Yarra Valley Water | a fresh approach

Yarra Valley Water Ltd
ABN 93 066 902 501

Lucknow Street
Mitcham Victoria 3132

Private Bag 1
Mitcham Victoria 3132

DX 13204

Facsimile (03) 9872 1353

Email enquiry@yvw.com.au
www.yvw.com.au

6 April 2009

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

Dear Ron

Inquiry into an access regime for water and sewerage infrastructure services: Response to Issues Paper

We strongly support initiatives – such as improving access to monopoly facilities – that will foster the development of innovative water and sewerage services that deliver real benefits to customers, community and the environment. Given the other potentially far-reaching reform initiatives presently underway in the water sector – and the bearing that these may have on the design of a State based access regime – it is appropriate that a step-by-step approach be taken to the development of access arrangements.

This letter sets out Yarra Valley Water's initial high-level views on the key issues arising in the context of the establishment of an access regime in the Victorian water sector.

1. Background: Present water policy environment and rationale for access regimes

In relation to the purpose and objectives of access regimes, the Issues Paper notes that:

- the key purpose of establishing an access regime in any industry comprised of elements that have natural monopoly characteristics is to enable more than one business to operate in those segments of the industry where competition is feasible; and
- there is scope for innovative water and sewerage services to be provided and there are private operators potentially interested in supplying such services. Facilitating access would be expected to enhance the environment for new entry and further innovation in potentially competitive segments of the market.

We recognise that the principal rationale for an open access regime is to facilitate competition in upstream and downstream markets. We support open access to monopoly infrastructure in the water

sector where this will encourage innovation and activities that deliver benefits to customers, community and the environment.

In relation to the policy context for the Commission's review, we note that the terms of reference directs the Commission to be cognisant of a number of other inter-related work programs that are currently underway in the Victorian water sector including:

- arrangements for optimising management of the expanded water grid and new water sources;
- amendments to bulk water entitlements;
- consideration of possible market-based mechanisms;
- the definition of appropriate roles and responsibilities; and
- clarification and improvement of the water rights framework relating to alternative water sources.

We note that further progress in key areas such as water grid expansion, the possible introduction of a water grid manager, and the trading of bulk water entitlements will bring forth industry developments that are almost certain to impact on the optimal design of the access regime.

In addition, the Issues Paper identifies a number of factors that may presently discourage competition and private participation in the water industry. These factors include:

- constitutional constraints,
- legislative and regulatory barriers affecting matters such as trading in bulk water entitlements,
- lack of transparency in water demand and supply management, and
- a lack of clarity of property rights, especially in relation to wastewater, recycled water and stormwater.

In this context, it is noteworthy that the Commission states (on page 18 of the Issues Paper):

> "Without extensive and wide-ranging research into the types of reforms required in the Victorian water industry, identification of their expected outcomes and quantification of their costs and benefits, it is not possible, at this stage, to map out a detailed reform strategy or to identify an end-point for the reform process. In these circumstances, it will be important to introduce measures to complement a Victorian access regime in a carefully staged process."

We therefore strongly concur with the Commission that a carefully staged, step-by-step approach is required in the development of an access regime for water and sewerage infrastructure.

In addition, we consider that the Commission's review should adopt a pragmatic approach and recognise that the most important challenges facing the industry will not be addressed through an access regime. In particular, creation of a water grid manager, the better allocation of water entitlements; optimising environmental flows; and developing new water sources in an economically efficient and environmentally sustainable manner, are immediate concerns that can only be partially addressed by encouraging competition through the development of an open access regime. The reasoning underpinning our view is set out in further detail in section 2 below.

2. The benefits of a step-by-step approach to open access

As noted above, the optimal design of an access regime will need to consider the likely implications of possible future institutional, trading and other arrangements in the water sector. In addition to considering these broader industry reforms, the Commission should examine the extent to which:

- innovation and third party access are impeded by the present regulatory arrangements; and
- new beneficial activities are likely to be facilitated or encouraged by the establishment of an open access regime.

In considering these matters, it is noteworthy that the Issues Paper[1] provides a number of examples which illustrate that innovative methods of providing water and sewerage services are already occurring, albeit on a limited scale. The Issues Paper[2] also notes that in rural areas of Victoria:

- Water rights have been unbundled to separate entitlements to receive water from the rights to have that water delivered via the infrastructure. To date, unbundling has occurred mainly for rural irrigation services.
- Water trading has also been introduced, allowing the trading of water entitlements and delivery shares. Trading by irrigators and other rural customers has led to water being re-allocated to more valuable uses, using the rural businesses' delivery networks to transport purchased water to where it is needed.
- Regional water businesses have also purchased water entitlements in the market and used the rural businesses' delivery networks to transport the water from its source to their own customers.

