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INQUIRY INTO AN ACCESS REGIME
FOR WATER AND SEWERAGE
INFRASTRUCTURE SERVICES

FINAL REPORT
VOLUME I:
FINDINGS AND RECOMMENDATIONS

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PREFACE

While there may be no monopoly over good ideas, the same cannot be said about much of the infrastructure that provides water and sewerage services to Victorians. Large parts of this infrastructure display natural monopoly characteristics. A third party access regime provides the framework for ensuring that the owners of monopoly infrastructure cannot place unreasonable barriers in the way of potential new service providers. Indeed, a well designed access regime will provide infrastructure operators with a set of incentives to maximise the benefits to the broader community derived from the infrastructure under their control.

The Victorian Government announced in July 2008 that it would develop an access regime for water and sewerage infrastructure services. In November 2008, the Commission was directed to conduct an inquiry into developing an access regime and to present its final report to the Minister for Finance by 28 September 2009.

An effective state-based access regime would promote innovation, efficiency and reliability in water resource management and in the delivery of water and sewerage services to Victorians. Over recent years, prolonged drought conditions across most of Victoria and across southern Australia more generally, have highlighted the need for new thinking about how water is supplied, used and re-used throughout the state.

Clear and effective arrangements for allowing new water and sewerage service providers to share the use of existing (often under-utilised) natural monopoly infrastructure would facilitate broader participation in the water sector. This would allow businesses with innovative ideas, products and technologies for supplying water and sewerage services to participate in the water sector (without the prohibitive costs of inefficiently duplicating existing infrastructure). A state-based access regime would establish a clear and transparent framework for these businesses to negotiate arrangements for sharing the use of infrastructure facilities with an infrastructure operator. An effective access regime would neither favour nor discriminate against incumbent service providers.

Following an extensive process of research, analysis and consultation, the Commission is pleased to present its findings and final recommendations on developing a state-based access regime for water and sewerage infrastructure services.

In reaching its conclusions and formulating its final recommendations, the Commission has taken into account: submissions to its February issues paper and June draft report; feedback provided at the May and July public hearings; the National Competition Council's assessment of the New South Wales water industry access regime; access regimes in other industries and other jurisdictions; and its own detailed research and analysis.

One of the Commission's key priorities in recommending on the design of a state-based access regime has been to enable the development of a regime that provides certainty, clarity and transparency for participants in the water sector by:

- clearly defining the scope of a regime
- establishing a clear and transparent framework for negotiations and dispute resolution
- developing guidance on access pricing
- implementing accounting ring fencing potentially as a first step towards the functional separation of some businesses and
- establishing a licensing system to ensure that new water and sewerage service providers (including new infrastructure service providers) comply with obligations relating to health and safety, water quality, and customer and environmental protection.

Recognising the extensive work program required to establish an appropriate state-based access regime, the Commission has recommended that a staged implementation process be undertaken over the current regulatory period (to mid-2013). The first stage would facilitate the negotiation of access agreements without requiring legislative amendments. This would be in place within 12-15 months and it would ensure that the benefits from innovation and greater public participation in the water industry are not delayed while a comprehensive state-based regime is developed.

These initial arrangements will be built upon and refined in subsequent stages as knowledge about, and experience in, providing access increases. In time, new and more diverse service providers will start to participate in the Victorian water industry. Their experiences, along with those of incumbent operators, will inform the design of the final access arrangements. This will ensure that the resulting regime is comprehensive, clear and transparent and tailored to conditions in Victoria's water industry.

Additional benefits from a staged approach include: providing an opportunity to refine the access regime in light of state and national policy developments; better managing the implementation costs for the water businesses and other industry participants; and providing greater certainty that the Victorian regime will, in due course, satisfy the criteria for certification as an effective state-based access regime.

Discussions about access regimes do not make for light reading. To assist the reader and make the Commission's findings more accessible, this report is presented in three volumes. Volume I provides a synopsis of the Commission's findings, conclusions and recommendations. For readers wishing to delve further, the Commission's comprehensive analysis and discussion of issues is set out in volume II of this report. Supplementary background and technical information is provided in volume III.



Dr Ron Ben-David
Chairperson

STRUCTURE OF THE FINAL REPORT

The Commission's final report on its inquiry into developing a state-based access regime for water and sewerage infrastructure services is set out in three volumes:

- This volume sets out the Commission's findings and its recommendations to the Minister for Finance.
- The second volume provides a comprehensive explanation of the Commission's analysis and findings. It elaborates on the reasoning behind its recommendations and discusses responses received from stakeholders.
- The third volume comprises supplementary material set out in appendices to the report. These appendices provide background information and more technical analyses related to several issues covered in the second volume.

The three volumes are all available on the Commission's website www.esc.vic.gov.au. The Commission's issues paper, its presentation to the public hearing on 15 July 2009, submissions to the issues paper and draft report, and a report prepared by Deloitte on functional separation are also available on its website.

