

Draft ESC Report of June 2009 on an Access Regime for Water and Sewerage Infrastructure Services:

A response in relation to the Goldfields Superpipe

Introduction

The Essential Services Commission (ESC) has identified the Goldfields Superpipe (GFSP) as a suitable asset for declaration under the proposed Access Regime for Water and Sewerage Infrastructure Services. The GFSP is a joint project by Central Highlands Water and Coliban Water and the two water authorities have entered into a Joint Venture (JV) agreement covering the ownership and maintenance of the Superpipe, and access to the water it provides. Indeed the asset is in the final stages of completion and can be considered a Greenfield asset.

This submission has been prepared by the JV specifically in relation to the GFSP, to address issues which particularly impact on the GFSP, including community utility of the asset, pricing and ring fencing.

Community Utility

The community utility in the GFSP arises because both the Commonwealth and Victorian governments contributed funding towards the GFSP in order to guarantee the security of water supplies to Bendigo and Ballarat. In addition the GFSP would constitute a greenfields infrastructure investment because while parts of the GFSP are operational, other sections are still to be completed.

It would be appropriate therefore to ensure that the investors and the community are fully engaged in discussions about the expected utility that the GFSP will deliver to them in terms of the social obligations that were the primary purpose of its construction. An access regime introduces increased risks for these investors and the community which can reduce their expected utility. For example, these stakeholders are entitled to know that a third party access regime is capable of delivering a secure supply of drinking water. At issue is whether a risk premium placed on the access price is completely capable of compensating the community for failing to supply it with some agreed minimum quantity of drinking water, or whether minimum quotas should be implemented to ensure that this never happens.

In addition, the green fields sections of the GFSP are potentially subject to hold –up risk. This is the risk that an infrastructure water provider will fail to proceed with a potentially lucrative investment because it cannot form a mutually beneficial contractual arrangement with a retail water business that would deliver the water. The retail business is in a much stronger bargaining position because it undertakes substantially less investment than the infrastructure operator.

The JV notes that a representative from the Department of Sustainability and Environment (DSE) attended the Hearing on 15 July and welcomes her statement that the Government will provide guidance in relation to these matters. The JV would be willing to take part in any discussions or contribute to any debate on this issue. However, the JV shares the concern expressed by a number of participants in the Hearing that it might not be possible to provide an access price in some circumstances until this matter is resolved.

Pricing

The JV notes the ESC's recommendations about when to adopt either the cost of service or the retail minus pricing approaches. In particular, the JV notes the ESC's recommendation that the access commitments developed during the implementation period should identify which access pricing approach will be used to calculate access prices for the services provided by each particular infrastructure facility. However, the JV notes that the ESC has recommended that the cost of service approach should be applied to the GFSP.

The JV understands that competition may result in a loss of revenues for incumbent water businesses. It also notes that the ESC has identified the cost of service pricing approach as applying to the GFSP because access is to be provided to a discrete infrastructure facility and the costs associated with this infrastructure can be identified easily.

However, the task may not be as easy as the ESC envisages. For example, the schematic diagram on page 2 illustrates the complex nature of the interconnections between the GFSP and related water infrastructure. This makes determining separate prices for sub-groupings of the assets very difficult when the cost of service or building block approach to pricing is to be used.

There also seems to be some expectation that the cost of service pricing approach will eliminate postage stamp pricing by removing all cross subsidies and introducing price discrimination. A cross-subsidy is commonly taken to be a situation where one group of consumers pays more than another.

However, Section 35 C (b) (i) of the *Essential Services Commission Act 2001* states that access price structures should allow for multi-part pricing and price discrimination *when it aids efficiency* (emphasis added). A corollary of this is that cross-subsidies really only matter economically when they result in some inefficiency.

The cross-subsidy can really only be inefficient if one group of consumers pays less than LRMC. To illustrate this point, suppose for example, that charges are implemented through a two-part tariff in which LRMCs are fully recovered through the variable part of the charge.

Any amount paid over and above LRMC, that is the fixed fee, is necessarily applied to the recovery of fixed costs. It can be demonstrated that while differences in the recovery of fixed costs have welfare implications they do not have any impact on efficiency. Since the amount of this fixed fee is determined through negotiation between the infrastructure provider and the access seeker, two access seekers can pay quite different average costs for access and the outcome will still be efficient provided they each pay a variable charge that is equal to their own LRMC.

