remove the revenue generated by the access seeker from the total revenue requirement for retail customers. We recommend that the Commission clarifies its approach to incorporating access prices into the revenue requirement for regulated retail tariffs.

Due to the interaction between access prices and retail prices, it is also important to clarify situations in which an incumbent might be warranted in providing "prudent discounts" that differed from the standard access pricing approach. We note that there may be some cases in which a third party could by-pass the incumbent's infrastructure at a cost below the access price but above the incumbent's incremental cost. The incumbent may therefore be warranted in offering an access seeker a price as low as, but no lower than, the incremental cost of providing the service.

In summary, we recommend that:

1. the retail minus approach is used to determine access prices in all cases in which the access seeker will utilise access to service customers that would otherwise pay a regulated retail tariff;
2. the cost of service approach is used to determine access prices in situations in which no regulated retail tariff exists. For the avoidance of doubt, the cost of service approach would require the access seeker to meet all of the incremental costs of providing access to the incumbent's infrastructure plus an equitable contribution toward shared costs and sunk assets utilised by the access seeker; and
3. the incumbent has discretion to offer "prudent discounts" to facilitate access if there is evidence that a third party could by-pass the incumbent's infrastructure for less than the access price but more than the incremental cost of providing the service. These discounts should be appropriately reflected in the setting of regulated retail revenue requirements.

Access to Storage in Dams

In VicWater's response to the Issues Paper, it was noted that storage dams provided a buffer against future years' supply shortages and should therefore not be included in a third party access regime. The Draft Report recognises the important role of dam capacity in contributing to security of water supply in the long term, but has noted that there may be scope to use spare capacity to provide short term storage services. The Draft Report states that providing such services may improve efficiency by making use of under-utilised infrastructure and allow infrastructure operators to earn a return on the spare capacity in the storages.

VicWater agrees that short term access could be made available in some circumstances, but notes that this should be a commercial decision made by the infrastructure operator, who must weigh the benefits of providing access against the operational impact of utilising dam capacity. Some dams can fill rapidly and the timing and magnitude of rainfall are difficult to predict in advance. A dam that appeared underutilised in one year could quickly fill in the next. If the incumbent provides access to its dam capacity it may not have sufficient capacity to capture all subsequent inflows. Therefore, the decision to “lease” dam capacity on a short-term basis should be at the discretion of the water business and should be based on a case-by-case assessment of risk compared with the commercial return to the business.

We therefore recommend that dam storage capacity should not be covered under the Victorian access regime.

However, if an access regime for dams proceeded, consideration would need to be given to clarify pricing issues as well as determining storage rights. Water stored in a dam under an access regime should be the first to be lost and/or spilled or displaced by storage right holders utilising their share of the storage. The incumbent who provides access to ‘air-space’ in storages does so on the condition that it is the access seekers’ water that is the first to spill. That is, the access seeker can use the available storage on an opportunistic basis only.

Procurement Processes

The Commission has suggested that there is a lack of transparency in decision making and that there may be a real or perceived conflict of interest for water businesses when selecting which sources to invest in or use. The Commission suggests that this may limit broader participation in bulk water provision and therefore recommends that the government reviews its bulk water procurement processes to “improve opportunities for development of low-cost new water sources.” The Commission notes, for example, the model proposed by the Western Australian Economic Regulation Authority (ERA), in which it has been proposed that an independent body should select new water sources that the water business is then compelled to utilise.

We recommend that any review of bulk water procurement processes should involve extensive consultation with water businesses and should carefully consider the benefits of existing procurement practices, including the water business’s greater knowledge of customer and operational needs, and the greater clarity of responsibility when one entity is responsible for all facets of providing a water or wastewater service.

We also note that the model proposed by the ERA, in particular the level of control exhibited by the independent body, has no precedent in any other industry. More importantly, the Victorian water industry differs from WA in that the metropolitan retailers are holders of bulk water entitlements and the retailers and the Melbourne Water Corporation undertake joint planning when selecting new water sources as outlined in the retailers Statements of Obligations. In regional areas, the establishment of a separate agency for selecting bulk water sources would be technically infeasible due to the large number of regional water businesses and the localised knowledge required in each case.

We therefore contend that a review of bulk water procurement processes is not required as part of the current inquiry.

Functional Licensing Regime

The Draft Report recommends that the Government establishes a functional licensing system for new water and sewerage service providers (Draft Recommendation 8.3). The Draft Report does not provide specific details regarding the nature or extent of the licensing system.

VicWater recommends that any review of licensing requirements recognises the administrative burden placed on water businesses and that recommendations should only be developed after widespread industry consultation.

Conclusion

VicWater appreciates the opportunity to provide comments on the draft report and look forward to further discussions. We would also like to thank the Commission for their openness and their willingness to discuss issues with the industry.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Steve Bird', written over a circular stamp or seal.

Steve Bird
Chief Executive Officer