SUBMISSION BY THE ESSENTIAL SERVICES COMMISSION OF SOUTH AUSTRALIA

ON

THE REPORT PREPARED BY THE SOUTH AUSTRALIAN DEPARTMENT OF TREASURY AND FINANCE ENTITLED "ACCESS TO WATER AND SEWERAGE INFRASTRUCTURE"

15 March 2013

1. INTRODUCTION

1.1 The Essential Services Commission of South Australia (**Commission**) welcomes the opportunity to provide comments on the report prepared by the South Australian Department of Treasury and Finance (DTF), entitled *Access to Water and Sewerage Infrastructure* (**the Report**).

1.2 The Commission is established under the Essential Services Commission Act 2002 as a general independent economic regulator, and is currently responsible for economic regulation of the South Australian water industry. It also performs regulatory functions in the electricity, gas, ports and rail industries.

1.3 The Commission's primary objective is the "protection of the long-term interests of South Australian consumers with respect to the price, quality and reliability of essential services".[1]

1.4 The Commission's comments on the Report are informed by:

1.4.1 the *objects* of the Water Industry Act (the WIA), which include "*promote efficiency, competition and innovation", "the transparent setting of prices", "facilitate pricing structures that reflect the true value of services provided", "protect the interests of consumers*"; and

1.4.2 the Commission's primary statutory objective.

1.5 The Commission submits that a strong, comprehensive and effective state-based access regime is required if the promotion of competition and related key objects of the WIA are to be achieved.

1.6 The Commission further submits that the access regime should be stronger and more comprehensive than that proposed in the Report if it is to be effective in promoting competition and other WIA objectives.

1.7 The Commission's detailed submissions focus on two important aspects of access regulation:

1.7.1 the scope of the access regime; and

1.7.2 the extent of its light-handedness.

2. SCOPE OF THE ACCESS REGIME

2.1 The Commission submits that the scope of the access regime proposed in the Report is too narrow; in particular, the Commission has focussed on:

2.1.1 use of the "natural monopoly" test;

[1] Essential Services Commission Act 2002, section 6(a).

2.1.2 exclusion of certain infrastructure services; and

2.1.3 exclusion of access to resources (water and/or wastewater).

Use of the "natural monopoly" test and certification of the proposed regime

2.2 The report appears to use the "natural monopoly" test as the sole criterion to determine coverage of the access regime.

2.3 In that context, the Report rightly refers to clause 6(3)(a) of the Competition Principles Agreement (CPA) as providing guidance on this matter. A fundamental element of that clause, when considering the coverage of a regime, arises from clause 6(3)(a)(i): the "economically feasible" test.

2.4 That clause provides (relevantly):

> *6(3) For a State or Territory access regime to conform to the principles set out in this clause, it should:*
>
> *(a) apply to services provided by means of significant infrastructure facilities where:*
>
> *(i) it would not be economically feasible to duplicate the facility;….*

2.5 If the proposed regime is to obtain certification, the Government will need to be demonstrating that this test has been met. From the Report, it appears that the means by which this will be done is through use of a "natural monopoly test".

2.6 While ultimately a matter for the Government, the Commission notes that this "natural monopoly" test has recently been disapproved by the High Court in the matter of *The Pilbara Infrastructure Pty Ltd v. Australian Competition Tribunal* [2012] HCA 36.

2.7 In that matter, the High Court has stated that, for the purposes of clause 6(3)(a)(i), the relevant test for the "economically feasible" criterion is one of private profitability. The High Court said (at paragraph 77):

> *(i) The better view of criterion (b) is that it uses the word "uneconomical" to mean "unprofitable". It does not use that word in some specialist sense that would be used by an economist. Further, criterion (b) is to be read as requiring the decision maker to be satisfied that there is not anyone for whom it would be profitable to develop another facility. It is not to be read as requiring the testing of an abstract hypothesis: if someone, anyone, were to develop another facility. When used in criterion (b) "anyone" should be read as a wholly general reference that requires the decision maker to be satisfied that there is no one, whether in the market or able to enter the market for supplying the relevant service, who would find it economical (in the sense of profitable) to develop another facility to provide that service.*

2.8 The Commission submits that the Government should have regard to the High Court's decision in *The Pilbara* and amend the terms of its proposed regime accordingly.

