Sydney WATER

IPART review of developer charges and backlog sewerage charges for metropolitan water agencies 2017

Sydney Water response to IPART's Issues Paper – December 2017

Table of contents

Sydney WATER

1 Executive summary

Sydney Water Corporation (Sydney Water) welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART's) *Review of developer charges and backlog sewerage charges for metropolitan water agencies, Sydney Water Corporation, Hunter Water Corporation, Central Coast Council - Issues Paper - Water - October 2017* (the Issues Paper).

Developer charges are a method for helping fund the cost of infrastructure needed to serve population and employment growth. Developer charges can improve economic efficiency by ensuring infrastructure costs are considered in decisions about the location and scale of growth areas. A funding framework that includes developer charges can also promote a fairer outcome for the community, as the main beneficiaries of new infrastructure are obliged to bear some (or all) of the cost and risk of development decisions.

The growth challenge and integrated water cycle management

The level of population and employment growth envisioned in the Greater Sydney and Illawarra-Shoalhaven Regional Plans will require significant new economic infrastructure such as water, transport, gas, electricity and communications, as well as social infrastructure such as hospitals, schools and open space. This represents a major funding challenge.

IPART's Issues Paper is necessarily focussed on the methodology used to determine developer charges for the water, wastewater and stormwater infrastructure provided by Sydney Water, Hunter Water, and Central Coast Council. However, Sydney Water considers that there would be merit in undertaking a broader review of infrastructure funding arrangements, which could include:

- exploring the advantages and disadvantages of different funding mechanisms, including developer charges, user fees, and value capture
- identifying and removing any material barriers to competition
- developing consistent national guidelines on developer charges.

There are likely to be significant benefits in developing a more consistent approach across sectors and between jurisdictions. For example, who bears the cost of providing trunk stormwater infrastructure in Sydney depends on where the development is located. In some locations, the entire cost will be borne by developers, and in others the developer bears little or no cost. Differences in funding mechanisms and allocation principles can distort investment decisions by developers, customers and infrastructure providers, potentially leading to suboptimal outcomes.

This is likely to be a growing issue, as utilities increasingly plan their servicing solutions based on integrated water cycle management (IWCM) principles. Under this approach, the traditional distinction between different products (that is, water, wastewater, recycled water and stormwater) begins to break down, and customers are simply provided with 'water services'. This must be supported by a move towards more integrated pricing approaches (for example, a single integrated charge instead of multiple charges for different products).

Objectives of a developer charges framework

In undertaking a review, it is important to understand the objectives that the relevant policy or methodology is trying to achieve. Sydney Water considers that a developer charges framework (and any associated methodologies) should have the following objectives:

- to achieve an appropriate balance of cost sharing between direct beneficiaries and the wider community
- ensure costs are allocated in a logical and transparent manner
- provide a price signal that reflects the difference in cost to develop in different locations and promotes a competitive market
- minimises administrative effort for all parties
- ensures risk is allocated to the party best able to manage it (for example, exposure to development forecasting risk should rest mainly with developers)
- be flexible enough to ensure they meet the above objectives under the full range of likely future population and economic growth scenarios.

In practice, a trade-off between objectives may be necessary. For example, a competitive market may require some compromises in relation to the transparency of costs. Similarly, a desire to send accurate price signals about the relative costs of providing services in different locations must be balanced against issues such as complexity and administrative costs.

We generally support IPART's proposed changes

IPART's Issues Paper proposes some relatively small improvements to the developer charges methodology set in their 2000 Determination. We support some of the changes IPART has proposed and agree IPART's methodology:

- is theoretically sound
- is comparable to similar methodologies used in the rest of NSW and other states
- would send a cost signal to future development.

We note IPART's expectation that with minor changes, the methodology would be 'up-to-date' in the event of a NSW Government decision to allow Sydney Water (and Hunter Water) to levy a non-zero developer charge for water, wastewater and stormwater services. However, there may be a range of other issues that need to be considered in any transition to non-zero developer charges. In addition, a future change in policy could be implemented in many ways.

Options for further improvement

IPART has asked for comment on other aspects of the developer charges methodology. In our response, we analyse the advantages and disadvantages of options for further improvement, noting that some of these options may not be consistent with (currently unknown) future policy settings and would likely need to be reconsidered in the context of a new determination.

Our previous experience with implementing IPART's methodology was that it was overly costly to calculate (around $5 million each four to five-year review cycle). Developers also saw the resulting charges as inequitable and unreasonable. As a result, the process required significant effort to manage interactions with developers and levy the charges (around a further $1.5 million per year). We believe there is significant potential to improve on the previous experience. This could be supported by IPART providing clearer guidance in some respects and allowing greater flexibility in others. The key improvements we suggest are:

- allow the option of unregulated agreements between developers and utilities for premium or higher value services. These could be similar to the unregulated agreements IPART has allowed in their most recent retail and wholesale price determinations, and would be appropriately ring-fenced from postage stamp prices
- allowing greater consideration of who the beneficiaries are of the more stringent environmental standards for growth which occurs in catchments which discharge to sensitive receiving waters
- allow the allocation of costs from all growth assets (existing and future) in the charge calculation, not arbitrary sub-sets. Such a change would also allow use of a single discount rate rather than the current use of three
- allow the option of allocating the RAB value for existing assets as an alternative to the MEERA value, as MEERA may overstate the charge.

We also briefly consider other methods of setting charges, such as a postage stamp developer charge, capped charges, regional charges (for example, some regions in coastal areas could have a lower charge as they represent a lower incremental cost to serve), a minimum service availability charge and an averaging process where adjacent DSP areas have a similar charge.

We would welcome the opportunity to work with IPART to assess the costs and benefits of these process and methodology improvements.

Sydney Water Developer Direct

Developer Direct is a new service offered by Sydney Water, designed to improve satisfaction and deliver greater value for small developers by increasing competition in the market.

We understand IPART considers it may be obliged to regulate construction services provided by Developer Direct, as the relevant activity appears to fall within certain definitions used in the *Independent Pricing and Regulatory Tribunal (Water; Sewerage and Drainage Services) Order 1997*. The IPART Order was made more than 20 years ago, and circumstances in the relevant market have changed significantly since that time. Recognising the highly competitive nature of the relevant market, Sydney Water considers that there is likely to be a good case to update the IPART Order to better reflect contemporary circumstances. However, it is also possible that some aspects of Developer Direct do not fall within the definitions used in the IPART Order, meaning that price regulation would not be necessary. Sydney Water also notes that price regulation of construction services may result in unintended and perverse outcomes, such as a potential decrease in competition in the relevant market leading to increased costs for consumers.

2 Introduction

Developer charges are charges paid by developers to a water utility to cover the costs of providing water, wastewater and/or stormwater infrastructure to their developments. Sydney Water welcomes the opportunity to provide input to the Independent Pricing and Regulatory Tribunal's (IPART) review of developer charges and other related charges for Sydney Water Corporation (Sydney Water), Hunter Water Corporation (Hunter Water), and the Central Coast Council.

In this chapter, we discuss the broader context for IPART's review and the outcomes any future developer charges framework should support. We also include a summary of our response to each of the issues IPART has sought comment on in the October 2017 Issues Paper.

2.1 Context

Developer charges and other capital contributions have been a topic of debate and at times controversy for as many years as they have been levied. Lately there has been a particular focus on their role in delivering affordable and timely infrastructure in the context of the unprecedented population and employment growth which has already begun and will continue for many years. IPART's review of developer charges presents an opportunity to examine the effectiveness of the current methodology in the context of the increased pressures growth will place on our cities.

One of the challenges for IPART's review is that the NSW Government set Sydney Water's and Hunter Water's developer charges for water, wastewater and stormwater to zero in 2008. This means that IPART must assess the effectiveness of a regulatory framework that has not been in use for almost ten years (for the majority of the area it applies to). However, this challenge could also be seen as an opportunity, as changes to the methodology could be considered and/or introduced without them causing disruption to long-standing practices.

The *Draft Productivity Commission's National Water Reform report* recommends reviewing the role that developer charges play in planning for new developments so that integrated water cycle management (IWCM) approaches are considered on an equal footing alongside traditional approaches[1]. Sydney Water has long supported consideration of IWCM on an equal footing with traditional approaches and has implemented one of the largest IWCM schemes in Australia, at Rouse Hill. It is important that any change to the developer charge methodology does not inadvertently reduce the potential for IWCM approaches to enhance the liveability of our growing cities.

Prior to 2008, there were a number of regions within our area of operations which faced very high developer charges. In other locations, the methodology resulted in a zero charge despite new developments relying on existing infrastructure originally sized for growth. We believe it will be important that any change to the methodology is conducted with consideration of the broader context of housing affordability. The Greater Sydney Commission's *Draft Regional Plan – Our*

[1] 2017, Productivity Commission, *Draft Report on National Water Reform*, Recommendation 6.4d

Greater Sydney 2056, a metropolis of three cities – connecting people (GSC Draft Regional Plan) articulates the need to:

> *carefully balance requirements to fund infrastructure without burdening private development unreasonably, by better understanding the cumulative impacts of developer contributions in different markets across Greater Sydney*[2]

Sydney Water supports this objective and looks forward to working with IPART and other stakeholders to ensure housing affordability is prioritised.

2.2 Outcomes

Sydney Water commends IPART's support of, and continual moves towards, outcome and risk based regulation. Many of the outcomes for this review can be interpreted from the matters to be considered under section 15 of the IPART Act. We understand and agree that IPART's developer charges review should support the following outcomes:

a) consumers are protected from abuses of monopoly power in terms of prices, pricing policies and standards of service

b) water utilities receive an appropriate rate of return on their assets, including appropriate payment of dividends to the Government for the benefit of the people of New South Wales

c) the delivery of services becomes more efficient over time

d) competition for the supply of services increases over time

e) unintentional and unwarranted negative social impacts are not created

f) services are provided at sufficient standards of quality, reliability and safety

g) risks are born by the entity best-placed to manage them

h) regulatory oversight is proportional to risk.

2.3 Structure of this report

Our response to the Issues Paper includes discussion of potential improvements to the current regulation of and methodology for developer charges and our views on the related charges for backlog sewerage services, minor service extensions. We also consider the need for regulation of Sydney Water's new Developer Direct service.

Our response is structured as follows:

- Chapter 3 outlines our views on the appropriate level of regulatory oversight, the cost drivers for growth infrastructure and implications for this review of wholesale pricing

[2]2017, The Greater Sydney Commission, *Draft Regional Plan – Our Greater Sydney 2056, a metropolis of three cities – connecting people*, p 31.

- Chapter 4 analyses the current developer charges methodology and parameters and suggests options for improvement
- Chapter 5 discusses the current procedural requirements, the choice of developer service plan (DSP) boundaries and potential improvements
- Chapter 6 contains our views on the two other related charges in our area of operations; backlog sewerage, minor service extensions
- Chapter 7 contains our views on regulatory options for Sydney Water's Developer Direct service.

The following section contains a summary of each of our responses to IPART's questions. These are also discussed in more detail in the Chapters. We note we have no comment to make on Questions 15 and 16 (as these only relate to Central Coast Water) and Question 24 (as this relates to Hunter Water).

2.4 Summary of our response to IPART's questions

The following table provides a summary of Sydney Water's response to IPART's questions.

