IPART

Review of Prices for Hunter Water Corporation

From 1 July 2016 to 30 June 2020

Draft Report

UDIA NSW SUBMISSION

April 2016

Executive Summary

The Urban Development Institute of Australia - NSW Division (UDIA NSW) is the State's leading property development industry body. We represent over 500 organisations from the public and private sectors. Our members include developers, planners, engineers, academics, regulators, and leading professional advisors. A quarter of our members are based in regional NSW. Our extensive Committee and Regional Chapter structure involves more than 150 of the development industry's key players in policy formulation.

The Hunter Water Corporation's (HWC) pricing structure and funding policies have a direct impact on the delivery of new housing within the Hunter region. UDIA NSW welcomes the opportunity to provide comment on the IPART Draft Report of its review of the HWC pricing for services from 1 July 2016 to 30 June 2020.

Related to IPART's pricing review, the HWC Board of Directors is also undertaking a review of its growth funding policies. UDIA NSW welcomes this review and underscores its importance. The introduction of the Water Industry Competition Act (WICA) and the entry of private service providers (PSPs) in the Hunter has resulted in a loss of market share for HWC that may not be fully reflective of a level playing field. UDIA NSW believes that HWC's current growth funding policies put it at a competitive disadvantage to PSPs, and we recommend a change in policy in order to maintain HWC's competitiveness and increase the supply of affordable housing in the Hunter.

RECOMMENDATIONS

1. **HWC's allowance for capital expenditure should be increased**
2. **HWC should adopt the Sydney Water Corporation policy to fully fund lead infrastructure in identified growth areas**
3. **HWC should engage in commercial terms with individual developers for the delivery of lead infrastructure**
4. **HWC should be allowed to utilise Specified Area Levies to fund lead infrastructure**
5. **Hunter Water should be allowed to pay for works by raising funds through credit-rated debt instruments**

Background: Impact of Funding Policies on a Development Project's Viability

Over the past decade, service providers to Hunter green field developments in new urban release areas have slowly and progressively shifted the cost of providing lead infrastructure from the service authorities themselves, as part of their capital works programs, to a direct development cost on the lead developer and hence on to the eventual home owner. This policy shift has led to a subsequent increased cost to the supply of new housing within these new regional urban release areas, and has directly diminished the viability of some developments, leading to stalled development in the Hunter.

Regional areas of NSW are now competing for limited capital in a market where metropolitan areas (i.e., Sydney) are generally providing a greater rate of return over a shorter payback period. The impact of HWC's current growth funding policy on a development's feasibility lies in both the outright cost burden as well as in the timing of that cost. Coupled with recent changes in a developer's access to finance, HWC's funding policy adds a sometimes insurmountable hurdle to a development project's feasibility.

The current HWC service model unreasonably burdens developers who are obliged, in most instances, to fund the cost of enabling infrastructure in full. The developer must then not only donate the infrastructure to HWC at no cost, without any provision for reimbursement from Hunter Water (other benefitting developments contribute toward the cost of the infrastructure as they connect), but also carry this financial burden throughout the life of the development, accumulating interest on that capital expenditure. As we understand it, this funding model is currently in place due to the severely limited HWC Growth Capital Works Program.

The current HWC Growth Infrastructure Funding Policy includes the following three funding structures:

1. Works are fully funded by the 'lead' developer with HWC collecting reimbursements from future benefitting developers when connection is made to the system, and returning these to the original developer. Reimbursements are collected and returned for 15 years after the installation of the infrastructure.

2. 'Minimum' size assets are funded by the developer with HWC funding the upgrade to 'ultimate' size infrastructure to service the catchment. HWC recover costs as other benefitting developments connect.

3. HWC fully fund lead infrastructure and recover costs as development proceeds.

HWC lead water and sewer infrastructure is most usually funded under scenario 1 with the lead developer being forced to fund infrastructure that will usually service 100's of lots. In the majority of cases, the initial staged release of 40 – 50 lots cannot viably support the construction of lead infrastructure, and hence the development stalls.

In contrast, both Sydney Water Corporation (SWC) and private service providers (PSP) offer policies that mitigate the up-front capital burden of delivering lead infrastructure. These policies can greatly increase a project's financial feasibility.

RECOMMENDATION #1
HWC's allowance for capital expenditure should be increased

UDIA NSW is concerned with Section 1.3.1 of the Draft Report, which will reduce HWC's proposed allowance for capital expenditure. UDIA NSW believes that HWC's capital works program is already too constrained, and recommends that IPART approve, at a minimum, HWC's proposed allowance for capital expenditure. Furthermore, IPART and HWC should consider new funding policies that will allow a greater investment in capital investment.

Options for Policy Changes

RECOMMENDATION #2
HWC Funded Lead Infrastructure

UDIA NSW supports the Sydney Water Corporation policy for funding lead infrastructure and would urge the adoption of a similar policy for HWC.

SWC has a fully funded growth infrastructure program that is based on the Growth Strategy Plan (GSP). SWC's policy also provides flexibility by including a scheme for cost reimbursement to a developer who chooses to proceed "out of sequence", in which the lead developer initially funds the cost for the lead infrastructure but is later reimbursed by SWC once hurdle rates are met. This model is further discussed below.