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THE COMMISSION'S FINDINGS

KEY FINDINGS

- The access regime should **cover the entire state**. Particular water or sewerage assets or networks within Victoria that display natural monopoly characteristics could be declared to be subject to the access regime.
- The access regime should establish **protocols for negotiations** between the owners of declared infrastructure ('infrastructure operators') and third parties wishing to use that infrastructure ('access seekers') in order to deliver services to customers.
- The access regime should provide mechanisms for the **resolution of disputes** between an infrastructure operator and an access seeker. Two models should be available: private arbitration by a commercial arbitrator or arbitration by the independent regulator.
- In most cases, the **price of access** should be determined using a 'retail minus' methodology. In some instances, it will be more appropriate to use a 'cost of service' approach.
- Functional separation of the competitive and non-competitive elements of the relevant water businesses would support the effective operation of an access regime. In the short term, **accounting separation** of declared assets will be more expedient.
- A licensing system should establish obligations and provide a legal framework for **enforcing compliance** with respect to resource management, health and safety, water quality and environmental and customer protection.
- Implementing an access regime will involve an extensive work program and detailed consultation with stakeholders. A **staged approach** over a three-year **implementation period** is recommended.
- In the first stage and prior to the legislated regime being enacted, the relevant water businesses should be required to **make 'access commitments'** applying to infrastructure that may be of interest to third parties.
- The Essential Services Commission has the necessary expertise to be the independent regulator of the Victorian water industry access regime. It should prepare the **necessary guidelines and frameworks** including those that would apply ahead of a legislated regime.
- This inquiry makes 36 recommendations in accordance with its terms of reference and identifies a range of matters requiring further consideration during the implementation period.

Background

On 19 November 2008, the Minister for Finance directed the Commission to undertake an inquiry into developing a state-based access regime for water and sewerage infrastructure services. On 15 April 2009, the Minister extended the due date for the Commission to submit the final report by four weeks to 28 September 2009.

The final report, which is set out in three volumes, presents the Commission's findings and final recommendations to assist the Government in developing an access regime covering water and sewerage infrastructure across Victoria.

As required by the terms of reference, the Commission has made recommendations on:

- defining the coverage of an access regime, that is, identifying clearly which infrastructure services should be subject to an access regime
- establishing a certain and transparent negotiation framework and dispute resolution mechanisms
- applying appropriate methodologies for access pricing and ring fencing of infrastructure operators' accounts and services subject to access
- identifying the measures necessary to maintain health and safety, water quality, customer protection, and environmental standards
- regulating an access regime, including defining the role of the Commission, and
- devising an implementation process with an indicative timeframe.

The report also identifies other policy areas where complementary measures could be implemented to support the effective operation of an access regime.

Objectives of an access regime

Developing an access regime is one aspect of the Government's broader policy program to ensure 'the efficient utilisation of existing and new sources of supply to protect the long-term interests of consumers with respect to water security, quality, reliability and price'.¹ An access regime will contribute to this objective by:

promoting the economically efficient operation of, use of and investment in water and sewerage infrastructure, thereby promoting effective competition in upstream and downstream markets.²

¹ Victorian Government 2008, *Victorian Government Response to the VCEC Final Report, Water Ways: Inquiry into Reform of the Metropolitan Retail Water Sector*, July, p. 5.

² From the terms of reference for the inquiry (see appendix A).

Competition is not an end in itself. Enabling new water and sewerage service providers to compete with the incumbent water businesses has the potential to benefit the community through greater innovation and efficiency in water sourcing and in water and sewerage service delivery.

But to compete effectively, a new water and sewerage service provider needs to share the use of infrastructure facilities operated by the incumbent businesses (as the infrastructure operators). The major water industry infrastructure facilities are 'natural monopolies'—this means that it is cheaper and more efficient to have a single provider of these infrastructure facilities. Where these facilities are not fully utilised, duplicating them would be wasteful of the community's resources. In addition, the prohibitive costs of duplicating facilities would make new water and sewerage service providers uncompetitive with the incumbent water businesses.

An effective access regime would facilitate the sharing of natural monopoly infrastructure facilities by potential new service providers. It would do this by establishing a legal right for potential new service providers to apply to share the use of (that is, obtain access to services provided by) natural monopoly infrastructure. It would also establish a clear and cost-effective framework for negotiating access agreements, backed up by mechanisms to resolve disputes where negotiations were unsuccessful.

In making its recommendations on developing an effective state-based access regime for the Victorian water industry, the Commission has focussed on designing access arrangements that will increase certainty, clarity and transparency for businesses seeking to share the use of infrastructure facilities (the access seekers) and the businesses operating those facilities (the infrastructure operators). These arrangements will streamline the access application process, reducing costs for both infrastructure operators and access seekers. In finalising its conclusions and recommendations, the Commission has taken into account the information and comments provide by stakeholders and other interested parties during its extensive consultation process.

The scope of a Victorian water industry access regime

The terms of reference for this inquiry required the Commission to make recommendations on which infrastructure services in the Victorian water sector should be subject to (or covered by) a state-based access regime. In broad terms, these will be services provided by natural monopoly infrastructure facilities that are not economically feasible to duplicate. The coverage, or scope, of an access regime should be clearly defined in order to provide certainty and clarity to infrastructure operators and access seekers.