Current methodology and parameters
1 Does the current methodology remain fit for purpose in setting developer charges? While the methodology remains theoretically sound, we believe it would be beneficial for IPART to consider potential alternatives to the current methodology before making their determination. The current methodology proved costly to calculate and administer and was not developed with consideration of the current pressures faced by our growing cities. Sydney Water believes it would be timely to consider how it might be improved to better support the community's expectations around liveability and affordable housing creation. See section 3, page 14
2 Should we update the parameters for the Sydney Water and Hunter Water developer charges methodology in line with the changes made in 2013 for Gosford and Wyong Councils (now the Central Coast Council)? We agree with IPART's proposed update to the indexation. However, we propose IPART examine the benefit of alternative options for discount rates and the inclusion period for assets. For indexation, see section 4.1.8, page 27 For discount rates, see section 4.1.7, page 27 For inclusion period for assets, see section 4.1, page 19

Capital costs included in developer charges

3 Does inclusion of existing assets in the capital charge component of developer charges continue to be appropriate? If not, why and how should it be modified?

Yes, exclusion of existing assets would lead to unintended incentives to invest in inefficient servicing solutions, volatile developer charges, and would present a barrier to new entrants.

See section 4.1, page 19

4 Would it be appropriate to modify the period of exclusion of assets from the current 'pre-1970 assets' to those commissioned prior to 30 years from the time of the DSP review?

All assets with a nexus to development should be included in the charge calculation. Sydney Water proposes a cost allocation method that would remove the need to make arbitrary distinctions such as pre-1970 assets or 'DSP date minus 30 years' assets.

See section 4.1, page 19

5 Would it be appropriate to limit the period of inclusion of future assets? If so, what is the appropriate period (eg 5 or 10 years)?

No, all assets which will be required to service growth should be included in the charge calculation. The forecast period should align with the water utility's growth planning horizon, which is typically 30 years.

See section 4.1, page 19

6 Is it appropriate to include the capital costs of headworks infrastructure assets in the calculation of developer charges if these assets are not owned by the utility?

Although we agree with this approach in principle, we are concerned that the administrative costs to include WaterNSW water headworks charges may be higher than the potential benefits considering that headworks charges are likely to be the same across all water systems.

See section 4.1.3, page 22

7 How should the cost of assets that serve more than one DSP area be apportioned between DSP areas?

IPART should consider providing overarching principles regarding appropriate methods for apportioning costs of assets that serve more than one DSP area, and allow each business to determine what is suitable for their region. We discuss further advantages and disadvantages of the current ET method, as well as alternatives such as average and peak demand, in section 3.5, page 25.

See section 4.1.4, page 24

8 What information is considered necessary, but not currently provided by water utilities, to ensure that assets are apportioned correctly between DSP areas?

If IPART adopts a principles approach to apportionment, and autonomy for each utility to choose the approach that aligns with that utility's cost allocation methodology (CAM), this should provide developers and other stakeholders with sufficient information to assess the reasonableness of the developer charge in each DSP area.

See section 4.1.4, page 24

9 Does MEERA continue to be appropriate to value existing assets, for the purpose of the developer charge determination? If not, how should existing assets be valued?

No. Disaggregated RAB values, should be used for existing assets, if available, to ensure consistency with periodic charges, and that developers do not pay more than their fair share of costs to service their development. Where disaggregated RAB values are not available, depreciated optimised replacement cost (DORC) should be used rather than MEERA.

See section 4.1.5, page 25

The 'reduction amount'

10 The 'reduction amount' component of the developer charge formula takes into account postage-stamp revenues and location-specific operating costs for a period of 30 years. Does this approach continue to be appropriate? If not, how should it be modified?

We support the continuation of 30 years being applied to the reduction amount as this aligns with Sydney Water's growth planning horizon. We agree that the net present value of operating costs and tariff revenues beyond this point would be immaterial.

See section 4.1.6, page 26

Discount rates

11 What discount rates should apply in the developer charges methodology? Is it still appropriate to distinguish between pre and post 1996 assets?

IPART should apply the pre-tax real WACC for the periodic price determination to ensure end-use customers and developers both pay an equal allocation and fair share of the costs of investment. Sydney Water proposes a cost allocation method that would remove the need to make arbitrary distinctions such as pre-1970 assets or 'DSP date minus 30 years' assets. In turn, this would eliminate the need for the methodology to have more than one discount rate.

See section 4.1.7, page 27

Equivalent tenements (ETs) and consumption forecasts

12 Does our measure of ET continue to be appropriate for determining developer charges? If not, how could it be improved?

Yes, ET remains appropriate so long as the DSP area is of sufficient size to minimise forecast inaccuracy and the definition is updated regularly. We would be happy to work with IPART on developing appropriate improvements to the wording in DSP documents in relation to how ETs apply to different property types to improve clarity for developers.

See section 4.1.9, page 28

13 In line with the Central Coast Council determination, is it appropriate to update the annual consumption for an average residential customer of Sydney Water and Hunter Water, with average consumption values established in the water utility's prevailing price determinations?

Yes, this is appropriate and consistent and should mitigate the risk of forecast inaccuracy due to changes in demographic or other variables over time.

See section 4.1.9, page 28

Implications of wholesale customers and WICA licensees

14 What are the implications (if any) of wholesale customers and WICA licensees for the public water utilities' developer charges methodology and determination? That is, do wholesale arrangements or the activities of WICA licensees mean the methodology and/or determination should be amended? If so, how and why?

As IPART's 2017 wholesale price determination makes it clear that non-zero developer charges should be passed through via the facilitation component of wholesale prices, we see no need for any additional amendments to the methodology and determination for developer charges.

See section 4.2, page 31

Stormwater contributions

15 In funding stormwater infrastructure for new development, how has each of the former Central Coast Councils (ie, Gosford and Wyong) distinguished between developer charges and development contributions under section 94 of the EP&A Act?

No comment.

16 Is the distinction between stormwater services that Central Coast Council funds through developer charges and those funded via contributions under section 94 of the EP&A Act clear to developers and customers? If not, what should be done to improve the transparency of charges?

No comment.

Determining DSP areas

17 What principles or criteria should guide the determination of DSP areas? Are the developer charges in the consolidated DSPs for the Central Coast Councils cost-reflective?

Sydney Water believes the following principles should inform the choice of DSP boundaries:

a) incremental costs of servicing are incorporated into developer decision making

b) administrative costs of calculation and implementation are minimised

c) risks are allocated appropriately between developers and utilities depending on which entity is best placed to manage the risk. In most situations, developers should bear development forecasting risk

d) decisions are made in a consistent, robust and transparent manner

e) boundaries should support government planning policies and objectives.

We have no comment on Central Coast Council's consolidated DSPs.

See section 5.1, page 32

18 What role, if any, should IPART play in determining or reviewing DSP areas (eg, should IPART be required to approve DSP areas)?

IPART should retain an audit role only. DSP's should be registered with IPART (as they are now).

See section 5.1, page 32

Price indexation factor

19 Should the March-on-March CPI adjustment factor, as used in our retail price determinations, be applied to index developer charges over time? Or should a different indexation factor be applied in some instances, eg for the Central Coast Council?

A price index that includes construction costs may be more relevant to a developer charges framework, as it would better reflect underlying movements in cost drivers. However, we accept that March-on-March CPI adjustment is consistent with the indexation approach used to adjust regulated tariffs in our retail price determinations, and this may have advantages for our communications with customers.

We have no comment on the Central Coast instance.

See section 4.1.8, page 28

Procedural requirements

20 Do the current procedural requirements, including DSP content requirements and IPART's role in reviewing and registering DSPs, remain appropriate?

We do not believe there are any reasons to modify IPART's current role. We also note that because our most recent experience of following the current procedural requirements occurred almost ten years ago, it is difficult to make suggestions for improvement.

See section 5.2, page 33

Backlog sewerage charges methodology and application

21 What backlog sewerage charges are currently being levied by water utilities, and in what areas? Will they be required in future?

Sydney Water does not currently levy any specific charges for backlog sewerage areas. For schemes delivered to date under the Priority Sewerage Program (PSP), these were paid for by the Customer Service Obligation approved by Treasury in June 2000. Currently there are no backlog or PSP schemes being constructed or awaiting construction on our capital program. Services will be provided to the areas of Austral, Menangle and Menangle Park through our future growth servicing programs. The future of the remaining three PSP schemes is a policy decision for Government.

See section 6.1, page 35

22 Do our current methodologies for backlog sewerage charges continue to be appropriate? If not, what is an appropriate methodology for determining backlog sewerage charges?

Sydney Water supports IPART reassessing the methodology to recognise the potential wider community benefits that can occur when properties in certain locations connect to sewerage services. We believe there would be merit in this concept being extended to the developer charges for growth within all environmentally sensitive catchments.

See section 6.1, page 35

23 Should backlog customers continue to have the option of an upfront payment or annual charges? If so, is it appropriate to use the WACC established in the water utility's prevailing retail price review as the discount rate to calculate the annuity charges?

Unlike developer charges, backlog sewerage charges do not necessarily coincide with the sale of a property so upfront payment could be difficult for some households. The opportunity of paying over time is therefore likely to be of benefit to some customers. To avoid any disadvantage to the water utility, it would be appropriate to use the WACC established in the prevailing retail price review when setting the annual customer charge.

See section 6.1, page 35

Other related capital charges

24 Are there any other capital contribution charges that IPART should consider incorporating into this consolidated review of developer (and other capital contribution) charges?

No. We note that it would have been beneficial to include recycled water developer charges in this review although we understand IPART's reasons for deferring consideration of the recycled water framework. We look forward to participating in the recycled water review next year.

See section 3, page 14

Hunter Water's Major Service Connection Charge

25 Is a major service connection charge warranted and, if so, how should this be determined?

We have no comments to make on this question.

Sydney Water's Minor Service Extension Charge

26 Should the methodology for the minor service extension charge be set in Sydney Water's periodic price review or should it be set under this developer charges review?

Sydney Water has no preference unless IPART decides to adopt a more efficient method, in which case we would prefer to be able to apply this sooner rather than later.

See section 6.2, page 37

27 Should we maintain the current methodology for determining the minor service extension charge, or make amendments to this methodology? Should this be applied by other water utilities (Hunter Water and the Central Coast Council)?

We believe similar outcomes could be achieved using a simpler, and more administratively efficient charge. Adopting a more efficient method would be particularly important if IPART chose to expand the application of these charges to other water utilities.

See section 6.2, page 37

Sydney Water's Developer Direct

28 If we were to regulate the price of construction services provided by Sydney Water under Developer Direct, how should these prices be determined?

Many of the physical assets constructed via the Developer Direct service are owned by the customer on completion, and ownership does not transfer to Sydney Water. The works therefore don't form part of Sydney Water's regulated infrastructure networks, and it is arguable that IPART has no role in price regulation for what is essentially private plumbing work.

Alternatively, constructing a physical connection to Sydney Water's network could be considered an ancillary service to the core function of providing water, recycled water, wastewater and storm water services. This is similar in nature to Sydney Water's hot water metering service, which IPART has previously agreed is a contestable service with unregulated prices.

In the event these threshold regulatory questions can't be resolved, the competitive nature of the construction market means the case for any form of price regulation would seem to be weak. Sydney Water has entered the market to improve services and increase choice for customers, and some forms of price regulation could result in Sydney Water being forced from the market. This would seem to be a perverse outcome and not in the best interests of customers. If IPART considers that price regulation is unavoidable, Sydney Water would prefer that IPART set a methodology to determine prices.