It is important to add any community service obligations (CSOs) which are paid on behalf of a group of consumers to the amount that those consumers have paid themselves for the purposes of before determining whether they are paying less than LRMC. Provided this is done, the cost of service pricing approach will generally not result in price increases for these vulnerable consumers.

This is discussed more fully in the *Simplified Water Cross-Subsidy Guide* prepared by the Orion Consulting Network for the Local Government Association of Queensland, Inc, in May 2003. The Guide is intended to be a supplement to the *Guidelines for Identification and Measurement of Cross-Subsidies* that were issued by the (then) Queensland Department of Natural Resources (DNR) in 1998. The DNR even goes so far as to define cross-subsidies as only existing where one group of consumers is subsidising another group provided that the group being subsidised is paying below LRMC. Otherwise, the DNR calls them price differentials.

It should also be noted that any access prices which are calculated using the cost of services approach will similarly be efficient even when they contain cross-subsidies providing that they are set such that every consumer group pays at least LRMC. Therefore, even when economically inefficient cross-subsidies exist, postage stamp pricing could still be justified on the grounds that it is inefficient to implement price discrimination. See *Approaches to urban water pricing*, Waterlines Occasional Paper No 7, July 2008, prepared by Frontier Economics for the National Water Commission - see

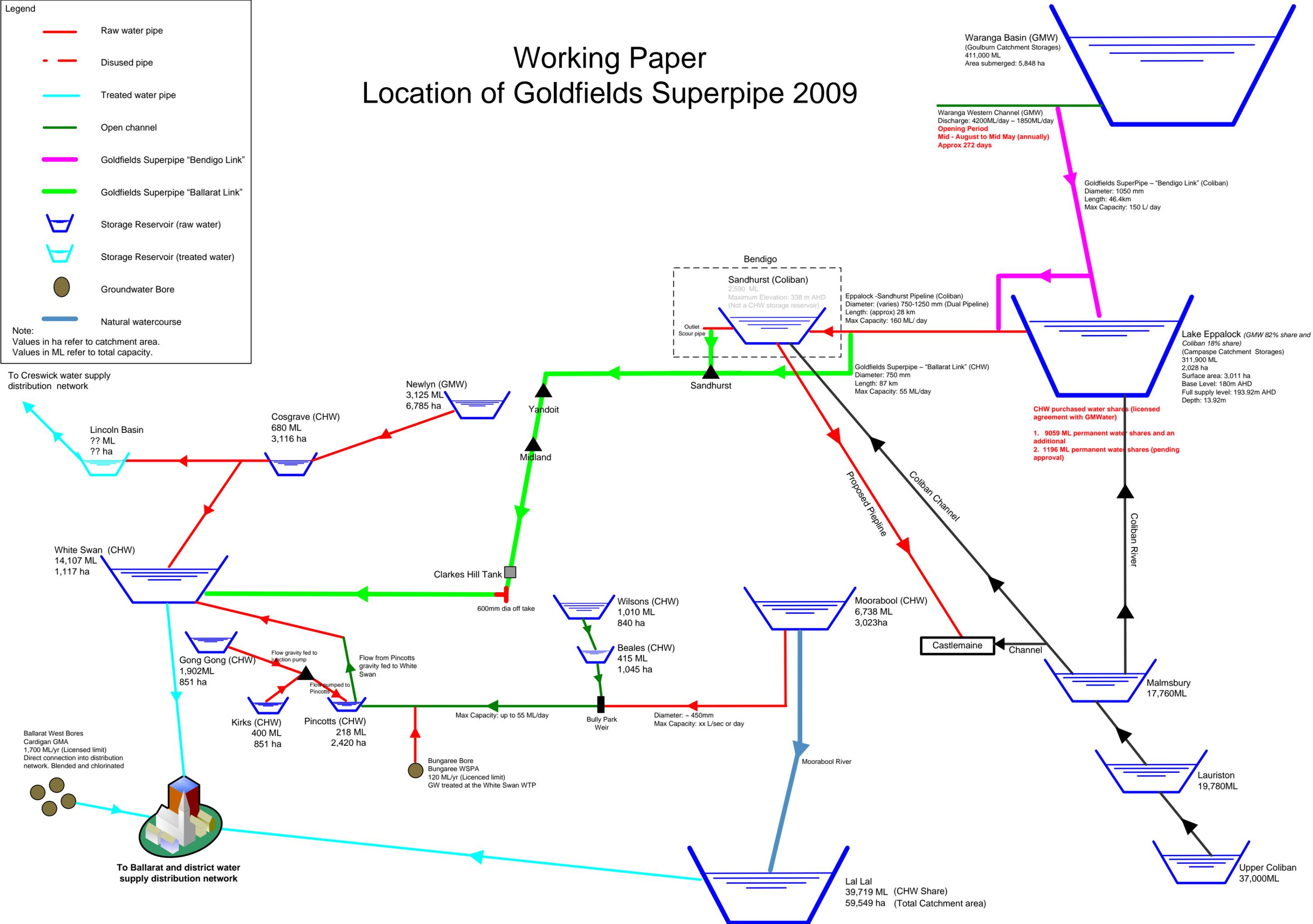
http://www.nwc.gov.au/resources/documents/UrbanWaterPricing_Waterlines-Body-0708.pdf .