The Commission has concluded that an access regime should cover the entire state of Victoria to give access seekers and infrastructure operators certainty about the regime's scope.

A Victorian access regime should apply to urban and rural water and sewerage transport services including services, such as storage and metering services, that are subsidiary but inseparable to providing transport services. They would exclude:

the filtering, treating or processing of water or sewage; the use of a production process; the use of intellectual property; and the supply of goods, including the supply of water or sewage; except to the extent that these services are an inseparable part of providing transport services.

Storage services provided by large storages like dams and reservoirs should also be subject to an access regime. In the Commission's view, providing access to short term storage services would: facilitate new water services providers' capacity to provide water services to meet their customers' needs; improve efficiency by making use of under-utilised infrastructure; and allow infrastructure operators (the existing water businesses) to earn a return on the spare capacity in large storages.

The Commission did not accept submissions that potential operational and risk concerns justified excluding these storage services from the scope of an access regime. Access seekers and infrastructure operators would negotiate appropriate arrangements for dealing with operational issues, including the risks associated with providing access. A number of options are available to appropriately minimise and allocate risk.

It is important to highlight that an access regime would only apply to infrastructure facilities. It would not apply to the resources—the water, recycled water, sewage and other wastewater—that are transported by or stored in infrastructure facilities like water and sewerage pipelines and dams.

The Commission sees value in identifying specific infrastructure services that would be subject to (that is, declared as covered by) a state-based access regime from the commencement of the regime, that is, when the legislation establishing the regime takes effect. The specific services to be declared from the commencement of the regime would be identified during the implementation period recommended by the Commission. Those services would both meet the declaration criteria and be most likely to be subject to access applications.

Declaring specific infrastructure services from the outset would improve certainty and clarity for industry participants and potential new entrants. It would also reduce the time and costs associated with obtaining access to the declared services.

The Commission has concluded that provisions for non-coverage declarations should not be included in a state-based access regime as they do not significantly improve certainty for infrastructure operators or address investment risks. It recommends that the regime include provision for case-by-case review of coverage declarations to take account of changes in relevant circumstances.

While recognising the potential for inter-state issues to arise, particularly in respect of the Murray-Darling Basin, the Commission notes that it is not possible to address matters of consistency at this time in the absence of detailed information about proposed regimes in other States. In designing their respective access regimes, all Governments should be mindful of keeping transaction costs as low as possible for access seekers making applications across access regimes in different jurisdictions.

Negotiation framework and dispute resolution

The negotiate/arbitrate model forms the basis of an access regime as it allows infrastructure operators and access seekers to negotiate access on mutually beneficial terms and conditions that suit their particular circumstances. Well designed negotiation and dispute resolution processes will promote efficient outcomes by enabling access seekers and infrastructure operators to negotiate on an equal footing within a transparent and certain framework.

The Commission recommends that a state-based access regime should establish negotiation protocols, timeframes for various stages of the negotiation process, and minimum requirements for information provision. The Commission would develop guidelines on these matters and publish general information about the access regime, the regulatory framework, the application process, negotiation protocols, dispute resolution mechanisms, licence requirements, and water resource planning in Victoria.

Infrastructure operators should be able to apply to the regulator of an access regime for approval of access undertakings that set out the terms and conditions of access for specific infrastructure services. Undertakings would give infrastructure operators and potential access seekers greater certainty about the terms and conditions on which access will be made available, while allowing for negotiation on specific matters.

Where an infrastructure operator and access seeker cannot reach agreement through negotiation, and mediation is not successful in resolving an access dispute, an access regime should provide for binding arbitration of the dispute by an independent party. Two arbitration options would be available: private arbitration under the *Commercial Arbitration Act 1984* by a commercial arbitrator agreed on by the parties; and arbitration by the independent regulator (the Commission).

When the Commission arbitrated in a dispute, the parties would have recourse to two avenues of appeal: limited merits based review (which would assess the correctness and reasonableness of the decision) and judicial review (which would assess whether the decision was made correctly according to law). Decisions made by a private arbitrator would be subject only to judicial review.

Access pricing

Access prices will play a key role in the effectiveness of an access regime. Access prices should allow new water and sewerage providers to participate effectively in the water sector while ensuring that infrastructure operators can recover the costs of providing access. They should also create incentives for businesses to operate efficiently.

The Commission considers that access pricing negotiations between an infrastructure operator and access seeker would be facilitated by formulating pricing principles and guidance on pricing methodologies. Access pricing principles should be designed to allow new water and sewerage providers to participate

effectively in the water sector while ensuring that infrastructure operators can recover the costs of providing access. They should also create incentives for businesses to operate efficiently.

The two key approaches to determining access prices are the cost of service approach and the retail minus approach. Both approaches ensure that the infrastructure operator is able to generate sufficient revenue to cover the efficient cost of providing access to the relevant infrastructure without allowing it to generate monopoly profits.

Under the cost of service (or 'building block') approach, access prices are determined by estimating the cost to an infrastructure operator of sharing with an access seeker the use of its infrastructure. In contrast, the retail minus approach uses existing regulated retail prices as the basis for determining access prices. The regulated retail price for a bundled service is discounted by the costs that are avoided by not providing those components of the bundled service that the access seeker does not require. Conceptually the cost of service and retail minus approaches are different ways of calculating the same access price although, in practice, difficulties in estimating some costs may result in somewhat different prices.