See section 7, page 39

3 Regulation of developer charges

Issues Paper questions:

Question 1

Does the current methodology remain fit for purpose in setting developer charges?

While the methodology remains theoretically sound, we believe it would be beneficial for IPART to consider potential alternatives to the current methodology before making their determination. The current methodology proved costly to calculate and administer and was not developed with consideration of the current pressures faced by our growing cities. Sydney Water believes it would be timely to consider how it might be improved to better support the community's expectations around affordable housing creation and liveability.

Question 24

Are there any other capital contribution charges that IPART should consider incorporating into this consolidated review of developer (and other capital contribution) charges?

No. We note that it would have been beneficial to include recycled water developer charges in this review although we understand IPART's reasons for deferring consideration of this issue until broader Government reviews into recycled water have been completed in 2018. We look forward to participating in the recycled water review next year.

3.1 Is the current methodology fit for purpose?

One of the key considerations for this review should be how it might best support the community's expectations of housing affordability and liveability. The GSC Draft Regional Plan articulates several aims relevant to this review including to

> *explore and, where appropriate, trial opportunities to share value created by the planning process and infrastructure investment (such as rail) to assist funding infrastructure.*[3]

IPART's current methodology resulted in developers being able to connect to our infrastructure for free in a substantial portion of our area of operations, primarily due to the capacity available in major trunk assets constructed prior to 1970 and a view that the cost of some of these assets may have already been fully recovered through water prices. Sydney Water agrees that we should not be paid twice for providing infrastructure. However, the reason why some infrastructure has capacity to service growth, yet, has already been fully paid for is simply that no forecast of growth, demand and cost recovery is ever completely accurate. Existing customers bear the risk, and increased bills, when these forecasts lead to under recovery of the cost to service growth. It would seem fair to allow these same customers to benefit when an asset remains capable of servicing growth but its value has already been fully recovered.

[3] 2017, The Greater Sydney Commission, *Draft Regional Plan – Our Greater Sydney 2056, a metropolis of three cities – connecting people*, p 31.

The availability of water, wastewater and stormwater infrastructure is inherently valuable and will result in increased property value regardless of whether the assets servicing that property have been fully paid for or not. As such, we believe it fair that the existing customer base should benefit (by paying lower ongoing bills) by allowing a minimum, non-zero developer charge for all growth. Such a charge, linked to the value of availability of services, would not necessarily result in Sydney Water being paid twice for some assets. This is because IPART could still reduce Sydney Water's RAB by the total developer charges collected. As such, any additional funds collected in areas which might otherwise attract a zero charge, would simply result in lower ongoing customer bills.

There are also methods available for analysing historical costs to assess whether costs for historical assets have been recovered by the utility. For example, the cost allocation methodology used by Sydney Water to determine to access prices for its declared wastewater systems would allow for the estimation of notional RAB values for all existing assets. A non-zero RAB value would imply that all costs have not yet been recovered. These estimated RAB values could be used in the developer charges calculation, replacing existing methods for the inclusion of existing assets and ensuring that developers pay their fair share of costs.

The GSC Draft Regional Plan has also identified the need for greater certainty and ease of understanding for developers and local communities. Previously, Sydney Water had implemented IPART's developer charge determination by creating 75 separate DSP areas (42 for water, 32 for wastewater and one for stormwater). In combination, this meant there were almost one hundred different locational charges. The geographic size of our networks means that the assets that service a development can often be quite remote from the development site. For example, wastewater from developments Western Sydney locations such as Parramatta can ultimately be treated at the North Head Wastewater Treatment Plant at Manly. Understandably, this was often a source of confusion for developers. If non-zero charges were to be re-introduced, Sydney Water believes a more user-friendly approach would be beneficial (See section 5.1, page 32).

The Water Industry Competition Act (2006) and *Water Industry Competition Amendment Act (2014)* have also changed the context for delivery of water infrastructure to service growth since IPART's last determination of developer charges in 2000. Many decisions about the location, timing and scale of new development are now undertaken in competitive situations, with the incumbent utility such as Sydney Water competing against one or more private sector entities on factors such as price and quality of service (that is, competition for the market). There may now be merit in IPART moving towards a lighter-handed approach to the regulation of developer charges in this context.

We note IPART's expectation that with the minor changes it has proposed in the Issues Paper, the methodology would be up-to-date in the event of a NSW Government decision to allow Sydney Water (and Hunter Water) to levy a non-zero developer charge for water, wastewater and stormwater services. However, there may be a range of complex issues that need to be considered in any transition to non-zero developer charges. In addition, a future change in funding policies could be implemented in many ways that do not involve a simple decision to re-establish non-zero charges in the same way they were implemented in the past.

In this context, Sydney Water considers that there is merit in considering alternative developer charge options. The following section considers some of these alternatives.

3.1.1 Options for change

Best practice regulation will match regulatory oversight to level of risk. IPART has made many recent decisions which show their support of a risk based approach to regulation. In light of this, there may be advantages in considering other methods for estimating and applying developer charges. Each has various levels of merit. Some examples include:

- **a capped charge.** This would allow location based price signals in the majority of locations combined with a safety net in others. The disadvantage of this option would be the difficulty in defining the quantum of the cap and whether it should apply to all areas equally or some areas should be excluded, for example, 'out-of-sequence' growth.
- an average **'postage-stamp' developer charge.** This might allow for some reduction in administrative effort; however, is not preferable given it would provide no location based cost signal to development and evidence from other states suggests this approach would not be acceptable to developers[4].
- a **developer charge offset** paid by on-going customer bills. This would reduce the total costs recovered from developers and would be somewhat of a half-way progression from the current situation where all growth is funded by on-going customer bills. Similar to a capped charge, the difficulty with this option is determining the quantum of the offset and whether it should apply to all growth equally. One option would be to set the offset at the average cost to service growth, so that developers only pay for above average costs.
- **Voluntary agreements** with developers for delivery of a higher level of service. We believe that these may better support delivery of IWCM approaches and stormwater solutions which go above a basic level of service. We discuss this concept is in more detail in section 3.2**Error! Reference source not found.**, page 17.
- Allowing greater **consideration of who the beneficiaries are** of the more stringent environmental standards for growth which occurs in catchments which discharge to sensitive receiving waters, and allowing allocation of costs among beneficiaries. IPART's determination for backlog sewerage charges has long recognised the potential that some infrastructure provides benefits to the wider community. We discuss this option further in section 6.1, page 35.
- Revision of the methodology so that it reflects the inherent value provided to every new property which connects to a water utility's infrastructure. This could be achieved by setting

[4] The Essential Services Commission in Victoria reported that their previous 'one-size-fits-all' developer charge (termed new customer connection charge) caused many disputes between developers and utilities about whether the cost of new connections was fairly allocated to those who benefit. Essential Services Commission 2012, *Guidance paper – new customer contributions*, August 2012, pIV.

developer charges with a minimum contribution, equal to the estimated difference in value between properties with and without services available.

Some of the above options may also allow water utilities to revisit their infrastructure growth funding policies. This could also support growth to occur more efficiently in response to market forces.

3.2 Voluntary agreements between developers and utilities

The development industry contains many large businesses who are well able to make their own judgement as to whether it is in their interest to enter into commercially negotiated agreements. The current developer charges determination does not specifically allow voluntary agreements with developers to deliver additional infrastructure which may benefit their development and/or the wider community. Sydney Water is particularly interested in working with developers to ensure our current and future stormwater infrastructure delivers as much benefit as possible to the wider community.

In this section, we look at how two similar voluntary agreements, unregulated wholesale and retail pricing agreements, could inform IPART's articulation of support for similar voluntary agreements between developers and utilities. Both these agreements exist in parallel to regulated prices or charges; however, they allow for alternative or higher value products or benefits to be delivered upon mutual agreement between the parties of the costs, terms and conditions.

IPART's 2017 wholesale price determination allowed wholesale customers to opt out of the system wide regulated prices. This followed on from IPART's 2016 retail price determinations for Sydney Water and Hunter Water, which allowed for unregulated pricing agreements with large non-residential customers where both parties agree to an alternative arrangement. IPART reasoned that both wholesale and large non-residential customers are relatively large entities, and should be able to judge whether it is in their interest to enter an unregulated pricing agreement. We believe large developers possess this same ability.

IPART was also of the view that there is evidence to suggest that unregulated agreements can work where there is effective regulatory support. IPART also considered that providing the option for parties to negotiate is consistent with the development of the market for the provision of water and sewerage services. The option of unregulated agreements provides the flexibility for parties to agree to pricing outcomes that reflect location or scheme specific characteristics. For wholesale agreements, it might also avoid the need for IPART to undertake a scheme-specific review. We see particular benefit in specifically allowing voluntary agreements to deliver innovative infrastructure or services which would provide additional benefits to the wider community.

Voluntary agreements could allow a utility and a developer to deliver infrastructure at a higher standard than that which might be considered prudent and efficient for the purposes of IPART's regulated prices. While the scope for higher standards is probably quite limited for water and wastewater infrastructure, there are many ways stormwater infrastructure can be used to enhance liveability outcomes for the local community and downstream environments. For example, a

developer may wish to contribute additional funding so that a utility's stormwater trunk infrastructure near a development could be naturalised at an earlier date than scheduled.

Just as is the case with unregulated wholesale and retail agreements, changes in costs resulting from any unregulated pricing agreements with developers would need to be 'ring-fenced.' This ensures the water utilities' regulated cost base and regulated prices continue to reflect the efficient costs of providing regulated services in the future.

4 Review of the current developer charges methodology

In this section, we address the specific issues raised in relation to IPART's existing methodology.

Issues Paper questions:

Question 2

Should we update the parameters for the Sydney Water and Hunter Water developer charges methodology in line with the changes made in 2013 for Gosford and Wyong Councils (now the Central Coast Council)?

We agree with IPART's proposed update to the indexation method. However, we propose IPART examine the benefit of alternative options for discount rates and the inclusion period for assets.

For indexation, see section 4.1.8, page 27

For discount rates, see section 4.1.7, page 27

For inclusion period for assets, see section 4.1, page 19

4.1 Input parameters

4.1.1 Existing assets

Issues Paper questions:

Question 3

Does inclusion of existing assets in the capital charge component of developer charges continue to be appropriate? If not, why and how should it be modified?

Yes, excluding existing assets would lead to inadequate incentives for utilities to invest in efficient servicing solutions, as well as resulting in more volatile developer charges. The resulting artificially low charges would also present a barrier to new entrants.

Incremental or marginal cost

IPART should seek to maintain its current, incremental approach, as the inclusion of existing assets in the capital charge component of develop charges continues to be appropriate.

It is generally more efficient to deliver infrastructure in discrete stages over time, with spare capacity provided at the time of construction to allow for future growth. Since virtually all new developments will make use of planned spare capacity in existing infrastructure, the relevant share of the costs of existing assets should be included in the developer charge, rather than only including new assets required to service the development.

Inclusion of existing assets ensures the developer receives an efficient price signal regarding the costs of connecting at that location, and an equitable share of the cost of those assets between all (both existing and future) customers over time.