Legend

- Raw water pipe
- - Disused pipe
- Treated water pipe
- Open channel
- Goldfields Superpipe "Bendigo Link"
- Goldfields Superpipe "Ballarat Link"
- Storage Reservoir (raw water)
- Storage Reservoir (treated water)
- Groundwater Bore
- Natural watercourse

Note:
 Values in ha refer to catchment area.
 Values in ML refer to total capacity.

Working Paper Location of Goldfields Superpipe 2009



The JV notes that the ESC intends to develop pricing principles and other guidance to assist the water businesses in applying the pricing approaches. The JV would welcome the opportunity to take part in this process, and/or otherwise discuss the pricing principles more fully with the ESC.

Ring fencing

With respect to ring fencing, the JV notes that the ESC has already identified the GFSP as a likely candidate for functional separation and recommends that functional separation should have begun within 6 months of the regime commencing.

The JV understands that the costs of the ring fencing regime are not to be recovered entirely from access seekers, and proposes to implement ring fencing via a staged approach.

There are several advantages to implementing ring fencing in this way. Firstly, it is more likely to achieve an appropriate balance between coverage in a regime where specific infrastructure services are declared from the outset and the likelihood of receiving an access request. This is because it focuses the effort on areas where access requests are most likely to come from.

Secondly, implementing ring fencing via a staged approach enables the JV to apply the approach in progressively more challenging settings so that the lessons learned can be adapted and refined. Thirdly, it provides time for the JV partners to seek to potentially reopen the price determination so that it can pass on the very significant costs that will be involved in implementing full functional separation.

Access Regime Preparedness

Under an access regime there are a number of scenarios requiring different levels of data and organisational reform.

Regional Water Corporations for the most part are vertically integrated and derive economies of scale from this integration. This is different from the Melbourne structure where separation between wholesale/transmission (Melbourne Water) and the distribution/retail functions has already occurred.

Therefore all of JV's systems and data are arranged on the basis of postage stamp pricing across integrated systems based on this notion of vertical integration. In moving to an Access regime there are a number of scenarios, each of which has different social, organisational, system (data), risk and governance requirements.

Both JV partners have initiated third party access trials using the GFSP for existing customers. They have done this to enable customers (including Councils and Sporting Groups) to gain some relief from water restrictions through purchasing their own water entitlements and using the existing distribution infrastructure to access this water. Under this arrangement both Central Highlands Water and Coliban Water take the risk of managing the water asset once purchased (placing water transfer orders and storage).

The following issues need to be resolved or better understood in order to facilitate third party access:

- Accounting ring fencing of the GFSP asset (currently managed individually across two authorities) would need to be developed.
- Review and modify the JV Governance Structure to manage the allocation of capacity in accordance with investor user utility expectations (over time), provide a consistent pricing methodology and shareholder return.

- Development of access protocols and access pricing.
- Develop processes and systems including dispatching and the efficient operation of the asset (i.e. smoothing peak flows will provide all users with efficiencies in reducing power costs), risk allocation (leakage, evaporation losses, missed dispatches, maintenance regime etc).
- Implementation of a single operating contract – the Joint Venture is currently developing a single operating contract for the GFSP which is expected to be completed in early 2010.