Each approach has different advantages and disadvantages in practice. The retail minus approach is generally regarded as simpler and less costly to apply than the cost of service approach and only needs to be applied when an access application is received. Conversely, the cost of service approach provides greater certainty that access prices reflect costs and is consistent with the Commission's approach to setting regulated prices during its regular price reviews. Adopting it for setting access prices would, however, require the calculation of disaggregated regulatory asset values for infrastructure facilities providing services subject to access.

Submissions by a number of water businesses opposed use of the cost of service approach on the grounds that it would allow for 'cherry picking' of high-value customers by new water and sewerage service providers (who, it is claimed, would have an unfair advantage that allowed them to undercut the existing service providers). This concern is unfounded if the cost of service approach is applied correctly—that is, if it is applied in combination with an averaging process to ensure that access prices and retail prices exhibit the same level of aggregation.

After weighing up each approach's advantages and disadvantages, as well as the practical considerations, the Commission has concluded that the retail minus approach be used to calculate access prices in most cases where the final retail price is regulated and the infrastructure operator provides services in the regulated retail market.

The cost of service approach should be used in two circumstances. The first is where the costs associated with providing an infrastructure service can be easily identified, such as services provided by a discrete infrastructure facility (for example, a large pipeline like the Goldfields Superpipe) where a separate regulatory asset value for the facility could be easily calculated. The second case is where a price for providing infrastructure services has already been calculated

using the cost of service approach, such as Melbourne Water's charges for bulk water and sewerage transport services.

The Commission considered that a number of other more technical pricing issues should be addressed when the detailed provisions for establishing an access regime are determined during the implementation period. These issues related to the structure of access prices, greenfields investments, capacity constraints and allocating augmentation costs, pricing when by-pass is possible, consistency between access pricing and the current regulatory framework, and the setting of disaggregated regulatory asset values.

Ring fencing—accounting separation and functional separation

Ring fencing is the process of separating certain services or functions provided by a business from its other services or functions. In the context of an access regime, the purpose of ring fencing is to ensure that the costs of providing the infrastructure services subject to access are clearly identified and exclude any costs that should be allocated to other services.

Clarity around these costs will promote the effective operation of an access regime by providing transparency in access pricing. This will, in turn, give access seekers confidence that access prices accurately reflect costs and do not discriminate between users of those infrastructure services to, for example, give a cost advantage to a business (or business unit) associated with the infrastructure operator relative to the access seeker.

Effective ring fencing arrangements will provide the owners of the relevant assets with an incentive to maximise the value of those assets by actively facilitating their use by access seekers. The efficacy of a ring fencing arrangement can be assessed by how well it aligns the interests of the infrastructure owner with the interests of water and sewerage customers—observed through the introduction of innovative (and/or less costly) products and services.

There are several ring fencing options available to policymakers. These involve different degrees of institutional robustness. More rigorous forms of separation will produce greater benefits in terms of cost transparency, efficiency in the setting of access prices, and confidence in access pricing processes. While providing infrastructure owners with clearer incentives, more rigorous forms of separation are more costly to implement.

The Commission has found that functional separation is the option that is most likely to promote the effective operation of an access regime. Functional separation would require an infrastructure operator to operate its natural monopoly infrastructure functions as if they were independent of the business' retail and corporate service functions. This would entail separation of accounts and staffing, controls on information flows, separate decision making, and payment through transfer prices for services provided by and to other functional units.

The Commission recognises, however, that implementing functional separation would involve significant costs and an extended implementation period, as

highlighted in submissions by VicWater and the water businesses. It has concluded, therefore, that functional separation should not be required at this stage. In order to avoid unnecessary costs and delays in implementing an access regime, the Commission considers that, at least initially, ring fencing should be limited to accounting separation of all infrastructure services that can reasonably be expected to be the subject of an access application.

Accounting separation would entail only the separating out (or ring fencing) of the accounts for infrastructure facilities providing services subject to access from the rest of the business' accounts. The costs incurred in providing shared services, such as corporate services (like finance, human resource management, and IT) and services supplied by shared infrastructure facilities, would have to be allocated between the separated infrastructure facility and the business' other activities. It would be significantly cheaper and easier to implement than functional separation, particularly as some water businesses already have some degree of accounting ring fencing in place.

After accounting separation has been implemented and operating for a reasonable period of time, the Commission will assess whether it has resulted in sufficient clarity and transparency of costs. The Commission will also assess whether accounting separation has supported the effective operation of an access regime by providing market participants and potential access seekers with sufficient confidence in access pricing and compliance with other processes. If this is found not to be the case, functional separation (at a minimum) should be implemented by the relevant water businesses. The Commission considers that the review of outcomes from accounting separation should be undertaken towards the end of the implementation period.

Protection of health, customers and the environment

An important objective in implementing an access regime is to ensure that existing obligations related to health and safety, water quality, customer protection and environmental protection are extended, as necessary, to new water and sewerage service providers, including infrastructure service providers. There was general support in submissions to this inquiry for extending these existing obligations to new providers of water and sewerage services.