These observations suggest that there is already some scope to accommodate innovation and new activities (which may require access to monopoly infrastructure in the Melbourne metropolitan area) within the existing regulatory arrangements, or with minimal change to those arrangements. We also note that there is little evidence to suggest that the existing arrangements – or the commercial conduct of the incumbent water companies in Victoria – are impeding the development of innovative services through third party access to monopoly facilities.

Whilst there are undoubtedly benefits from further facilitating open access, it should also be recognised that there are a number of industry-specific constraints that limit the potential benefits from open access. Our preliminary views on these constraints are as follows:

- Competition in water retailing is unlikely to drive new sources of potable water because the existing resource cost of water (which is embedded in current retail tariffs) will continue to be much lower than the marginal costs of new water sources.
- We estimate that our cost of retailing is less than 5% of the water and sewerage service value chain. Given the comparatively low cost of the retail function, we think it is highly unlikely that encouraging competition between existing retailers will deliver real benefits to customers or the industry. Rather, it is more likely to conflict with the environmental and societal objectives of the existing tariff structures without providing any discernable net benefits to consumers or the industry.

---

1 Essential Services Commission, *Inquiry into an Access Regime for Water and Sewerage Infrastructure Services: Issues Paper*, February 2009, Section 2.2.1, page 13.

2 Ibid, section 2.2.2, page 15, and section 4.1.2, page 39.

- The experience in other jurisdictions is that open competition is more problematic in the water sector than in other utility sectors such as gas and electricity. In the UK, there has been a clear recognition of the benefit of an incremental approach to introducing competition in the water sector. In this regard it is particularly noteworthy that the November 2008 interim report of the independent review by Professor Martin Cave of competition and innovation in UK water markets (the Cave review) states:

> "As there is so little experience of competition in the water industry to draw on, and because some key contributory factors are absent, I support a step-by-step approach, starting where the risk-return ratio is most favourable. At specified break points, higher quality data will be available, allowing the Government, with stakeholders, to better review the costs and benefits of further competition."[3]

In summary, there are industry-specific constraints on the benefits that can be achieved through open access, whilst some innovative services are capable of being provided under the existing industry arrangements. These observations have led us to conclude that the Commission should adopt a step-by-step approach to improving access to monopoly infrastructure. Specifically, a step-by-step approach should:

- address any immediate barriers to innovation and access that are present in the existing arrangements; and

- introduce incremental changes to the existing arrangements so that third party access is facilitated where there is an opportunity to deliver real benefits to customers and the industry.

A step-by-step approach should also be guided by a consideration of the types of new activities that might be facilitated or encouraged by the establishment of an open access regime. In relation to this question, there is considerable uncertainty as to the nature of the future activities and innovations (and hence the potential benefits) that might be forthcoming under an open access regime. This in part reflects the present uncertainties stemming from the other reform activities now underway in the Victorian water sector.

We note that experience in the water sectors of other jurisdictions also suggests that the scope and nature of future requests for access are highly uncertain. For instance, in assessing reforms of the water sector in Western Australia (including the establishment of an access regime), the Economic Regulation Authority considered that "a simple regime that can be refined later should be implemented, given that likely demand for access is unknown".[4]

In the present uncertain and evolving water policy environment, the potential benefits from the development of an open access regime are also uncertain. The other work programs currently underway within Victoria, coupled with the development of the water grid should deliver further state-wide benefits in terms of more efficient water allocation and usage. It would be premature to develop a fully-scoped open access regime in advance of a better understanding of these developments.

We are receptive to approaches from new entrants for third party access. While our experience has been limited in recent years, the seminal Melbourne access case is City West Water's arrangements for sewer mining access by the City of Melbourne for water for their new six-star building and this can be used as a model for the next steps with the development of an open access regime.

---

3 Martin Cave 2008, *Independent Review: of competition and innovation in Water Markets*, November, page 3.

4 Ibid, page 33.

3. First steps in developing an open access regime

We favour a number of initial steps to promote access and encourage the development of innovative water and sewerage services as described below. These steps are based on the introduction of a simple negotiate-arbitrate model.

3.1 Obligation to provide access on fair and reasonable terms

All incumbent water companies would have new obligations to:

- provide access to infrastructure assets on fair and reasonable terms; and to
- not engage in conduct for the purposes of preventing or hindering access.