Use of the "natural monopoly" test generally

2.9 Section 3.1.1 of the Report states that, based on market analysis (which has not been provided for review), only four elements of the supply chain (bulk water transport, water distribution transport, bulk sewerage transport and local sewerage transport) are likely to "*exhibit natural monopoly characteristics*". It indicates that no other infrastructure should be within the access regime unless they are "*integral to the operation of the infrastructure services for which access is being sought*".[2]

2.10 No reasons are given for exclusion of other supply chain elements, other than the suggestion that a 1997 report prepared by Tasman Asia Pacific identified only four elements of the supply chain as meeting the criteria for declaration of access.

2.11 The inclusion or exclusion of supply chain elements is a fundamental consideration in an access regime and the Commission submits that this area of the proposed regime should be revisited so as to make clear why certain elements are to be excluded.

2.12 In that context, the Commission notes that the concept of natural monopoly is an important reason why some players may not have access to vital supply chain elements required to compete, but it is not the only one.

2.13 In particular, industry participants may not be able to access some elements of the supply chain (at least on competitive terms) simply because an incumbent – for historical reasons, rather than natural monopoly reasons – has control of those elements. Given that those elements exist, it may not be profitable for any other player to duplicate them.

2.14 The Commission has made this point previously; for example, in its advice to the Treasurer in June 2012 it stated that:

> *The Commission believes that the introduction of a strong, comprehensive and effective access regime is imperative for the achievement of the Act's objectives. The Commission also believes that the access regime will need to cover infrastructure services that are subject to the potential misuse of market power, including natural monopolies (such as transportation pipelines and distribution infrastructure) and other infrastructure services largely controlled by SA Water (such as bulk water supply sources).*[3]

[2] Department of Treasury and Finance, *Access to Water and Sewerage Infrastructure*, February 2013, p 15.

[3] Essential Services Commission of South Australia, *Economic Regulation of the South Australian Water Industry: Final Advice*, June 2012

2.14.1 The Commission submits that more infrastructure services should be included within the access regime.

2.14.2 The Commission's survey of other water access regimes indicates that a broader approach has generally been adopted, in order to maximise the benefits of access. For example:

(a) In Scotland, the incumbent (Scottish Water) is required to sell bulk water (that is, wholesale) to retailers, delivered to the retailer's customer's premises. Scottish Water uses infrastructure from all elements of the supply chain to do this. It must charge under the "Wholesale Charges Scheme" and these charges are set by the regulator. Retailers therefore indirectly have access to all elements of the supply chain.

(b) In England and Wales, incumbents must use best endeavours to negotiate "bulk supply agreements" with new entrants for the delivery of bulk water and the regulator can (and does) determine prices if no agreement can be reached. Again, retailers therefore indirectly have access to all elements of the supply chain.

(c) In addition, the U.K Draft Water Bill will allow retailers to buy raw water and access all infrastructure elements to move the water to their customers' premises.

(d) Under the NSW access regime, "water infrastructure" is broadly defined as "*any infrastructure that is, or is to be, used for the production, treatment, filtration, storage, conveyance or reticulation of water" to the access seeker's connection point*".

(e) The Victorian access regime is most similar to that proposed in the Report, as it defines the relevant water infrastructure services as "transport services including services, such as storage and metering services that are subsidiary but inseparable to providing transport services".

However, in addition to its requirements under the access regime, the main bulk water supplier (Melbourne Water) is required to have separate "bulk water supply agreements" with each retailer and the regulator (ESCV) must approve the prices at which Melbourne Water sells bulk water. As Melbourne Water uses infrastructure including supply catchments, treatment plants and transmission pipelines to supply bulk water to metered points the retailer's service area, retailers do not need direct access to that infrastructure.

Exclusion of access to resources

2.15 The access regime excludes the underlying resources (such as bulk water and sewage).

2.16 This would not be a problem if there was a separate requirement for incumbents to negotiate bulk supply agreements (on acceptable terms) with downstream participants, including new entrants. However, the Report does not propose that requirement.

2.17 The Commission has previously stated that consideration should be given to including access (either through the access regime or a bulk supply requirement) to the underlying resources themselves (such as bulk water).[4]

2.18 This is because, while bulk water may not be a "natural monopoly", incumbents (particularly SA Water) have, purely as the result of history, control of a diverse portfolio of the lowest cost and most reliable bulk water sources.