There are a number of reasons why an incremental approach is preferable to a marginal cost approach:

- Existing assets have all been designed to service future growth. This is because it is economically optimal to design asset investments after consideration of the development expected to occur over the lifetime of the asset. Otherwise, these assets might have needed to be constantly augmented and/or replaced as development caused their capacity to be breached. As such, existing assets should be included in developer charges to ensure the charges follow the impactor and benefiter pays principles.
- A purely marginal cost approach would require the cost of all existing assets to be recovered through periodic (fixed and variable) charges instead, even though development was benefiting from those assets. Under the principle of equity, consumers would consider it unfair if they were cross-subsidising another customer group's decision to either connect to the network, or consume services via that connection.
- An incremental cost approach will result in a set of charges that are more stable over time, and less susceptible to fluctuations due to capacity constraints in the network. For example, as capital expenditure is necessarily lumpy, a marginal cost approach would result in lower estimates of the marginal cost where current capacity is sufficient to satisfy incremental changes in demand. Equivalently, it can produce very high estimates of the marginal cost where even slight changes in demand are sufficient to bring forward the next investment in new capacity. An incremental cost approach would therefore tend to promote greater price stability than a marginal cost approach.
- Implementing a marginal cost approach would also require that only the forward looking incremental costs and revenues of the connecting property were included in the charge. It is likely that a marginal cost approach would result in a negative developer charge for more locations than an incremental approach. As developer charges are likely instead to be capped at or above zero, this would result in even less incentive for development to occur where it was most efficient.
- It may create a barrier to entry to new entrants, if the new entrant was required to invest in new water or wastewater infrastructure, and Sydney Water's developer charges did not include the appropriate share of the costs of existing assets.

4.1.2 Period for inclusion

Issues Paper questions:

Question 4

Would it be appropriate to modify the period of exclusion of assets from the current 'pre-1970 assets' to those commissioned prior to 30 years from the time of the DSP review?

No. All assets with a nexus to development should be included in the charge calculation. As water and wastewater assets typically have a lifetime of around 100 years, there are many existing assets which service growth but were commissioned far earlier than 30 years ago.

Question 5

Would it be appropriate to limit the period of inclusion of future assets? If so, what is the appropriate period (for example, 5 or 10 years)?

No, all assets which will be required to service growth should be included in the charge calculation. The forecast period should align with the water utility's growth planning horizon to ensure an equitable contribution from all development that will benefit from infrastructure needed in the future.

Period for inclusion of assets

Existing assets to be included in the calculation should include all those that were designed to cater for growth. Section 2.2.1 of IPART's Issues Paper details the relevant assets that IPART considers should be excluded from capital costs. Sydney Water agrees with the exclusions listed, except for assets commissioned prior to 1 January 1970 (or, IPART's suggested alternative, any assets constructed more than 30 years before the date of the developer charges determination).

Water and wastewater assets typically have an average useful life of around 100 years[5]. Where an asset was designed prior to 1970 to meet future growth, and a value still remains in the Regulatory Asset Base (RAB) (therefore having both a remaining useful life and unrecovered costs), it is fair and reasonable that the relevant share of that cost is passed on to the developer. This will improve economic efficiency as the impact of the development is reflected into the developer charge and there is a clear nexus between that cost and the benefit the developer gains from connection to that asset. It is also reasonable to assume that customers would expect developers to pay their share of the benefit derived from this prior investment.

Distinguishing capital assets by date of commission could create an arbitrary and subjective rule on the costs associated with developments. It would also add to the administrative costs of implementing developer charges. Sydney Water understands that IPART's rationale for using a pre-1970 exemption is to reflect the possibility that growth assets could already be fully recovered and therefore should be not included in any developer charge.

However, where a business has validated disaggregated data on its assets, including value, condition and service life, and can demonstrate that this asset was designed to service future growth, IPART should allow the business to include these costs in the calculation of developer charges, irrespective of whether they existed prior to, or post, 1970.

As such, inclusions should be:

- all existing and future growth-related assets that service the development area
- with reference to existing assets, those that remain in service, have not been fully depreciated and can be identified as servicing growth

[5] Civil assets have the longest lives. For new assets, water civil asset life is 140 years and wastewater is 90 years. For existing assets, water civil asset lives are 93 years and wastewater 80. Electronic assets have the shortest lives – about 9 years for existing and 15 for new. The overall (water, wastewater, stormwater and corporate) weighted average existing asset life is about 75 years.

- the part of the assets that services the DSP area in question
- the capacity of the asset designed to cater for future growth.

Sydney Water strongly believes that there should be symmetrical treatment (with regards to timing) of historical and forecast capital costs within the developer charges calculation. In other words, charges should send an appropriate signal regarding all relevant historical and future costs that development imposes on the network, independent of the timing of those works. Without this fundamental principle, some costs would be essentially cross-subsidised by the existing customer base through periodic charges.

Any future costs, where their prudency and efficiency can be demonstrated, should be included within the calculation. Should IPART allow inclusion of prudent and efficient capex beyond the notional five to 10-year limitation, the likely cost impact is relatively small, as these costs will be heavily discounted.

As a result, and to ensure an equitable sharing of historical and forecast costs related to servicing growth, Sydney Water considers that IPART should not place a limit on the period for inclusion of future (or historical) assets. Incremental cost should be calculated over a period that aligns with Sydney Water's growth planning or asset utilisation horizons (currently 30 years). For operating costs, this should be the same as the revenue assessment period.

4.1.3 Headworks

Issues Paper questions:

Question 6

Is it appropriate to include the capital costs of headworks infrastructure assets in the calculation of developer charges if these assets are not owned by the utility?

Although we agree with this approach in principle, we are concerned that the administrative costs to include WaterNSW water headworks charges may be higher than the potential benefits considering that headworks charges are likely to be the same across all water systems.

Treatment of headworks capital costs

Sydney Water agrees that there are sound reasons why a developer's impact on existing and future headworks assets should be reflected in developer charges, in much the same way that a share of costs for assets further along the value chain are also recovered from developers.

There are also likely to be some advantages in specifying a separate headworks charge, which might sit alongside Sydney Water's developer charges for treatment and transport of water and wastewater. For example, a separate charge will allow developers to compare the costs and benefits of a centralised network connection against decentralised solutions. Proponents could more easily determine whether it is cheaper to invest in (for example) on-site supply versus sourcing water from the centralised network, or in providing recycled water networks in lieu of discharging to the wastewater network. In this way, disaggregation of pricing would provide stronger signals for economically efficient investment.

There is, however, a reasonable question regarding the appropriate party to seek recovery of these costs from developers. Historically, the cost of existing and future headworks investments has been included in the regulated bulk water tariff levied by WaterNSW on Sydney Water. The cost of headworks investments has therefore been recovered via postage stamp prices. This arrangement reduced administrative costs, since WaterNSW was not required to maintain a DSP nor manage the calculation and receipt of payments directly from developers – and developers did not need to deal with two separate entities to calculate and meet their developer contributions liabilities.

If Sydney Water were required to physically transmit the component of its developer charges revenue relating to headworks charges to WaterNSW, there are several issues that would need to be considered and resolved. For example:

- Under the current approach, developer charge revenue is fully netted off the RAB. This means Sydney Water only earns a rate of return on incremental expenditure not recovered up-front through developer charges. If Sydney Water's developer charges recover a headworks component, there is the potential for the RAB to be over-deducted, as the capital costs related to that development were not incurred by Sydney Water, and the pass through of such headworks costs (from WaterNSW) would likely be captured under annual OPEX. If Sydney Water were to levy this charge to developers, IPART would need to make an allowance under its roll-forward approach to ensure headworks charges were not netted off Sydney Water's RAB
- There would be administrative costs related to transactions between Sydney Water and WaterNSW. Further, under the assumption that Sydney Water levies these charges, related inquiries would likely be directed to Sydney Water, whom may then have to forward these inquiries to WaterNSW for resolution – a duplication of process and an unnecessary cost imposition.

Given that any headworks charges are likely to be the same across all water systems, the price signal sent to developers will not necessarily influence the location of development. As such, there are advantages with the current situation, whereby headworks costs are recovered via postage stamp prices rather than a separate charge. This is similar to the method used for the costs of the Sydney Desalination Plant, where all water users contribute to the cost under IPART's impactor pays approach.

4.1.4 Methods to apportion shared assets

Issues Paper questions:

Question 7

How should the cost of assets that serve more than one DSP area be apportioned between DSP areas?

IPART should consider providing overarching principles regarding appropriate methods for apportioning costs of assets that serve more than one DSP area, and allow each business to determine what is suitable for their region. We discuss further advantages and disadvantages of ET, average and peak demand in section 4.1.9, page 28.

Question 8

What information is considered necessary, but not currently provided by water utilities, to ensure that assets are apportioned correctly between DSP areas?

If IPART adopts a principles approach to apportionment, and autonomy for each business to choose an approach that aligns with their cost allocation method (CAM), this should provide developers and other stakeholders with sufficient information to assess the reasonableness of the developer charge in each DSP area.

Apportioning the cost of assets

IPART should consider providing overarching principles regarding appropriate methods for apportioning costs of assets that serve more than one DSP area, and allow each business to determine what is suitable for their region. This will allow each business to balance the relevant cost driver, with the information available to support the apportionment approach, and its approach to cost allocation as documented within each business's cost allocation method (CAM).

'Equivalent tenement' (ET) is the measure of the demand the new development will place on the water and wastewater infrastructure compared to an average residential dwelling[6]. Historically, this has been used as:

- the basis for levying developer charges,
- apportioning costs between DSP areas, and
- planning future increments in capacity in catchments with mixed development types.

ET is an administratively simple and commonly understood method for apportioning costs in the water industry.

However, Sydney Water's (and other network service providers) growth assets are usually designed to service peak demands (for water) and average or peak wet weather flows (for wastewater). The size of assets is not only driven by the number and type of connections to that

[6] For example, under IPART's 2000 developer charges determination for Sydney Water, the average annual water consumption of one residential dwelling (one tenement) was set at 240 kilolitres.

asset but also requires further analysis beyond a simple ET forecast to ensure assets cater for the estimated peak demands they will encounter over their lifetime.

To drive more economically efficient outcomes, and where this data is available, it may therefore be appropriate to apportion costs based on the percentage of total peak capacity of the asset in question. As such, IPART may consider not prescribing the unit of measurement for apportioning costs, but instead providing utilities the flexibility to choose what is most appropriate for their business.

As an example, one of the increasing challenges that Sydney Water is facing (that may or may not be as significant in other regions) is that ET may not account for the impacts of ongoing water efficiency improvement on average demand unless its definition is regularly updated. The average demand of households has significantly changed in recent years due to BASIX and WELS, which has increased the water efficiency of appliances and increased reliance on alternative supply sources (rainwater tanks and recycled water). Furthermore, both water conservation education and the millennium drought have resulted in a significant change in water use behaviour. This has had, and will continue to have, an impact on, future demand and capacity constraints.

In a practical sense, a developer may choose to invest in reticulated recycled water provision for toilet flushing, clothes washing and/or external use. These assets would materially decrease average consumption of the development however, they would not necessarily change the capacity required for managing peak flows. In principle, an efficient pricing framework would provide the right price incentives for each of these options. A simple metric such as ET may not necessarily achieve this outcome.

A principles approach to apportionment, and autonomy for each business to choose the approach that aligns with their CAM, should provide developers and other stakeholders with sufficient information to assess the reasonableness of the developer charge in each DSP area.