The SWC growth infrastructure program is available to the development industry. If development is within the GSP area, then provision of lead water and sewer infrastructure is fully funded by SWC. If development is outside the GSP, the

developer funds the delivery up-front, but there is a graduated program in place for reimbursement, with balloon payments made from SWC as milestones are reached. The milestones are based on the development's relative location to the GSP. Dependent on the location of the development site, contributions are made by SWC when either one-third or two-thirds of the development has been completed and occupied.

The Sydney Water Corporation process provides the developer some certainty in funding and return on investment when determining the feasibility of projects. In contrast, the Hunter Water Corporation process offers no benefit to return on investment and instead adds uncertainty, which makes financing more difficult to obtain.

RECOMMENDATION #3
Commercial Terms

UDIA NSW would encourage HWC to investigate what commercial options are available to the corporation that are competitive with the private providers. These commercial terms could implement, for example, a Special Area Levy (see below), and/or include shared upfront infrastructure funding costs with the developer and agreed repayments over a certain time period.

In the Hunter, the introduction of the WICA legislation and PSPs now offers a potential benefit to a development project's financial feasibility. Development projects of a significant size have, in a number of cases, found more favourable financial terms with these private providers rather than running under HWC's requirements. These financial terms, whilst distinct to each project, tend to focus on repayment terms that are less burdensome upfront to the development project. Again, the overall cost as well as the timing of the cost burden proves important to the viability of the project.

Each development is unique, and depending on a variety of factors will present its own risk profile to HWC, making it worthwhile to consider each project on its own merits and commercial terms. UDIA NSW therefore cautions HWC against creating a rigid policy around how projects would be assessed. Rather, we recommend that HWC adopt a set of guidelines and draft commercial terms as a standard framework for early discussions with developers on the provision of lead infrastructure.

RECOMMENDATION #4
Specified Area Levy

UDIA NSW urges IPART to consider allowing HWC the opportunity to introduce Specified Area Levies (SAL) as a means to deliver enabling infrastructure in new developments.

The application of a SAL is a proven and relatively easy policy to implement. A SAL is ideally suited to services that can be attached to real property and that are provided by a monopoly. Local councils and service utilities fall into this category as their services are usually non-contestable. Additionally, as land is immobile, a levy or charge attached to land offers security and reliability of revenue.

Broad based land taxes and municipal rates are already acknowledged as being an efficient way to raise revenue. In fact, municipal rates are widely accepted as one of the most efficient taxes in Australia.[1] It follows then, that utility providers also have an inherent efficiency in collecting revenue.

The principles of land-based taxes can be applied to the provision of lead infrastructure for land developments. The immobility of land and the non-contestability of the infrastructure provide a potential revenue stream effectively in perpetuity; that is, it is not easy for a land owner to take their land elsewhere, or connect their property to a different sewer pipe. This allows infrastructure to be funded by the owner of the infrastructure on much longer time horizons than would normally be the case when deploying capital.

Presently a land developer must fund the infrastructure and any trunk upgrades or new lines. These costs, together with the on-costs such as finance charges, need to be passed through to the buyer of the developed lot through an increased land price. The buyer then requires a larger deposit and larger loan in addition to paying more stamp duty and GST charges.

Under a Specified Area Levy, Hunter Water would enter into an agreement with the land developer, or impose as a condition of approval, that all lots within the estate will be required to pay a special infrastructure levy. The levy is not linked to *usage* of the service, rather it is a charge that runs with the land, like Council rates. This means that the revenue stream is secure whether the developer has sold the lots to new buyers or not, or whether there is a house using the service or not.

The Specified Area Levy would be disclosed to buyers of the land up-front through inclusion in the section 88B instrument and the land sales contract. Upfront

[1] Australian Government. (2015). *Re:think. Tax Discussion White Paper.* Canberra: Australian Government

disclosure, when properly implemented and explained, rarely results in resistance to a buyer decision, particularly when a lower land price is the reward. In fact, many home buyers are rarely thinking they will be in the same place in 30 years' time, so it is unlikely the original buyer will "pay back" much of the cost of the infrastructure. However, the ownership of the land is immaterial to Hunter Water as the levy applies to each and every owner of the land at the time.

The complexity in calculating the levy would depend on the nature of the infrastructure requirements. In a large green field development, the water infrastructure upgrades required are typically and logically linked to coincide with certain lot production rates and demand loads. This makes a levy relatively easy to calculate and distribute over a defined area of lots.

Where another development connects into the newly constructed infrastructure, lots in that new development would also be required to pay a contribution. This means that the buyer in the first development can easily be "rewarded" by seeing a reduction in their levy as a result of the new development. This removes some of inequity barriers for developers who pre-fund large infrastructure and never see a return on their investment when another developer subsequently connects into the infrastructure. Given that it is ultimately the land buyer who pays for everything, then it is logical that they receive the benefits from another developer connecting into new infrastructure.