The Government will need to conduct a comprehensive review of the relevant legislation and regulations to identify amendments or additional measures needed to extend these obligations and ensure the relevant regulator has sufficient powers to require compliance. Legislation requiring possible amendment would include the *Environment Protection Act 1970*, the *Safe Drinking Water Act 2003*, and the *Occupational Health and Safety Act 2004*.

The Commission recommends that a licensing system be established to clarify the rights and responsibilities of water and sewerage service providers and establish a legal framework for enforcing compliance with obligations relating to resource management, customer protection, health and safety, water quality, and the environment. Licences would impose certain conditions and obligations on new water and sewerage service providers, including operational and technical

requirements, information collection and reporting requirements, and financial capacity requirements. The types of licences and detailed licence conditions should be considered further during the process of establishing a licensing system during the implementation period for an access regime.

Recognising the Minister for Water's role in managing Victoria's water resources under sec. 22 of the *Water Act 1989*, the Commission proposes that the Government should determine whether the Minister or the Commission should be responsible for granting or refusing license applications and the appropriate role of the Minister in making those decisions. The Government would also need to consider whether the publicly-owned water businesses should be licensed under a licensing system and whether any amendments to the Statements of Obligations applying to those businesses are necessary.

Regulation of an access regime

The Commission considers that it is best placed to regulate an access regime for the Victorian water industry, including making coverage declarations for specific infrastructure services, arbitrating in access disputes, determining access prices (where necessary) and formulating pricing principles, administering the licensing system, and advising the Government on the operation of the regime.

The Commission has significant experience in regulating access regimes in other industries as well as considerable expertise in regulating the water industry. Appointing it as the regulator of a water industry access regime would ensure consistency in the regulation of the industry and reduce the regulatory burden on the industry. The Commission is independent and sufficiently resourced to properly regulate an access regime.

The transparent and open manner in which the Commission undertakes its regulatory functions would promote confidence in the effectiveness of the regulatory framework for the regime. In addition, its decisions would generally be subject to limited merits review by an independent appeal panel.

Other issues

The terms of reference for this inquiry invited the Commission to make observations regarding potential barriers to implementing an effective access regime. The Commission has identified a number of matters requiring further consideration by the Government in the context of establishing an effective access regime. These matters are listed in the section below ('Matters for further consideration').

Coordination and network management measures will also be needed to ensure that the operation of the Victorian water industry is economically efficient when a larger number of businesses are providing water and sewerage services in the existing service areas.

A staged approach to implementing a Victorian water industry access regime

The Commission's final report sets out a large number of recommendations on measures to establish an effective access regime tailored to conditions in the Victorian water industry. An extensive work program would be required to work out the details of these measures, in consultation with stakeholders, and then to implement them. Legislative amendments would be required to: establish the legal framework for the regime; extend obligations relating to health and safety, water quality, and customer and environmental protection to new water and sewerage service providers, including establishing a licensing system; and to provide the necessary powers to the relevant regulators.

In addition, it will be necessary to investigate the potential barriers to the effective operation of an access regime and then to identify and implement appropriate measures to address them.

The Commission recommends a staged implementation process for establishing an access regime and a licensing system. A staged process would allow for monitoring of early outcomes and for refinements as required to tailor the regime to the specific conditions of Victoria's water sector. The initial measures would establish the basic foundations for an access regime, with subsequent measures building on these foundations to produce a comprehensive and well-designed regime that will maximise the benefits for Victorians.

A major advantage of this staged approach to implementation is the opportunity to refine and improve the initial arrangements based on the information and knowledge gained from experience during the implementation period. Learning from experience is particularly important since there are limited models of effective access regimes in other industries available to inform the development of a water industry access regime in Victoria. In these circumstances, the Commission considers that proceeding straight to developing a comprehensive, legislated access regime could run the risk of 'locking in' poorly designed arrangements that do not achieve the Government's objectives for an access regime.

The Commission recommends that an access regime for the Victorian water industry be implemented in four main stages:

- The first stage would establish the foundations for a state-based access regime. The Commission would develop guidance, in consultation with stakeholders, on the initial arrangements. Relevant water businesses will be required to make 'access commitments' to clarify which infrastructure services will be subject to access and to set out a transparent framework for negotiations (backed up by dispute resolution mechanisms) between infrastructure operators and access seekers. These arrangements would be developed in the first 12 months of the implementation period. The Government would commence the process of developing a licensing system (expected to take 12-18 months in total).
- In the second stage, the early outcomes from the measures implemented in the first stage would be monitored to identify any shortcomings or unintended

consequences from the arrangements. The monitoring process would take about 12 months. The legislative amendment process would commence in the later part of this stage (and is expected to take 12-18 months in total).

- The third stage would include the enactment or amendment of legislation and regulations underpinning the regime, completing the legislative amendment process commenced in the second stage. Any required refinements to the access arrangements, identified during the monitoring conducted in the second stage, would be made during this stage.
- The final stage would occur after the legislation establishing the access regime and licensing system is enacted and the Commission has completed and published all necessary guidance documents. The Government would then decide when to apply for certification of the regime under the *Trade Practices Act 1974*.