Should IPART prescribe an approach to apportioning costs (for example, use of ET), it may need to establish how issues described in our response (for example, average consumption of existing vs new properties with rainwater tanks vs new properties with a recycled water connection) should be addressed. We discuss further advantages and disadvantages of ET, average and peak demand in section 4.1.9, page 28.

4.1.5 Asset valuation methods - MEERA vs RAB or DORC

Issues Paper questions:

Question 9

Does MEERA continue to be appropriate to value existing assets, for the purpose of the developer charge determination? If not, how should existing assets be valued?

Disaggregated RAB values should be used for existing assets, if available, to ensure consistency with periodic charges, and that developers do not pay more than their fair share of costs to service their development. Where disaggregated RAB values are not available, depreciated optimised replacement cost (DORC) should be used.

MEERA vs RAB or DORC

Sydney Water agrees with the analysis provided in IPART's Issues Paper that using a Modern Engineering Equivalent Replacement Asset (MEERA) basis for determining the value of existing assets is not ideal. This is because it results in an arbitrary transfer of costs from the current customer base to developers (and ultimately the purchasers of property), because the MEERA value is higher than the RAB value so does not align with impactor or beneficiary pays pricing principles.

It is Sydney Water's strong view that developers (and therefore purchasers of property) should not have to pay more than their fair share of the cost of the asset. Once utilities complete work to better understand the disaggregation of RAB values to the asset driver and asset class level, it would be appropriate to allow utilities to use these as the basis for the value of existing assets.

In summary, it would be appropriate to allow the use RAB values, because:

- where possible, there should be consistency in asset values used for developer charges and periodic charges (that is, ongoing fixed and variable retail customer charges)
- in the future, utilities may be able to better disaggregate RAB values down to asset categories and asset classes for both water and wastewater assets, which would support the ability to adopt this approach
- developers should not have to pay more for their share of existing assets designed to cater for growth, than those already connected to that asset
- asset renewals are funded by ongoing customer bills, so it would be inconsistent to charge developers based on the MEERA or new replacement value of an asset, when their development is only relying on a depreciated asset.

In the absence of disaggregated RAB values, existing assets should be valued based on depreciated optimised replacement cost (DORC), that is, the asset value should be reduced to reflect the portion of the useful life of the asset that has been used. Using DORC would go some way towards reducing the transfer of costs from the current customer base to developers which would occur if MEERA values continued to be used.

4.1.6 The 'reduction amount'

Issues Paper questions:

Question 10

The 'reduction amount' component of the developer charge formula takes into account postage-stamp revenues and location-specific operating costs for a period of 30 years. Does this approach continue to be appropriate? If not, how should it be modified?

The treatment of the 'reduction amount' component remains appropriate. It is important that both incremental operating costs and revenues continue to be included in the charge calculation to ensure the charges reflect the true location-specific net cost impact of development. The 30-year

forecasting period is also appropriate as this aligns with Sydney Water's 30-year growth planning horizon.

The net cost impact of development

Sydney Water supports the continued application of a 'reduction amount' within the formula for calculating developer charges. As well as the capital cost to connect properties to the network, development will result in additional operating and maintenance costs to the utility. It is reasonable that these costs are included in the charge calculation. It is also reasonable that these costs should be offset by the expected revenue from ongoing customer charges over that same period as a result of that same development. To ensure developer charges signal the net cost impact of development, it is important these annual ongoing costs and revenues are considered in the developer charge calculation over the same forecast period.

4.1.7 Discount rate

Issues Paper questions:

Question 11

What discount rates should apply in the developer charges methodology? Is it still appropriate to distinguish between pre- and post-1996 assets?

IPART should apply the pre-tax real WACC for the periodic price determination to ensure end-use customers and developers both pay an equal allocation and fair share of the costs of investment.

Consistent application of discount rate

Within Determination No. 9[7], IPART states the following:

> *The discount rate (or interest rate) used in the calculation of developer charges should reflect the opportunity cost to the agency of funding infrastructure works. In providing infrastructure prior to development, agencies may face a number of risks. These risks include the rate of connection, the cost of construction, and possible changes in interest rates.*
>
> *Costs of infrastructure already provided to service a development should take into account the finance costs incurred or the interest foregone. In this case, the discount rate can be referred to as a holding charge. Holding charges apply between the time the investment is made and when the capacity can be used. There is no fundamental difference between holding charges and the required rate of return on assets.*

Leveraging this definition, developers should face the financing costs related to infrastructure already provided. This financing cost will change, according to market conditions and the credit rating of the agency, and is therefore not static (nor pegged to past conditions).

[7] 2000, Independent Pricing and Regulatory Tribunal, *Developer Charges from 1 October 2000*, *Sydney Water Corporation, Hunter Water Corporation, Gosford City Council and Wyong Shire Council*, pg. 18

To determine periodic service and usage charges, Sydney Water currently recovers a rate of return on the value of its RAB consistent with the benchmark weighted average cost of capital (WACC) set by IPART. This same WACC is used to discount future cash-flows into dollars of the day, and there is no variation between rate of return earned on assets valued in the RAB before or after 1996.

To ensure consistency between periodic charges and developer charges, and that end-use customers and developers both pay an equal allocation and fair share of the costs of investment, IPART should apply the same discount rate as the benchmark WACC determined for the periodic price determination. This should be the pre-tax real WACC, as developer charges are calculated on a pre-tax basis.

4.1.8 Indexation

Issues Paper questions:

Question 19

Should the March-on-March CPI adjustment factor, as used in our retail price determinations, be applied to index developer charges over time? Or should a different indexation factor be applied in some instances, for example, for the Central Coast Council?

March-on-March CPI adjustment is preferable as it is consistent with that used to adjust the regulated tariffs in our retail price determinations.

We have no comment on the Central Coast instance.

Consistent choice of indexation

There are a few alternatives to using the Consumer Price Index (CPI). For example, the Australian Bureau of Statistics (ABS) publishes various price indices for the construction sector, at both a State level (for example, NSW) as well as for specific parts of the construction industry (for example, roads). However, we agree with IPART that consistency across price determinations is preferable. Also, the ABS applies significant rigour to calculating the CPI and, as it is used across many sectors, many people are familiar with it. The use of CPI may therefore also have advantages for our communications with customers.

4.1.9 Use of the Equivalent Tenement (ET) as the cost and revenue metric

Issues Paper questions:

Question 12

Does our measure of ET continue to be appropriate for determining developer charges? If not, how could it be improved?

Yes, ET remains appropriate so long as the DSP area is of sufficient size to minimise forecast inaccuracy and the definition is updated regularly. We would be happy to work with IPART on developing appropriate improvements to the wording in DSP documents in relation to how ETs apply to different property types to improve clarity for developers.

Question 13

In line with the Central Coast Council determination, is it appropriate to update the annual consumption for an average residential customer of Sydney Water and Hunter Water, with average consumption values established in the water utility's prevailing price determinations?

Yes, this is appropriate and consistent and should mitigate the risk of forecast inaccuracy due to changes in demographic or other variables over time.

Estimation of an ET

IPART's current method requires that Equivalent Tenement (ET) be used as both the divisor for total costs and the multiplier for future expected revenue. IPART notes four elements which should be considered in estimating this parameter:

1. choice of consumption forecast,
2. choice of consumption granularity (peak or average),
3. accuracy of planning and demographic data, and
4. choice of multipliers.

We discuss these elements below.

Consumption forecast

In the current developer charges determination, ETs are only loosely defined by a hard-coded, static estimate of average annual consumption for a single residential dwelling. We agree with IPART that it would be preferable to at least update this hard-coded value to mirror the consumption used in the most recent retail price determination. Best practice consumption forecasts should reflect location-based differences in demand and, where possible, any step changes and trends which may be expected to occur over time. The water utility's forecast in their most recent retail price determination is appropriate for the developer charges calculation as it:

- is regularly updated (every four years) so is adaptable to change
- is transparent and consistent
- minimises unnecessary additional administrative effort
- ensures there is consistency in forecasting risk between the calculation of the prices existing customers pay and the charges for developers.

Sydney Water notes, however, that demand forecasts at a local scale may differ slightly from global estimates of total water demand, particularly in terms of the rate of growth between years.

Consumption granularity, average day, peak day or peak hour

While it is true that estimates of peak day and peak hour may not be found in existing publications, all assets are designed using such criteria so these estimates would, in theory, be available. The advantage of adopting an appropriate peak definition of ET over a simple average is that it may

provide a more accurate indicator of the demand that an ET will place on the infrastructure, so might more closely reflect the benefit each ET would receive. The disadvantage, as IPART notes, is that water utilities are not currently required to publish their design criteria. We also see no merit in design criteria being subject to approval by IPART as utilities should be free to revise and update these criteria to run their business efficiently to meet system performance standards and customer expectations.

Another problem of moving to a peak definition for ET is that non-residential demand is highly variable, even for properties in the same business category. It is also possible that a single non-residential property will be used for different purposes over time. Even if a site specific peak flow estimate was reasonable at the time the developer charge was levied, it would not necessarily reflect the demand that property may place on the connecting infrastructure in future years.

We consider that the approach we take in implementing the recycled water developer charges determination is appropriate. That is, average day is used for the default definition for ET; however, non-residential property charges can be assessed on a flows basis, where there is sufficient evidence that the default charge is not appropriate.

Accuracy of planning and demographic data

Planning and demographic forecasts are generally quite reliable at a high level or over large geographic areas. For smaller precincts, forecasts can be highly volatile. This has been particularly evident in recent times when forecasts for some precincts have increased up to tenfold over periods as short as 18 months. Developer charges must be set over reasonably wide geographic areas or risk high volatility and/or revenue over or under recovery. If the DSP area is sufficiently large to overcome localised forecast volatility, then the overarching consumption forecast (from the most recent retail price determination) should provide a reasonable adjustment for other variables, such as occupancy rates, which could be expected to change over time.

Choice of multipliers by water utilities

The choice of multipliers by water utilities should not be subject to approval by IPART. There may be some merit in these multipliers being better articulated by the water utility in the DSP documents. We would be happy to work with IPART on developing appropriate wording which would improve transparency for developers.

4.2 Impact of wholesale price determination

Issues Paper questions:

Question 14

What are the implications (if any) of wholesale customers and WICA licensees for the public water utilities' developer charges methodology and determination? That is, do wholesale arrangements or the activities of WICA licensees mean the methodology and/or determination should be amended? If so, how and why?

As IPART's 2017 report on the wholesale price determination makes it clear that non-zero developer charges should be passed through via the facilitation component of wholesale prices, we see no need for any additional amendments to the methodology and determination for developer charges.

Interaction between wholesale prices and developer charges

Since the last determination of developer charges in 2000, there has been two key changes to the context for these charges. The first was the introduction of the *Water Industry Competition Act* (WICA), which commenced in 2008. This allowed new development areas to be serviced by utilities other than Sydney Water, Hunter Water or the Central Coast Council. The second important change was IPART's recent decision to regulate the wholesale prices charged to these new utilities (WICA Licensees) when they on-sell the services from Sydney Water and Hunter Water.

In its 2017 report on the wholesale price determination[8], IPART decided that the facilitation costs Sydney Water or Hunter Water incurred to augment their network to supply a wholesale customer should be passed through via the facilitation component of wholesale prices. The current policy for Sydney Water's and Hunter Water's water, wastewater and stormwater developer charges is that these have been set to zero for 'in-sequence' development. As a result, growth expenditure is currently funded through retail prices. We agree with IPART's decision that, in this context, facilitation costs should not include any additional augmentation costs related to in-sequence development. We also agree with IPART's decision that for 'out-of-sequence' development, facilitation costs should cover the full cost of the augmentation that would have been funded by the developer according to the water utility's growth funding policy.