The creation of real titles creates a valuable non-contestable revenue stream which is leveraged via the SAL to fund the enabling infrastructure. PSPs recognise the opportunity to leverage the perpetual revenue stream and are building their businesses accordingly. If a private venture with clear profit motives can find a way to participate in these systems, then a large, reliable water utility like Hunter Water is arguably in a similar or even better position to participate in infrastructure funding arrangements.

Financing

Under current HWC policy, the developer is typically required to fund lead infrastructure and upgrades entirely. There is a current critical shortage of finance available to regional developers, in an era where foreign banks have exited the Australia finance market, lenders have a reduced appetite for risk and developers have a greater reliance on equity funding. The additional upfront cost burden of funding lead infrastructure has a negative impact on the financial feasibility of a development project.

The costs of developer funding of these works at commercial lending rates available at the time are passed on to the first home buyer. There are numerous ripple effects of passing on increased costs, none of which are positive for HWC, the developer or the consumer:

- Passing on the costs leads to higher land prices (negative: purchaser),
- Which leads to a slowdown in sales rates (negative: developer),
- Which results in a slowdown in take-up of the service (negative: HWC),
- Increasing the financial burden (negative: developer and HWC),
- Which again adds higher mortgage costs to the first home buyer (negative: purchaser),
- Ultimately removing disposable income from the broader economy (negative: regional growth).

To compound the problem, often it is first home buyers who are priced into green field developments (which have little infrastructure and hence high infrastructure costs) rather than established suburbs (with established infrastructure). This means that the people least able to afford increased costs - first home buyers - are often the ones having to pay.

Funding the infrastructure through a considered and planned approach is a much better alternative. UDIA NSW proposes that Hunter Water be allowed to pay for these works by raising funds through credit-rated debt instruments (e.g., through the Infrastructure Investment Loan Scheme, or via bonds; see below). The developer would/should be obliged to purchase/underwrite a percentage of these loans/bonds (e.g., 25%) to ensure there is a shared commitment.

RECOMMEDATION #5
Hunter Water should be allowed to pay for works by raising funds through credit-rated debt instruments

Infrastructure Investment Loan Scheme

UDIA NSW urges the establishment of a Regional Infrastructure Fund that would be financed through the Waratah Bond Scheme. This would help remove the single biggest impediment to housing delivery. The fund would provide loans to build lead-in infrastructure that is fully repaid via a bond style (plus provision for uncertainty) interest rate.

A Regional Infrastructure Investment Loan Scheme would allow a service provider like HWC or developers to apply for funding of critical infrastructure where it can be

demonstrated that the investment will be a catalyst for the delivery of affordable land. The fund would be repaid on a pro-rata basis.

Potential key terms for the fund include:

- Loans are secured by land with lender covenants over each lot
- As each lot is settled the loan relating to that lot would be fully repaid
- Interest is calculated monthly on the outstanding balance and included in lot payment
- Maximum loan term is 10 years
- Rates are set at the 10-year State Government bond yield.
- The Government could raise monies for the fund from the bond market as part of the Waratah Bond scheme.

UDIA NSW believes this system would overcome many of the issues of frontloading infrastructure payments and increase the economic feasibility of developments, particularly in greenfield estates, resulting in better delivery of housing in the Hunter.

Bonds

Hunter Water Corporation can raise capital more efficiently as a large, regional provider of utility services when compared to a group of fragmented and competing land developers of varying scales. One source of capital HWC should consider is the issuance of bonds.

The Australian Government offers Treasury Bonds and/or Notes at yields under 3% providing a significantly cheaper source of capital than is available to a developer. Whilst it's accepted that Hunter Water doesn't necessarily have the same ability to raise capital at yields like the Australian Government, it can be acknowledged that Hunter Water would fare better than a property developer in raising capital on competitive terms.

Many places in the United States have long established Municipal Utility Districts specifically designed to fund infrastructure over long periods of time. In essence, an area is established which ring-fences a precinct, a development, or a district. The Municipal Utility District issues bonds to investors to raise capital for the provision of a utility service to customers within the ring-fenced area. The revenue stream from the connected customers is used to pay interest on the issued bonds, and ultimately pay out the redemption value.

The attractiveness of the Municipal Utility District to an outside investor is the reliability of a revenue stream, the medium to long term investment horizon, and the fact that revenue is collected extremely efficiently (i.e. the cost of collection is low,

meaning more is available to be returned to investors). In the United States, Municipal Utility District bonds are usually tax free, increasing their attractiveness to investors. Regardless of tax treatment, these bonds would have a mixture of mid-to long term redemptions which are attractive to a range of investors, but particularly, to the superannuation institutions. Whether the bonds are tradeable is a matter for financial experts to consider.

Conclusion

Current HWC growth funding policies negatively impact on a development project's viability and can lead to stalled development. UDIA NSW urges IPART to allow an increase in the HWC Capital Works Budget to fund the provision of critical lead infrastructure under any of the above proposals.

Funding of lead infrastructure by HWC will assist in the provision of affordable housing in the HWC area of operations.

Should you have any questions, please contact UDIA NSW Hunter Regional Manager Elizabeth York on [redacted] or [redacted].