2.19 This issue has been overcome in other jurisdictions (Scotland, NSW and Victoria) by structural separation of bulk water providers; with structural separation, bulk water suppliers have an incentive to supply any industry participant. However, while South Australian incumbents remain vertically integrated, there is a strong case for requiring them to supply bulk water to any other player (on acceptable terms).

2.20 In that regard, the Commission notes that while the Report compares access requirements in the water and energy industries, it is important to accept that there are relevant (in this area) differences between the electricity supply industry and the water industry.

2.21 In the electricity market, a new generator can have the same cost and reliability as any other and retailers can buy from competing generators. In water, retailers can buy River Murray water when it is available, but this may often not enable them to supply water to their customers at a competitive cost or competitive level of reliability.

2.22 The Commission submits that potential competitors could be at a significant competitive disadvantage if they can only access bulk water sources not controlled by SA Water.

2.23 Supply of natural resources like water is different to the supply of human-made commodities. While a new entrant in electricity generation may have similar costs to those of incumbents, the least-cost sources of water are already within SA Water's control. For example, purchasing water from the Murray River may frequently not be the least-cost source of water and it cannot match the reliability benefits that SA Water enjoys from its diversified water sources.

2.24 England, Wales and Scotland have recognised this logic. In England and Wales, the Water Industry Act 1991 provides for wholesale supply of water supply by "primary water

[4] Essential Services Commission of South Australia, *Economic Regulation of the South Australian Water Industry: Draft Advice*, November 2011, p. 5.

undertakers" (the vertically integrated water infrastructure and retailing businesses). Retail licence holders are entitled to purchase water at wholesale from water undertakers.

2.25 The water industry regulator (**Ofwat**) defines access as: "*The wholesale supply of water by a water undertaker to a licensee for the purpose of making a retail supply of water to the premises of the licensee's customer; and the introduction of water by the licensee into a water undertaker's supply system for that purpose*."

2.26 Ofwat can determine access prices if negotiation fails; licensees must comply with access codes determined by Ofwat.

2.27 Under the Water Services etc. (Scotland) Act 2005, Scottish Water is required to attempt to negotiate wholesale services agreements with licensed retailers for the supply of bulk water and use of infrastructure. If a licensed retailer is unable to reach agreement with Scottish Water, it may apply to the Water Industry Commission for Scotland to determine the terms of the agreement.

2.28 In the early days of electricity deregulation in the UK, the regulator (**Ofgem**) restricted the amount of electricity production that vertically integrated electricity generators/retailers could sell at retail. These restrictions forced those companies to offer wholesale contracts to new entrants, which Ofgem considered important to facilitate retail competition.

2.29 In all jurisdictions noted above – Scotland, England & Wales, NSW and Victoria, incumbent infrastructure owners are required to sell bulk water to retailers, either as part of the access regime or through a required bulk water agreement.

2.30 While the Commission's submissions have focused on water examples for simplicity, a further example where access to goods would be important is sewer mining.

2.31 Sewer mining relies not only on access to sewerage infrastructure services, but to sewage itself. The NSW access regime goes hand-in-hand with the sewer mining scheme. Any party can seek a sewer mining agreement and the regulator may determine the price if negotiations fail.

2.32 The Report does not contemplate access to sewage. For potential sewer miners, access to sewerage infrastructure is useless without access to sewage. Enabling sewer mining may result in innovative solutions and environmental benefits. However, unless there is a requirement for relevant infrastructure operators to negotiate access to sewage on acceptable terms (either under the access regime or through sewer mining supply agreements) or (if negotiations fail) on terms set by a regulator or arbitrator, these benefits will be lost.

2.33 Access regimes can and do cover non-infrastructure goods and services. It is true that access regimes in many industries focus on infrastructure; however, they do so because the presence of multiple upstream suppliers (e.g. electricity generators) means that access to the upstream good/service is not an issue.

2.34 Governments have long recognised that access arrangements governing certain goods/services carried on infrastructure are required if competition is to exist. They have therefore introduced "wholesale must-offer obligations" which require infrastructure owners to provide access not only to infrastructure but to the relevant goods/services. Bulk water, electricity and pay television content are three examples of goods/services that regulators have applied such access requirements to.