Given IPART's clear decisions in their 2017 wholesale determination, we see no reason for consequential changes to the methodology or determination for developer charges. If the Government's developer charges policy were to change in the future, any non-zero charges could be passed through via the facilitation component of wholesale prices. Issues such as timing, forecast updates and other terms and conditions should be agreed between the wholesale service provider and the WICA Licensee. These could be set out in the Utility Servicing Agreement (USA) for each wholesale scheme, and should not require any additional regulatory oversight.

[8] IPART, *Prices for wholesale water and sewerage services - Sydney Water Corporation and Hunter Water Corporation,* Final Report, June 2017

5 Procedural requirements to set developer charges

In this chapter, we discuss potential improvements to the procedural requirements to set developer charges. In summary, we believe the choice of DSP boundaries should remain with water utilities and IPART should retain a similar level of regulatory oversight as set out in the current determination. We also support IPART's suggestion they could provide additional guidance and support by publishing a developer charges calculation spreadsheet.

5.1 Appropriate scale and number of DSPs

Issues Paper questions:

Question 17

What principles or criteria should guide the determination of DSP areas? Are the developer charges in the consolidated DSPs for the Central Coast Councils cost-reflective?

Sydney Water believes the following principles should inform the choice of DSP boundaries:

a) incremental costs of servicing are incorporated into developer decision making

b) administrative costs of calculation and implementation are minimised

c) risks are allocated appropriately between developers and utilities, based on the entity best placed to manage the risk. It is appropriate that developers should bear the majority of development forecasting risk.)

d) decisions are made in a consistent, robust and transparent manner

e) boundaries should support government planning policies and objectives.

We have no comment on Central Coast Council's consolidated DSPs.

Question 18

What role, if any, should IPART play in determining or reviewing DSP areas (for example, should IPART be required to approve DSP areas)?

IPART should retain an audit role only. DSPs should be registered with IPART (as they are now).

Principles for choice of DSP boundaries

The choice of DSP boundary will always represent a trade-off between the benefits of providing a precise location-specific cost signal and the administrative cost of creating this signal (while mitigating other negative effects such as volatility in the charges). For this reason, it may still be beneficial to consolidate DSP areas even when there are discernible cost drivers which could differentiate costs specific to the individual locations.

Consideration should also be given to the likely order of cost differential which would incentivise development in lower cost to serve locations. That is, considering the average price of a new house and land package in Sydney is around $800,000, a differential in developer charge of even

$5,000 per lot (well under one per cent of the price) is unlikely to drive any change in choice of location by the developer or property purchaser. As such, consolidation of DSP areas with the same order of costs should not reduce their effectiveness in providing a location based price signal to development.

We believe the following principles should inform the choice of DSP boundaries:

a) incremental costs of servicing are incorporated into developer decision making

b) administrative costs of calculation and implementation are minimised

c) risks are allocated appropriately between developers and utilities, based on the entity best placed to manage the risk. It is appropriate that developers should bear the majority of development forecasting risk.

d) decisions are made in a consistent, robust and transparent manner

e) boundaries should support government planning policies and objectives.

Sydney Water appreciates IPART noting that the current policy of zero developer charges for Sydney Water and Hunter Water has resulted in a backlog of DSPs that have not been reviewed since 2007. While we agree there may be instances where disaggregation or aggregation is justified, we do not believe aggregation would significantly decrease the administrative effort to create the charges for our entire area of operations. This is because we would still need to cost and allocate the same number of existing and future assets to create the charges.

One option that may reduce administrative effort for implementation would be for the water utility to calculate DSP charges by water supply and sewerage catchment zones, but levy the charges according to Local Government Area (LGA) boundaries using a proportional allocation. LGA boundaries are easily discovered and widely published. This could help developers more easily make informed decisions of where best to focus their development effort, especially considering that most other developer contribution charges are levied on an LGA basis.

5.2 Improvements to the current process

Issues Paper questions:

Question 20

Do the current procedural requirements, including DSP content requirements and IPART's role in reviewing and registering DSPs, remain appropriate?

We do not believe there are any reasons to modify IPART's current role. We also note that because our most recent experience of following the current procedural requirements occurred almost ten years ago, it is difficult to comment on implementation challenges or make suggestions for improvement.

Potential improvements to process

We appreciate IPART's aim to achieve an appropriate balance between minimising regulatory costs, delays and uncertainty, and ensuring the water utilities' developer charges are subject to suitable review and scrutiny. However, we note that because our most recent experience of following the current procedural requirements occurred almost ten years ago, it is more difficult to comment on implementation challenges or make suggestions for improvement.

We do not believe there are any reasons to modify IPART's current role under the Determination. For example, it is appropriate that issues such as choice of DSP boundaries, servicing options, design parameters and other multipliers should be made by the water utility. We also note that a light-handed approach is appropriate considering that developers have a natural incentive to represent the interests of future new customers and water utilities have a natural incentive to represent the interests of existing customers. Review of charges is therefore only appropriate if a developer disputes a charge just as is the case under the current determination.

We support IPART developing and publishing a standard Excel template or model for use by utilities to calculate developer charges as this could enhance transparency and accountability while also reducing administrative burden.

6 Backlog sewerage and minor service extension charges

In this chapter, we discuss two other charges that are similar in scope and calculation to developer charges: backlog sewerage charges and Sydney Water's minor service extension charge.

6.1 Backlog sewerage

Issues Paper questions:

Question 21

What backlog sewerage charges are currently being levied by water utilities, and in what areas? Will they be required in future?

Sydney Water does not currently levy any charges for backlog sewerage areas. For schemes delivered to date under the Priority Sewerage Program (PSP), these were paid for by the Customer Service Obligation approved by Treasury in June 2000. Currently there are no backlog or PSP schemes being constructed or awaiting construction on our capital program. We intend to service Austral, Menangle and Menangle Park through future growth servicing programs in the surrounding areas. The future of the remaining three PSP schemes is a policy decision for Government.

Question 22

Do our current methodologies for backlog sewerage charges continue to be appropriate? If not, what is an appropriate methodology for determining backlog sewerage charges?

Although the current methodology recognises the wider community benefits when properties in certain locations connect to sewerage services, we believe it is timely for IPART to consider what might be a reasonable share of costs between backlog sewerage impactors and beneficiaries.

In addition, we believe IPART's consideration of wider community benefits should be extended to the developer charges for growth within all environmentally sensitive catchments.

Question 23

Should backlog customers continue to have the option of an upfront payment or annual charges? If so, is it appropriate to use the WACC established in the water utility's prevailing retail price review as the discount rate to calculate the annuity charges?

Unlike developer charges, backlog sewerage charges do not necessarily coincide with the sale of a property so upfront payment could be difficult for some households. The opportunity of paying over time is therefore likely to be of benefit to some customers. In order to avoid any disadvantage to the water utility, it would be appropriate to use the WACC when setting the annual customer charge.

Context for backlog sewerage charges

A backlog sewerage service is the provision of improved wastewater management services by a water utility to urban and semi-urban areas where that service is not currently provided. The backlog sewerage program was initially created in the 1980's to provide reticulated sewerage services to remaining pockets of urban development where construction costs were very high.

An updated Priority Sewerage Program (PSP) was initiated by the NSW Government in the late-1990s. The updated program provided sewerage services to selected existing urban towns and villages in environmentally sensitive areas identified at that time by the Environment Protection Authority (EPA).

Since IPART's backlog sewerage determination in 1997, the NSW Government has paid the $3,000 charge determined by IPART as a social program or Community Service Obligation (CSO). Between 1997 and 2011, approximately fifteen PSP schemes were funded in this way with the remaining costs paid by our wastewater customers through ongoing charges. In 2011, the Minister directed Sydney Water to accelerate the PSP and increased their CSO subsidy of the program to $6,000 per dwelling, with an additional eight areas to be serviced by June 2015.

The backlog sewerage program and the PSP are NSW Government programs that Sydney Water has delivered on behalf of Government. There are six areas which remain identified within our Operating Licence as being part of the PSP. Three of these areas, Austral (50 lots), Menangle (100 lots), and Menangle Park (120 lots) are likely to be serviced over the next ten years when the surrounding areas are serviced.

Sydney Water is happy to participate in any Government review of the PSP, to determine the priority, delivery and funding of remaining schemes, as recommended by IPART as part of the end of term review of Sydney Water's Operating Licence in 2014-15.

IPART's review of the backlog sewerage charge methodology

Generally, we agree with IPART's preference of a funding approach based on a hierarchy where:

- the **impactor** should pay (being the party that created the need to incur the cost)
- if that is not possible, the **beneficiary** should pay (direct beneficiaries before indirect beneficiaries), and
- as a last resort, **taxpayers** should pay.

We support IPART's intention to consider what might be a reasonable share of costs between backlog sewerage impactors and beneficiaries. This will be important to achieve an appropriate balance of cost sharing between direct beneficiaries and the wider community. As noted in our submission to IPART's last end of term review of our Operating Licence Issues Paper, post implementation monitoring of completed Stage 1 PSP schemes indicated that there are demonstrated environmental and public health benefits in the immediate vicinity of PSP villages. No benefits were found beyond those localised areas. However, it could be that improvements beyond localised areas were too small to detect as these villages contain only a small number of lots.

Sydney Water supports the continuation of the backlog sewerage methodology retaining recognition of the potential wider benefits to the community from improved environmental outcomes.

As an extension of this position, we would also support this recognition being explored for the developer charge methodology in regions such as the Hawkesbury Nepean which need to discharge wastewater into sensitive receiving waters. We believe any consideration of non-zero developer charges should include an assessment of who are the beneficiaries of the higher environmental standards for wastewater discharge in such growth areas.

Unlike developer charges, backlog sewerage charges do not necessarily coincide with the sale of a property. As such, we believe it appropriate to continue to allow the option for backlog sewerage charges to be paid upfront or on an annual basis. We agree it is appropriate to use the WACC established in the water utility's prevailing retail price review as the discount rate to calculate the annuity charges.

6.2 Minor service extension charge

Issues Paper questions:

Question 26

Should the methodology for the minor service extension charge be set in Sydney Water's periodic price review or should it be set under this developer charges review?

Sydney Water has no preference unless IPART decides to adopt a more efficient method, in which case, we would prefer to be able to apply this sooner rather than later.

Question 27

Should we maintain the current methodology for determining the minor service extension charge, or make amendments to this methodology? Should this be applied by other water utilities (Hunter Water and the Central Coast Council)?

We believe similar outcomes could be achieved using a simpler, and more administratively efficient charge, as described in section 6.2. Adopting a more efficient method would be particularly important if IPART chose to expand the application of these charges to other water utilities.

The MSE methodology could be simplified

Minor Service Extension (MSE) charges apply when a property owner requests to extend the sewerage system and/or the water supply system to their property. In many cases houses have already been constructed on the subject properties, but they are relatively remote from the nearest centralised water and/or wastewater networks and therefore depend on on-site solutions (for example, rainwater and septic tanks). Unlike other areas where a single developer can organise the extension of services, ownership in these situation is usually fragmented. The MSE charge provides property owners with the option of extending the system to serve their property rather than wait for a developer to coordinate services to the area.