The new obligations could be given effect readily through a revised Statement of Obligations, or through a ministerial direction given to a water corporation pursuant to sections 307 and 307A of the Water Act[5]. The requirement to not engage in conduct for the purpose of preventing or hindering access would strengthen the regime[6]. It could be enforced by the Commission.

We recognise that this form of open access regime would not be a certified access regime and therefore access seekers would still be able to seek declaration of services under the Trade Practices Act. Nevertheless, we consider that the approach is desirable because it would clarify that open access to monopoly infrastructure is mandated and that Victorian water companies are required to provide such access on fair and reasonable terms. The proposal is therefore likely to deliver benefits without incurring the costs of developing a certified access regime.

3.2 Dispute resolution

An effective access regime must provide prospective access seekers with recourse to binding arbitration in the event that terms and conditions of access cannot be agreed. Such recourse could be readily established, using a model similar to that employed in chapter 6A of the National Electricity Rules. Under that access regime:

- A commercial arbitrator is appointed to resolve transmission services access disputes in relation to the terms and conditions of access for the provision of certain transmission services.
- The scope of disputes that may be subject to arbitration includes price and non-price matters.
- The independent commercial arbitrator is required by the Rules to make a decision within 30 days.

In establishing these arbitration arrangements, the Australian Energy Market Commission (AEMC) noted that the provision of a right to independent dispute arbitration would place access seekers in a

---

5 Melbourne Water is a statutory corporation. The Melbourne metropolitan water retailers are presently Corporations Law companies, however recommendation 7.3 of the VCEC report recommended that they be made statutory corporations. Sections 307 and 307A of the Water Act enable the Minister, after consulting the Treasurer, to give written directions to a water corporation in relation to the performance of any of its functions.

6 A similar requirement is present in Chapter 6A of the National Electricity Rules, which sets out the access regime relating to electricity transmission network infrastructure, and which forms part of a regime that has been certified by the National Competition Council as an effective access regime.

position to apply considerable countervailing power in negotiations with incumbent facility owners. The AEMC also stated[7]:

> "The Commission maintains the view that it is important that the arbitrator be skilled in dispute resolution techniques and have regard to the negotiation framework/criteria set out by the AER in the relevant Revenue Determination. However, considering the commercial nature of these negotiations and with an interest in maintaining a timely arbitration process, the Commission has retained the use of commercial arbitrators given their skill in commercial dispute resolution and likely proficiency in resolving disputes within the required 30 day timeframe. In addition, it ensures that the costs of arbitration remain with the negotiating parties."

We see merit in these sorts of arrangements being applied in the water sector.

3.3 Access pricing and accounting separation

For the reasons set out in sections 2 and 3 above, we consider that moving to fully unbundled retail pricing with separate access charges for infrastructure would be premature at this time.

As noted on page 50 of the Issues Paper:

> "The retail minus approach has generally been used in cases where the final retail price is regulated, where the service is bundled and where the infrastructure service provider also provides upstream or downstream services associated with the infrastructure in question. An example of the application of the retail minus approach is the ACCC determination in respect of the Sydney Water access dispute."

In the present circumstances, we consider that the application of a "retail-minus" approach to pricing in the water sector would be a sound first step.

We also note that page 50 of the Issues Paper states:

> "In practice, the discount used in the retail minus approach can be calculated in two ways. First the discount may represent the costs avoided by the infrastructure service provider in not having to provide certain service components to the access seeker. Second, the discount under the retail minus approach may represent the costs incurred by a potential new entrant to provide the services avoided by the infrastructure service provider in providing access, which provides an indication of the long run marginal cost of providing the service.
>
> The discount method is the key issue associated with the retail minus approach, as the cost concept used to calculate the discount will result in different access prices.
>
> Depending on the definitions and calculation of the various costs used to determine access prices, the cost of service and retail minus approaches can result in the same or very similar access prices."

We concur with the Commission's observations. It is worth noting that in its arbitration report on the access dispute between Services Sydney Pty Ltd and Sydney Water Corporation, the ACCC explained that[8]:

> "A retail-minus methodology is a type of top-down approach to calculating access prices. Differences in top-down approaches arise because they use different definitions for the costs that are to be subtracted from retail prices. One approach is to subtract only the costs that the access provider will actually avoid as a result of the access seeker supplying some customers in the downstream market.