2.35 It is true that the access provisions of the Australian Competition & Consumer Act 2010 generally do not cover the supply of goods "except to the extent that it is an integral but subsidiary part of the Service". There is no need to debate whether that exception applies to the case of bulk water. Access arrangements for goods and services are often imposed through specific legislation, rather than through general trade practices legislation. The South Australian Government could readily impose a requirement on SA Water to offer access to bulk water. The fact that SA Water is fully owned by the SA Government makes this particularly easy to do.

Summary of the Commission's submission on scope:

2.36 The Commission submits that the access regime should:

2.36.1 Err on the side of defining relevant infrastructure broadly, rather than narrowly, and exclude infrastructure only if there is no doubt that it would pass the "private profitability" test (rather than the "natural monopoly" test); that is, only exclude infrastructure from the access regime if there is no doubt that it would be privately profitable to duplicate.

2.36.2 Require any incumbent that harvests/produces resources (e.g., bulk water and sewage) to negotiate with any water industry entity that seeks access to bulk water (on acceptable terms) – either through the access regime or through separate bulk supply requirements – and require binding arbitration if negotiations fail.

3. Relative light-handedness

3.1 The proposed access regime is very light-handed. This appears to be based on the view that (as is noted at page 15 of the Report), clause 6(4) (a) of the CPA requires State-based access regimes to incorporate the principle that:

*(v) **wherever possible** third party access to a service provided by means of a facility should be on the basis of terms and conditions agreed between the owner of the facility and the person seeking access.*

(emphasis added)

3.2 The Commission agrees that this is the ideal situation. However, the Report assumes that it can be achieved with very light-handed regulation and provides no analysis as to whether or not achieving negotiated outcomes with such a light-handed model is actually "*possible*" in the relevant circumstances.

3.3 In the telecommunications sector, the initial access regime (which was stronger than that proposed in the Report) was insufficient to encourage a vertically integrated near-monopoly to provide timely access to competitors on fair terms. This is more likely to have led to consumer detriment than had a stronger access regime been established.

3.4 Therefore, the Commission does not agree that the access regulator should be required in the first instance to be light-handed: providing the potential for on-going assessment of the appropriate strength of regime (which is consistent with other access regimes in this State) should also be explored.

3.5 The Report argues (at page 16) that, as there is no vertical separation nor any intention to introduce full retail competition, light-handed access regulation may be appropriate.

3.6 The Commission submits that this circumstance in fact supports the opposite conclusion – that a stronger, rather than weaker, access regime should be implemented, for the following reasons.

3.6.1 The fact that SA Water is not vertically separated bolsters the case for strong access regulation. Vertical integration provides an incentive to use its position in non-contestable markets to disadvantage competitors in otherwise contestable markets. Strong access regulation is needed to minimise the potential for that misuse of market power.

3.6.2 In both the electricity and gas industries, access regimes for infrastructure were in place well before the introduction of full retail competition.

At the same stage of industry development, there were the same debates about the proportion of retail customers who could be contestable. The access regimes facilitated competition for large customers initially, well before decisions were made to extend the scope of competition to mass market customers and could have continued to operate effectively to support competition at that level even if full retail competition had not been introduced. Furthermore, they provided evidence for policymakers to realise that a higher proportion of the retail market was likely to be contestable after all.

3.6.3 Experience in Scotland has shown that at least making all business customers (regardless of size) contestable brings substantial benefits.[5] In South Australia, business (that is, non-household) customers account for about one-third of the retail water market.

[5] http://www.watercommission.co.uk/view_Our%20role%20and%20remit.aspx.

As one of the objects of the WIA is to promote competition (WIA, section 3(b)), to the extent that there is the potential for competition to occur in at least a large part of the retail market then the benefits of competition to at least that extent should be captured.

3.7 The Report also argues that light-handed regulation may be appropriate because access negotiations will be "*specific to the needs of the access seeker*" (page 15).

3.8 Some negotiations will be of that type. However, many are likely to fit into a small number of generic types. It may be the case that, as was found in the electricity and gas industries, which has many similar characteristics to the water and sewerage industries, there are identified a set or core (or "reference") services that are so critical to the success of competition (at some level) that it may be preferable for the regulator to set some prices upfront.

3.9 For those services, the pre-establishment of reference prices and terms and conditions (with regulatory approval) may best facilitate competitive outcomes. For all other services, the "*wherever possible*" test may be satisfied and the negotiation model could follow.