The recommended process will minimise implementation costs while avoiding unnecessary delay in opening up greater opportunities for participation in the water sector. It will also ensure that implementation costs will be spread over time, which avoids placing an unmanageable burden on industry participants, particularly the water businesses. If regulatory arrangements or implementation processes were to prove more costly than anticipated, modifications could be made to ensure that costs were kept within reasonable bounds.

The staged process will thereby ensure that the benefits from implementing an access regime outweigh the costs. It will allow for a step-by-step approach to addressing the full list of recommendations and broader work program set out in this final report. The Commission has drawn up an indicative timetable showing the sequencing of the key implementation stages and feasible timeframes for completing each stage. A three year implementation period is recommended.

RECOMMENDATIONS

Recommendation 3.1

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

Recommendation 3.2

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

Recommendation 3.3

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

Recommendation 3.4

That the storage services provided by large infrastructure facilities like dams and reservoirs be subject to a state-based access regime.

Recommendation 3.5

That rural water transport services be subject to a state-based access regime.

Recommendation 3.6

That the Government declares specified infrastructure services as being covered by the regime from the date when the legislation establishing the regime takes effect. In addition to satisfying the declaration criteria, these services will either have access arrangements in place or will have been assessed, during the implementation process, as likely to be subject to an access application.

Recommendation 3.7

That the Government establish a process for making coverage declarations for specific infrastructure services. An appropriate process should be established during the implementation period in consultation with the water businesses and other stakeholders. The process should not impose unreasonable costs on any of the parties or take an unreasonable length of time.

Recommendation 3.8

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

Recommendation 4.1

That the Government establishes a right for access seekers to negotiate access to infrastructure services subject to the state-based access regime and require infrastructure service providers to use all reasonable endeavours to accommodate access seekers' requirements.

Recommendation 4.2

That the regulator of a state-based access regime provides general information required by access seekers and establishes minimum requirements for the type of information that infrastructure operators must make available to access seekers and that access seekers must provide to infrastructure operators.

Recommendation 4.3

That the Government requires infrastructure operators and access seekers to comply with the negotiation protocols to be developed by the Commission, in consultation with stakeholders.

Recommendation 4.4

That fees and charges relating to access applications be determined by the regulator. These fees and charges would reflect costs.

Recommendation 4.5

That a state-based access regime should include provisions to allow infrastructure operators to submit voluntary access undertakings setting out the terms and conditions on which access will be made available to the infrastructure service(s) subject to the relevant undertaking. The regulator would assess the undertaking for consistency with the general provisions of the access regime and approve or reject the undertaking.

Recommendation 4.6

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

Recommendation 5.1

That the cost of service approach is used to determine access prices in respect of infrastructure where the costs associated with providing an infrastructure service can be readily identified or where a price for infrastructure services has already been calculated using the cost of service approach (such as Melbourne Water's bulk water and sewerage charges).

Recommendation 5.2

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

Recommendation 5.3

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

Recommendation 6.1

That the Commission develops guidance for implementing accounting separation of infrastructure services subject to access, in consultation with key stakeholders.

Recommendation 6.2

That within 3 months of an infrastructure service being coverage declared under an access regime or subject to an approved access undertaking, infrastructure operators must maintain separate accounting information for that infrastructure service, in accordance with the accounting separation guidance developed by the Commission.

Recommendation 6.3

That, after accounting separation has been implemented, the Commission should review the efficacy of accounting separation in generating sufficient clarity and transparency of costs and promoting sufficient confidence among market participants and potential access seekers in access pricing processes to support the effective operation of an access regime.

Recommendation 7.1

That, during the implementation period, 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. This legislation would include the *Environment Protection Act 1970*, the *Safe Drinking Water Act 2003*, and the *Occupational Health and Safety Act 2004*. The review should identify amendments or additional measures required to extend (as appropriate) existing obligations in regard to these matters to new water and sewerage service providers, including infrastructure service providers, and to ensure that the relevant regulator has sufficient powers to require compliance with these obligations by all service providers.

Recommendation 7.2

That the Government establishes a licensing system for new water and sewerage service providers, including new infrastructure service providers.

Recommendation 7.3

That the Government incorporates appropriate provisions for limited merits review of licensing decisions in establishing a licensing system.

Recommendation 7.4

That annual licence fees for licences in the Victorian water industry be determined by the Commission in consultation with other relevant regulators, including the Environment Protection Authority and the Department of Human Services and that licence application fees be determined by the Commission.

Recommendation 7.5

That the Government incorporates provisions for granting exemptions from some licence conditions in limited circumstances.

Recommendation 8.1

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

Recommendation 9.1

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

Recommendation 9.2

That the Government develop, in consultation with the water businesses, appropriate arrangements for: network balancing; interconnections into infrastructure facilities; information exchange and metering of water and sewage flows; network operation, maintenance and expansion; and emergency management.