---

7 AEMC, *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination*, 16 November 2006, page 42.

8 ACCC, *Access dispute between Services Sydney Pty Ltd and Sydney Water Corporation: Arbitration Report*, 19 July 2007, page 2.

> In contrast, the ACCC's determination requires those costs that the access provider could avoid in the long-run (that is *avoidable* costs) be subtracted from retail prices. Access prices are therefore lower than if only costs actually avoided are subtracted from retail prices.
>
> Thus, the implication for access seekers of the ACCC's determination that access prices are to be calculated as Sydney Water's regulated retail prices minus avoidable costs (plus any facilitation costs) is that it provides scope for entry so long as the access seeker is more productively efficient than Sydney Water in undertaking the contestable activities associated with the provision of sewerage services."

We note that the interim report of the Cave review has found that the retail-minus approach, as currently operated in the UK (which provides a discount reflecting an incumbent's variable costs and takes no account of the impact of a competitor's actions on fixed costs), effectively prevents competition. Accordingly, the Cave review has proposed that: "an access price based on an alternative approach, such as full economic costs, and which takes account of long-term costs is likely to be more appropriate as it recognises the value of the services provided by a competitor and gives the incumbent an incentive to improve its services."

We urge caution in interpreting the interim findings of the Cave review and applying these to Victoria, given the particular way in which the retail-minus access pricing approach has been applied in the UK, and the focus of the Cave review on, amongst other things, the potential benefits of retail competition in the UK water sector (where average retail costs for water are estimated to be in the range 10.6 per cent and 11.8 per cent of the total value chain, and 11.5 per cent and 13.5 per cent of the value chain for wastewater.)

We consider that a retail-minus approach would be best implemented in the Victorian water industry by setting out a number of pricing principles or guidelines that must be satisfied. Given the uncertainty regarding the extent and scope of access that is being sought, it would be most appropriate to implement the retail-minus pricing on a case-by-case basis as the need arises. It would not be appropriate, nor necessary, to make extensive changes to the regulatory accounting rules in order to substantiate and verify access prices in advance of any access request being lodged.

3.4 Ensuring delivery of benefits and the maintenance of a level playing field

We consider that the Commission should be required to licence an access seeker before that third party is permitted to provide services. The purpose of the licensing regime would be to ensure that:

- environmental, and health and safety standards are not compromised;
- a level playing field exists between incumbents and new entrants; and
- the new entrant delivers real benefits to customers and the water industry, rather than (for example) seeking to exploit tariff pricing anomalies.

In relation to the second point listed above, we note that the rail sector in the UK provides a useful case study of a regulatory regime in which there is an explicit regulatory policy to block the granting of access rights to competitors where these would be "primarily abstractive" of incumbents' revenues, to the extent that they would constitute "cherry-picking" and that the additional uncertainty and loss of revenue for Government franchises would not be justified by the competing service's other benefits[9].

---

9 Office of the Rail Regulator, *Moderation of Competition: Final Conclusions*, May 2004.

We consider that it is very important for the access regime to be aimed explicitly at delivering real benefits, having regard to prevailing and prospective environmental, and health and safety standards. Providing the Commission with a power to issue licences to new entrants only where the granting of access is expected to produce net benefits would provide an effective means of achieving this goal, without creating any barriers to efficient new entrants.

4. Summary

This letter has set out our high-level response on the key issues arising in the context of the proposal to establish an access regime in the Victorian water sector. We have suggested refinements to the present arrangements, which:

- could be readily implemented;
- would enhance access to monopoly facilities in the water sector;
- provide flexibility to accommodate a range of outcomes that might be delivered through the other important reform initiatives currently underway;
- deal effectively with the uncertainty relating to the scope and nature of the needs of future access seekers; and
- provide a sound foundation for the further development of access arrangements over time, as more certainty emerges around the critical matters noted above.

We strongly support initiatives that deliver benefits to customers, community and the environment – such as improving access to monopoly facilities to promote the development of innovative water and sewerage services. Given the other far-reaching reform proposals being considered in the water sector, it is appropriate that a step-by-step approach be taken to the development of access arrangements as these other initiatives have a bearing on the ultimate design of a State based access regime.

We note that there are a number of further stages in the Commission's inquiry on the access regime for water, including the publication of, and consultation on a draft report. We anticipate making further detailed submissions to the Commission in the course of its inquiry, and as new information comes to hand.

In the meantime, we would be pleased to discuss any aspect of this initial submission with you at any time.

Yours sincerely

Tony Kelly
MANAGING DIRECTOR