The charge methodology mirrors that for developer charges in that it recovers the cost of capital investment to extend the system to a property or group of properties less the expected increase in revenue less operating expenses over time.

Our experience is that the current method requires significant administrative effort to implement. We believe that this effort is disproportionate to any potential benefit it may bring by signalling the incremental cost for those properties to connect. Not only is it costly to our business to process the applications but it is particularly costly when compared to the very small number of customers who eventually decide to connect. We believe the same outcome could be achieved via a simpler, and more administratively efficient option. For example:

- a flat average connection fee per ET for all identified MSE properties
- setting a single connection fee per ET equal to the average cost to service growth[9].

These could be calculated once at each price review. Adopting a simpler, more efficient method would be particularly important if IPART chose to expand the application of these charges to other water utilities.

If IPART decides to include the MSE charge in the same review as developer charges, this may create the impression MSE charges should also be set to zero. That is, it may make more sense to include it with the other non-zero charges in the retail price determination. Also, as it is a charge paid by retail customers, not developers, it may make more sense to leave it in the retail determination. Other than this, we do not believe there is any significant advantage nor disadvantage of leaving it in the retail determination or including it in this one.

[9] Both the above options would require us to continue our policy that before we build any MSE, 50 per cent of properties who will benefit must commit to connect within the first 12 months after the connection is made available.

7 Sydney Water's Developer Direct

In this chapter, we discuss Sydney Water's Developer Direct service, introduced in mid-2017, as a measure to improve customer satisfaction for small developers. We provide an overview of the services offered by Developer Direct and the current pricing arrangements for this service. We also discuss the appropriate form of price regulation, if any, for Developer Direct.

7.1 Background

Staring in the early 2000s, Sydney Water introduced a new process where all developers had to engage a Water Servicing Coordinator (WSC) to apply for their Section 73 Compliance Certificate[10] (s73 certificate).

WSCs are private companies with expertise relevant to the provision of water, wastewater, recycled water, and stormwater services to developments. Under the new process, the WSC would act as a single point of contact for the developer, managing all aspects of the s73 application process, including any interactions with Sydney Water, from start to finish. WSCs would, for example, provide advice on how to best meet Sydney Water's requirements, and may also offer other services depending on the capability of the firm[11]. Similarly, a Sydney Water case manager would act as a single point of contact for the WSC, coordinating input from different business units as needed (for example, technical advice on a design proposal). The case manager would then issue the s73 certificate at the end of the process.

Under this model, there is no direct contact between Sydney Water and a developer at any stage.

From 2014 onwards, Sydney Water introduced a process change for a class of relatively simple developments known as complying development. As a result of this change, certain tasks were re-allocated to WSCs rather than Sydney Water. The change was intended to create more capacity for Sydney Water staff to focus on a growing volume of more complex developments, while also reducing total processing time for relatively simple applications.

There are currently 26 WSCs, and developers may choose any WSC for their development. There are also more than 150 providers who are recognised by Sydney Water as being able to perform construction services relevant to developments that need a s73 certificate. Customers are free to choose any constructor from the list, depending on the specific type of work needed for their development.

Each year, there are around 5,500 s73 applications, and around 55% of these are for developments that involve some form of complex works[12]. The remaining applications are relatively simple developments, and many of these will not need construction work. Sydney Water expects

[10] A Section 73 Compliance Certificate is issued under Section 73 of the Sydney Water Act (1994). It certifies that a development has satisfied all our requirements relating to the availability of drinking water, wastewater, recycled water or storm water services for that development.
[11] For example, many WSCs can prepare designs for new infrastructure, organise a constructor to build works, and provide project management during construction. Some WSCs also have their own construction services teams.
[12] Around 10% of applications are incorrectly entered as minor works, and will be re-classified as major works during the initial assessment of the application.

that around 1,600 developments a year could require some form of minor construction work to be completed.

7.1.1 Price regulation prior to 1 July 2017

Historically, Sydney Water's role in the s73 process has been essentially one of certifying compliance. In other words, Sydney Water undertakes various checks to ensure that all its requirements are capable of being met, ultimately allowing a s73 certificate to be validly issued at the end of the process. While WSCs also perform certain services for customers during the process, only Sydney Water has the legal authority to issue a s73 certificate. In this sense, and to better distinguish between the respective roles of Sydney Water and WSCs, the activities performed by Sydney Water could be termed 'certification services' rather than 'application services'.

Sydney Water accepts that the certification services it provides can be considered government monopoly services for which no alternative supply exists, since no other party can legally perform that service. As such, our certification services would fall within the meaning of the paragraph 3(f) of the *Independent Pricing and Regulatory Tribunal (Water, Sewerage and Drainage Service) Order 1997* (IPART Order), and would therefore be subject to price regulation by IPART.

Consistent with this interpretation, IPART has historically set maximum prices for these services. For example, Schedule 7 of the 2016 retail price determination for Sydney Water[13] includes maximum prices for the following:

- Item 23: building plan approval
- Item 33a: development requirements application – complying development
- Item 33b: development requirements application – other development
- Item 39: the hourly labour rate used for any other service where a designated charge does not otherwise apply.

The services performed by WSCs during the s73 process, including application services, are offered in the context of a competitive market, and developers can choose their preferred provider(s) based on factors such as price, quality of service, and capability. As a result, any additional fees and charges levied by WSCs (that is, over and above the Sydney Water regulated fees noted above) have never been subject to price regulation by IPART. This includes certain application services, but also any construction services procured or performed by WSCs.

7.2 Introduction of Developer Direct

Developer Direct is a new service that became available to developers from 1 July 2017. Since that date, developers have been able to choose whether to submit their s73 application through a WSC or directly to Sydney Water, via Developer Direct, without involving a WSC.

[13] Sydney Water Corporation – Maximum prices for water, sewerage, stormwater drainage and other services from 1 July 2016 (Determination no. 5, 2016).

Sydney Water will review each application and determine whether the development involves major works or minor works. Developments that need major works will be re-directed to a WSC, who will act on behalf of the developer for the remainder of the s73 process. In other words, Developer Direct involved no changes for customers with developments needing major works, and Sydney Water's involvement is still limited to providing certification services.

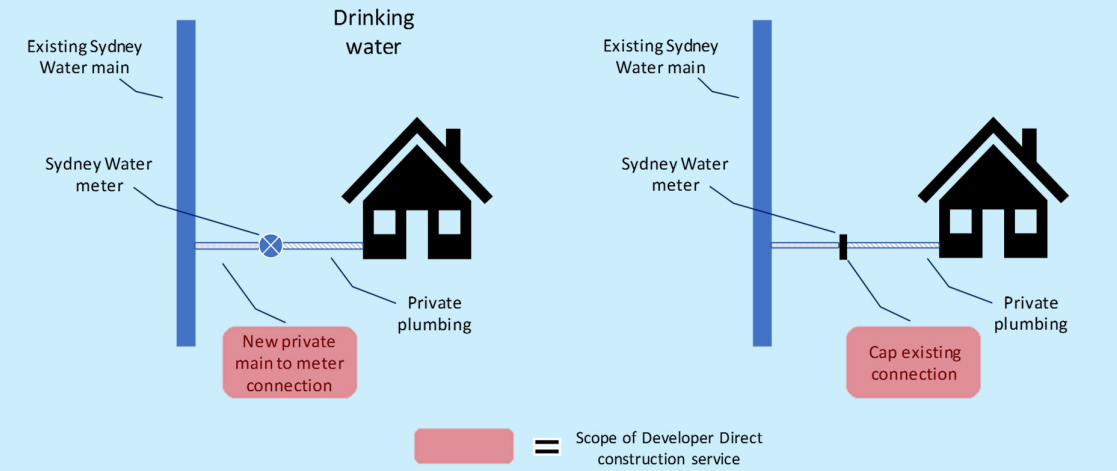
For developments that involve minor works (or, indeed, no work at all), Developer Direct means the application can now proceed to completion without the involvement of a WSC – if the developer chooses. Under this new model, Sydney Water can provide some application services to developers in addition to the traditional certification services that have always been provided. These application services are provided in direct competition with WSCs, and are relevant for developments that require some form of construction work. The application services provided by Developer Direct include preparing a design sketch for the works, and seeking quotes from potential constructors to build the works.

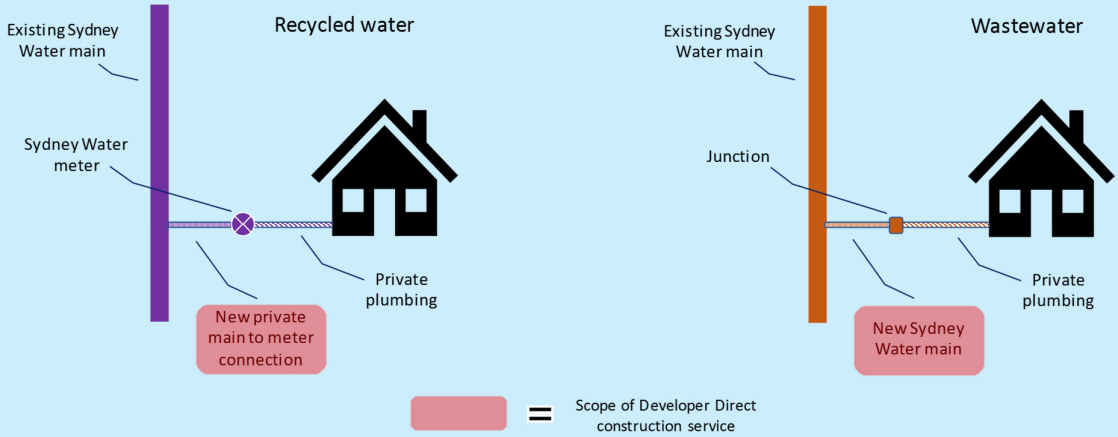
As well as providing some application services, Developer Direct also offers construction services. The design sketch prepared by Developer Direct will be referred to Sydney Water's panel of preferred constructors, with a request for fixed price quotations. Once quotes have been received from constructors, developers will be given the option of proceeding with the work using Developer Direct or obtaining their own quotes through a WSC. If a developer declines to use Developer Direct, they would need to engage the services of a WSC to manage the rest of the s73 application process. Whichever path is chosen by the developer, Sydney Water will remain solely responsible for providing certification services.

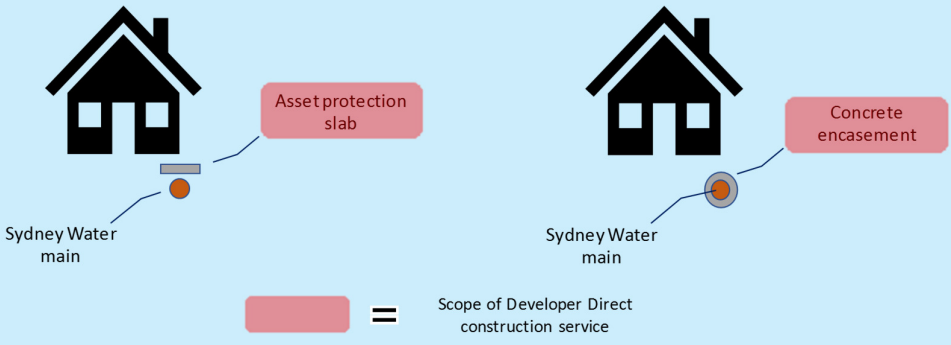
Developer Direct provides six construction services, which are described in more detail in Box 1. It is important to note that for water and recycled water main-to-meter connections, as well as asset protection measures such as concrete encasement, the works constructed do not vest in Sydney Water. In other words, the physical infrastructure does not form part of Sydney Water's works for the purposes of the *Sydney Water Act, 1994*. Sydney Water considers that construction services are therefore clearly characterised as an ancillary service, as the relevant works do not vest in Sydney Water or form part of the Sydney Water network of works. In other words, the provision of services to a customer is achieved by Sydney Water owned mains and related assets. The construction of minor works under the Developer Direct service (or via a WSC) to connect to Sydney Water-owned assets could therefore be considered an ancillary service to the provision of Sydney Water's core services.