3.10 While a negotiation model is the ideal, it may be unlikely to work without at least a credible threat of regulatory escalation to very strong levels.

Regulator should choose whether to set prices, arbitrate or appoint an arbitrator

3.11 The Report suggests that the regulator would not set prices upfront and that, if disputes arise, the regulator would simply appoint an arbitrator.

3.12 The Commission submits that the regulator should be given the discretion to:

3.12.1 choose whether to set any access prices directly or rely on negotiations as a first step; and

3.12.2 if negotiations fail, to choose whether to arbitrate or appoint an arbitrator.

3.13 The Report's proposed approach is based on the existing ports and rail access regimes. However, the ports and rail models are not necessarily the best or appropriate models on which to base an access regime for the water and sewerage industries, as there are fundamental differences between the industries.

3.13.1 There is vertical separation in the ports sector. Flinders Ports provides maritime infrastructure services, but does not generally operate in upstream or downstream contestable markets.

3.13.2 The rail industry in South Australia has, for many years, been underutilised. As a result, there is less incentive for the rail operator to deny or hinder access. Rail also faces a degree of competition from other transport modes (as recognised by the Productivity Commission in its 2007 Inquiry into road and rail freight infrastructure pricing).

3.13.3 In both ports and rail, access disputes are likely to be relatively small-scale in nature and limited to a particular piece of infrastructure.

3.13.4 In both ports and rail, private ownership is a dominant feature.

3.14 The appointment of an arbitrator for some disputes (such as those that are limited to a particular piece of infrastructure and which are likely to be one-off in nature) may well be sensible. However, many disputes are likely to be best handled by the regulator.

3.15 A reading of the determinations made by OfWat (the regulator in England & Wales) shows that these disputes are highly complex in nature, involving detailed examination of costs throughout complex networks. [6] These sorts of determinations require dedicated teams, not individual arbitrators.

3.16 In addition, similar complex issues and analyses are common to multiple OfWat determinations; this highlights the value of one organisation (which retains and builds relevant experience and knowledge on these complex matters) arbitrating each complex dispute. Such an approach would also result in more predictable and consistent regulatory decision-making, which is very important for all industry participants. It would also better promote the objects of the WIA, including competition, investment and innovation.

3.17 The Commission submits that it would be better to implement a model which regulates:

3.17.1 "core services" by having prices and terms and conditions of access either pre-determined by the regulator (as happens on Scotland) or arbitrated by the regulator if negotiations fail (as in England & Wales); and

3.17.2 "non-core services" by the negotiation model with the regulator choosing to arbitrate directly (as happens in the energy market in Australia and the water and sewerage markets in the England and Wales) or appoint an arbitrator if negotiations fail.

3.18 The Commission notes that in NSW, the regulator decides whether to arbitrate an access dispute or appoint an arbitrator and, in the latter case, the regulator chooses the arbitrator. The Victorian regulator also recommended a similar model.

Minister should not be involved in arbitration

3.19 Finally, the Commission recommends that the Minister for Water and the River Murray have no role in arbitration.

3.20 The Report states (at section 3.3.6), that the Minister for Water and the River Murray is to be given the right to participate in arbitration proceedings. This inclusion is not explained on a principles basis, other than the fact that there are similar provisions in place in the South Australian ports and rail access regimes.

[6] Available on the OfWat website http://www.ofwat.gov.uk/.

3.21 The Commission is concerned that any involvement by the Minister (as the shareholder of SA Water) may give rise to serious perceived conflicts of interest. In all of the access regimes involving arbitration discussed above, there is no Ministerial involvement. In matters relating to SA Water it is not clear why the Minister would separately be involved. In matters not relating to SA Water, the provision would potentially allow access to the commercial information of the competitors of SA Water.

3.22 This provision may diminish the credibility of any dispute resolution regime under the access arrangement.

Summary of the Commission's submission on "light-handedness"

3.23 In summary, the Commission submissions on "light-handedness" are as follows:

3.23.1 the regime should not require the regulator to *always* be light-handed;

3.23.2 the regulator should have the *discretion* to choose (based on objective assessments of relevant considerations) whether to set access prices, arbitrate or appoint an arbitrator, so that the best approach is chosen for each relevant situation; and

3.23.3 the Minister should not be involved in the access dispute resolution process, other than in cases where SA Water is involved and then only on behalf of SA Water.