Recommendation 10.1

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

Recommendation 10.2

That the Commission develops guidance, in consultation with the water businesses and other interested parties, on: identifying infrastructure services that should be subject to access commitments; matters that should be included in access commitments; a negotiations framework, including timeframes and negotiations protocols; access pricing methodologies and tariff structures for access prices; and accounting ring fencing.

Recommendation 10.3

That the Government requires the water businesses to prepare 'access commitments' giving access seekers the right to negotiate access to nominated infrastructure services during the implementation period, in accordance with guidance prepared by the Commission, within six months of the development of that guidance. These services would be key infrastructure services for which access requests are likely.

Recommendation 10.4

That provision be made for the water businesses to make additional access commitments in respect of specific infrastructure facilities subsequently identified as satisfying the criteria set out in the guidance prepared by the Commission and for access commitments already made by the water businesses to be revoked if justified by a change in circumstances.

Recommendation 10.5

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

Recommendation 10.6

That the Government require water businesses that make access commitments during the implementation period to establish accounting separation for the infrastructure service(s) subject to an access commitment, within three months of making the access commitment. The accounting separation measures adopted by the water business should be consistent with the relevant guidelines developed by the Commission.

Recommendation 10.7

That the Government develops and enacts new legislation and regulations, or amends existing legislation and regulations, to establish the legal framework for the access regime during an implementation period. The Government should aim to complete its legislative and regulatory work program within three years of the commencement of the implementation period.

Recommendation 10.8

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

MATTERS FOR FURTHER CONSIDERATION

Coverage of an access regime

Should the Murray-Darling Basin become (or be proposed to become) subject to another state-based access regime, the Victorian Government should, at that time, consider whether an inter-governmental agreement should be made with the relevant State Government to ensure that a single process applied for seeking access to infrastructure services.

The allocation of responsibility for providing retail meters should be considered by the Government in the context of establishing an access regime, its policy program for the water sector and other relevant policies.

Access pricing

In formulating pricing principles and guidance on access pricing, the Commission will give further consideration, in consultation with the water businesses and other interested parties, on:

- the structure of access prices to ensure that access prices reflect cost, send appropriate price signals and recover the full cost of providing access to services
- the calculation of risks associated with new infrastructure investments, including greenfields investments
- mechanisms for allocating capacity when capacity constraints exist
- allowing price discrimination when it aids efficiency, for example, in setting access prices to deter inefficient by-pass
- methods for determining separate regulatory asset values for specific assets, namely infrastructure assets providing services subject to access, and
- mechanisms for adjusting any scheduled access prices during a regulatory period.

In the context of the 2013 price review, the Commission will consider whether the extent of access during the implementation period is sufficient to justify determining scheduled access prices for specific infrastructure services.

Ring fencing

If the Commission's review of the efficacy of accounting separation finds that it is not sufficient to support the effective operation of an access regime, functional separation should be implemented by the relevant water businesses. An implementation process and timeframe should be developed by the relevant water businesses and approved by the Commission.

Licence conditions

The appropriate types of licence should be considered further during the implementation period.

Licences should specify licence conditions. The appropriate licence conditions should be considered further during the implementation period but should include:

- a condition requiring new water service providers to demonstrate how they plan to obtain sufficient quantities of water to provide the proposed services
- a condition requiring compliance with relevant parts of the Customer Service Code (according to the types of service provided and the nature of the customer) and any other relevant codes of conduct that may be developed
- a condition requiring any water or sewerage service provider providing services to retail customers to join the Energy and Water Ombudsman of Victoria (EWOV) scheme
- conditions establishing obligations relating to the preparation and implementation of adequate risk management plans and emergency management and contingency plans
- conditions relating to meter installation, maintenance, and reading, appropriate sharing of meter data, and customer connection procedures
- conditions requiring licensed infrastructure operators to prepare detailed infrastructure operating plans covering design, construction, operation and maintenance to ensure that facilities are properly designed and constructed, operated in a safe and reliable manner, and maintained in a proper condition
- a condition requiring licensed infrastructure operators to observe industry codes, standards, rules and guidelines in designing and constructing water and sewerage infrastructure
- conditions requiring licensees to provide the information required by:
 - the Commission to perform its regulatory and monitoring functions
 - other regulators, including the Department of Human Services, the Department of Sustainability and Environment, and the Environment Protection Authority, to undertake their regulatory and monitoring functions and
 - the Minister for Water to undertake the water resource assessments required under section 22 of the *Water Act 1989*
- a condition requiring the licensing authority to be satisfied that the applicant has, and will maintain, the technical capacity to comply with the conditions of the licence and has the continuous financial viability to do so, and
- a cross reference to existing legislative obligations giving the licensing authority the power to revoke a licence if a licensee persistently breached conditions set out in the *Environment Protection Act 1970*, the *Safe Drinking Water Act 2003*, the *Occupational Health and Safety Act 2004* or other relevant legislation.

In establishing a licensing system for new water and sewerage service providers, including new infrastructure service providers, the Government should nominate whether the Minister for Water or the Commission is responsible for making decisions on granting or refusing licence applications and licence transfer applications and revoking licences.

The Government should consider whether the constitutional provision in respect of public ownership in the Victorian water industry limits or affects whether publicly-owned water authorities should be incorporated into a licensing regime.