It is also important to note that Sydney Water does not perform any construction services directly. Developer Direct uses constructors from a preferred provider panel that was set up via a competitive tender process. The providers on the panel are drawn from the same construction market used by WSCs, and panel members may also perform works for WSCs. The market for construction services is clearly highly competitive, with more than 150 individual constructors listed on Sydney Water's website as being able to perform minor works.

Box 1 – Construction Services offered by Developer Direct







7.2.1 Current pricing for Developer Direct

The Developer Direct service was created after the most recent IPART price determination for Sydney Water. As such, prices for Developer Direct are, in effect, currently unregulated.

However, Sydney Water has been mindful that some regulated charges are likely to be applicable to the services provided by Developer Direct. For example, developers may obtain a Building Plan Approval via Developer Direct, and there is an existing regulated charge for this service. Where relevant, Sydney Water has therefore applied existing regulated charges when setting prices for Developer Direct. The application fee for Developer Direct is currently $495.03, which consists of the following regulated ancillary and miscellaneous service charges from our retail price determination:

- Item 23: building plan approval
- Item 33a: development requirements application – complying development.

In effect, these two items recover the costs of providing certification services by Sydney Water. The rest of the application fee recovers the cost of additional application services provided by Developer Direct in direct competition with WSCs. IPART has formed a preliminary view, and Sydney Water agrees, this component of the application fee is unlikely to need price regulation[14]. This is because the relevant services fall outside the scope of paragraph 3(f) of the IPART Order which only applies to ancillary and miscellaneous services for which no alternative supply exists. Clearly, the relevant applications services can also be provided by WSCs and competition therefore exists in the relevant market.

The cost of construction services provided via Developer Direct are charged to developers based on the fixed price quote supplied by the constructor, plus a margin applied by Sydney Water to earn a reasonable profit margin and to recover other minor costs (for example, use of corporate accounting systems to receive and process payments to constructors). IPART however, has formed a preliminary view that all construction services provided by Developer Direct appear to fall within the meaning of paragraph 3(e) of the IPART Order[15] and are therefore government monopoly services. This would imply a need under the *IPART Act* to regulate the price of construction services offered by Developer Direct. We consider this issue in the following sections.

7.2.2 Alternatives to price regulation for Developer Direct construction services

While a property can't generally receive services from Sydney Water without having a physical connection to the relevant network, there is a clear distinction between private plumbing and the wider network. As outlined earlier, much of the work completed via Developer Direct does not vest in Sydney Water, and therefore forms part of the private plumbing to be owned and maintained by the owner. This applies to all drinking water and recycled water pipes constructed by Developer Direct, as well as asset protection measures installed above or around existing Sydney Water

[14] Subject to the relevant costs and revenues being appropriately ring-fenced from Sydney Water's regulated business (IPART letter to Sydney Water's Managing Director, dated 21 September 2017).
[15] 3(e) "*Services supplied in connection with the provision or upgrading of water supply and sewerage facilities for new developments*"

drinking water, recycled water, or wastewater assets. Assets that don't vest in Sydney Water are not considered the *works* of Sydney Water as that term is used in either the Sydney Water Act or Sydney Water's Operating Licence. While some regulations exist in relation to technical standards for private plumbing, prices for private plumbing work are not regulated. Sydney Water therefore considers that it may not be within IPART's power to regulate the prices of all Developer Direct construction services, as the assets constructed do not form part of the Sydney Water network.

However, even if this interpretation is not accepted, Sydney Water also considers that the supply of services to a property is achieved via the infrastructure network Sydney Water owns and operates. Any private connections needed to access the network are ancillary to this core function. At worst, therefore, the construction services provided by Developer Direct could be considered to fall within the meaning of either paragraph 3(f) or paragraph 3(g) of the IPART Order. Noting that the market for the supply of private plumbing services is clearly highly contestable, it would then be open to IPART to not set a regulated price for most of the services supplied by Developer Direct because Sydney Water is not the only potential supplier.

More broadly, Sydney Water notes that the IPART Order dates from February 1997 and has remained unchanged since that time. The water industry has evolved considerably since that time, and the role of competition has expanded. In addition, new services have become available that are not addressed in the Order (for example, recycled water). Sydney Water itself has also evolved, and now sources most of its services from the market via competitive tender processes. If the Minister had to remake the IPART Order today (with no changes), it would not be within his power to do so because it would not be possible to certify that all services listed in the Order are services for which:

- there are no other suppliers to provide competition in the part of the market concerned; and
- there is no contestable market by potential suppliers in the short term in that part of the market.

While this does not affect the validity or enforceability of the current IPART Order, Sydney Water considers that there is a good case to update the IPART Order to better reflect contemporary circumstances. This would also be consistent with COAG's principles for best practice regulation (see Box 2), which recommend regular reviews to ensure that regulations remain relevant and effective.

As Developer Direct is clearly operating in a highly competitive market, the wording of any updated IPART Order would need to carefully consider whether and/or how construction services could be captured. The COAG principles for best practice regulation provide guidance in this respect, including a need to build the case for intervention, consider a range of regulatory and non-regulatory options, and assess the impacts on competition in the relevant market. In this spirit, Sydney Water has also considered what form of price regulation might be most appropriate for the construction services provided by Developer Direct, should IPART decide that prices must be regulated. This issue is considered in the following section.

Box 2 – COAG Best Practice Regulation Principles

COAG has agreed that all governments will ensure that regulatory processes in their jurisdiction are consistent with the following principles:

1. *establishing a case for action before addressing a problem*

2. *a range of feasible policy options must be considered, including self-regulatory, co-regulatory and non-regulatory approaches, and their benefits and costs assessed*

3. *adopting the option that generates the greatest net benefit for the community*

4. *in accordance with the Competition Principles Agreement, legislation should not restrict competition unless it can be demonstrated that:*
   a. *the benefits of the restrictions to the community as a whole outweigh the costs*
   b. *the objectives of the regulation can only be achieved by restricting competition*

5. *providing effective guidance to relevant regulators and regulated parties in order to ensure that the policy intent and expected compliance requirements of the regulation are clear*

6. *ensuring that regulation remains relevant and effective over time*

7. *consulting effectively with affected key stakeholders at all stages of the regulatory cycle*

8. *government action should be effective and proportional to the issue being addressed.*

Source: COAG (2007) *Best Practice Regulation: A guide for Ministerial Councils and National Standards Setting Bodies,* October 2007, p.4.

7.2.3 Options for regulating prices for Developer Direct construction services

Section 13A of the IPART Act sets out the options available to IPART in relation to the pricing of declared government monopoly services. In short, IPART can only:

- set a maximum price for the service, and/or
- define a methodology that can be used to calculate a maximum price for a service.

Once IPART has decided on the best approach, Sydney Water must charge the relevant maximum price unless it has written approval from the Treasurer of NSW to charge a lower price.

Sydney Water considers that there are likely to be significant difficulties trying to set and administer a regulated maximum price for each of the construction services provided by Developer Direct.

For example, costs will vary significantly from one job to the next and, as noted earlier, there are likely to be around 1,300 jobs each year across the whole market (that is, both Developer Direct and via WSCs). Job specific differences can be considered for other (major) construction work completed on behalf of Sydney Water to serve new developments, since IPART can assess the prudency and efficiency of capital expenditure before it is included in the RAB for recovery via

postage stamp prices (under the current pricing framework of zero developer charges). In contrast, a regulated price for construction services would need to set a fixed value for all jobs, regardless of size or complexity. In addition, Sydney Water would be the only provider in the market subject to this restriction, since the costs of construction services provided through WSCs would presumably remain unregulated. Price regulation in the form of a maximum price would therefore create an unlevel playing field in the relevant market.

To the extent that a regulated maximum price was set lower than the efficient cost of completing the work, there will be a short-fall that must be borne by either Sydney Water or the constructor. If the short-fall is borne by constructors, the likely outcome is that no one will bid for work and Sydney Water would be forced to withdraw from the market. Similarly, if Sydney Water had to bear the shortfall, this would reduce the financial viability of the Developer Direct service, and likely result in withdrawal from the market. This would seem to be a perverse outcome, given that Sydney Water has entered the market to promote competition, lower costs for customers and provide an improvement to the quality of service.

Conversely, if the regulated maximum price is above the efficient cost of completing the work, this would result in wind-fall gains to either Sydney Water or constructors. Again, this would seem to go against the interests of consumers. Sydney Water could, of course, charge below the maximum price, but this would require approval from the NSW Treasurer (either as a standing approval for all jobs, or on a case-by-case basis). This would also seem to be a perverse outcome, as Sydney Water would, in effect, be actively side-stepping the regulatory price setting process.

For these reasons, Sydney Water considers that a price methodology is likely to be a more appropriate form of price regulation than setting a maximum price. Given the competitive nature of the construction market, and the fact that any decision to proceed with Developer Direct for construction services is always at the discretion of the developer, a methodology that achieves a pass through of construction costs is likely to in the best interests of consumers. As outlined earlier, however, the competitive nature of the construction market means the case for any form of price regulation would seem to be quite weak. Sydney Water therefore has a strong preference for no price regulation of the construction services provided by Developer Direct.

8 Glossary

ABS	Australian Bureau of Statistics
CAM	Cost allocation methodology
COAG	Council of Australian Governments
CPI	Consumer Price Index
CSO	Community Service Obligation
DORC	Depreciated optimised replacement cost
DSP	Developer service plan
ET	Equivalent tenement
GSC	Greater Sydney Commission
GSC Draft Regional Plan	*Draft Regional Plan – Our Greater Sydney 2056, a metropolis of three cities – connecting people*
Hunter Water	Hunter Water Corporation
IPART	The Independent Pricing and Regulatory Tribunal
IPART Order	*Independent Pricing and Regulatory Tribunal (Water, Sewerage and Drainage Services) Order 1997*
Issues Paper	*Review of developer charges and backlog sewerage charges for metropolitan water agencies, Sydney Water Corporation, Hunter Water Corporation, Central Coast Council - Issues Paper - Water - October 2017*
IWCM	Integrated water cycle management
LGA	Local Government Area
MEERA	Modern Engineering Equivalent Replacement Asset
MSE	Minor Service Extension
PSP	Priority Sewerage Program

RAB	Regulatory Asset Base
SWC	Sydney Water Corporation
Sydney Water	Sydney Water Corporation
USA	Utility Servicing Agreement
WACC	Weighted average cost of capital
WICA	*Water Industry Competition Act 2006* (NSW)
WSC	Water Servicing Coordinator

Sydney WATER

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