If the publicly-owned water businesses are required to be licensed under a licensing system, the Government should review and amend, as necessary, the Statements of Obligations applying to those businesses.

If the publicly-owned water businesses are required to be licensed under a licensing system, the Government should incorporate provisions for deeming some existing water and sewerage service providers (that is, the publicly-owned water businesses) as having met the requirements for a licence from the commencement of a licensing system.

Periodic review of an access regime

During the first review of the state-based access regime following its implementation, the frequency of future periodic reviews of the regime should be determined.

Potential barriers to the effective operation of an access regime

The Government should review the entitlements system established by the *Water Act 1989* in the context of establishing an access regime and consider whether any new sources of water would require some form of entitlement.

The Government should investigate the implications for economic efficiency and assess the costs and benefits of extending the existing trading arrangements for water in the context of establishing an access regime

The Government should investigate the implications for economic efficiency of the provisions in the *Water Industry Act 1994* and the *Water Act 1989* that limit a water business to only servicing customers within a specified geographic area and assess the costs and benefits of removing those provisions in the context of establishing an access regime.

The Government should review its bulk water procurement processes to assess opportunities for improving the efficiency of those processes in the context of establishing an access regime.

The Government should review the adequacy and timeliness of publicly available information related to resource planning in the context of establishing an access regime.

The Government should review the application of restrictions policies and clarify whether, and if so, how, restrictions policies would apply to new water sources in the context of establishing an access regime.

The Government should review the application of the environmental levy, as well as other taxes and government charges paid by the water businesses, to identify whether the same taxes and charges would or should apply to new water and sewerage service providers in the context of establishing an access regime.

The Government should review the state planning schemes, and associated legislation and regulations, to determine whether any of their provisions would present a barrier to the effective operation of an access regime.

GLOSSARY

Access commitment	An agreement by an infrastructure operator to negotiate with access seekers on sharing specified infrastructure services.
Access regime	An access regime is a set of legislative and regulatory arrangements that establish a right for an access seeker to negotiate with an infrastructure operator to share the use of natural monopoly infrastructure. An access regime generally includes a framework to facilitate access negotiations and dispute resolution mechanisms to apply when agreement cannot be negotiated.
Access seeker	A business or individual who applies to share the use of natural monopoly infrastructure.
Access undertaking	A voluntary commitment by an infrastructure operator that sets out the terms and conditions on which it will share the use of a specified natural monopoly infrastructure facility.
Arbitration	A process for resolving disputes between people or organisations by referring them to an arbitrator, either agreed on by them or provided by law. Typically, an arbitrator's decision is final and binding.
Certification	A determination by the relevant Australian Government Minister (the Minister for Competition Policy and Consumer Affairs) that a state-based access regime is consistent with the principles in clause 6 of the Competition Principles Agreement.
Cherry picking	Singling out the most profitable customers from the larger customer base. Generally, this occurs where the price for a service reflects the average cost of providing a service to all customers and some customers can be serviced at a lower cost.
Cost of service approach	A methodology for determining access prices. Determined by estimating the costs of providing each element of a service covered by an access regime. Also known as the 'building block' approach.

Coverage	The scope of an access regime. Specifically, the geographical area and types of infrastructure services to which the regime applies.
Declaration	Confirmation that a particular infrastructure service satisfies the declaration criteria.
Declared service	A specific infrastructure service that has been determined to satisfy the declaration criteria for access.
Economies of scale	A reduction in the unit cost of an activity that occurs when the number of units produced (volume of output) increases.
Functional separation	Where certain functions or activities of the business are operated as if they were independent of the rest of the business.
Greenfields investment	Investment in a facility in an area where no similar facilities already exist.
Infrastructure services	Services provided by using water and sewerage infrastructure facilities.
Judicial review	A type of court proceeding in which the judge reviews the legality of a decision or action taken by a public body.
Merits review	A process where a person or body other than the original decision maker reconsiders the facts, law and policy aspects of the original decision to decide if it was the correct and reasonable decision given the available information and circumstances.
Natural monopoly	Exists where the costs of providing services is lower when there is a single supplier due to economies of scale over the range of demand for the service.
Regulatory asset value	The value of water business assets for regulatory purposes. These values were initially set by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.
Recycled water	Wastewater that is treated to a standard appropriate for its intended use.
Retail minus approach	A methodology for determining access prices. Determined by taking the approved retail price for a bundled service and applying a discount to account for the service components that the access seeker does not require from the infrastructure operator.

Ring fencing	The process of providing separate accounts for certain functions within a business.
Sewage	Liquid waste discharged into the sewerage system.
Sewerage	A physical arrangement of pipes and plant for the collection, removal, treatment and disposal of liquid waste.
Transfer price	The price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company in order to calculate each division's profit and loss separately.
Wastewater	Includes greywater, sewage and stormwater.
Water entitlement	A right to use water determined by the Minister for Water under the <i>Water Act 1989</i> (Vic). A water entitlement is the maximum amount of water authorised to be taken and used by a person or organisation under specified conditions.
Water storage	A space to hold water, such as a dam or reservoir.