



AUSTRALIAN WATER

8 February 2008

Dr Michael Keating
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230
Email: ipart@ipart.nsw.gov.au

Re: Review of developer charges for metropolitan water agencies

Dear Dr Keating,

I am writing to provide our submission to your current review of developer charges for metropolitan water agencies; and to introduce our organisation as a key stakeholder in the Australian water sector and in particular the new regime under the *Water Industry Competition Act 2006* (WICA).

About Australian Water and Rouse Hill Infrastructure Consortium

Australian Water Pty Ltd has evolved out of the Rouse Hill Infrastructure Consortium (RHIC), a private company formed in 1989. Since that time, RHIC has been responsible for the delivery of water infrastructure in the Rouse Hill Development Area (the North West Growth Centre) under an agreement with Sydney Water. To date, this has meant that RHIC has been responsible for funding, designing, construction delivery and project management, and commissioning potable water, wastewater, recycled water and trunk stormwater infrastructure for approximately 35,000 lots, spanning almost 3,000 hectares of land. To date, RHIC has delivered water infrastructure at a cost of approximately \$630 million, on time and to the highest levels of service quality.

The Rouse Hill Infrastructure Project is the first development on such a scale in Australia, and incorporates many innovative features, including:

- one of the first private funding arrangements for the delivery of public infrastructure in NSW;
- the first application on this scale of a dual reticulation recycled water system in Australia;
- integration of domestic water reuse and an urban drainage strategy for a development area on a regional scale; and
- significant environmental benefits in the form of reduced pollutant discharge to the Hawkesbury-Nepean river system as a result of the integrated approach to water cycle management in the region.

By staging the building of water infrastructure over an entire region, RHIC has been able to ensure a coordinated, sustainable and cost-effective approach to urban planning.

RHIC, through its agreement with Sydney Water, is responsible for the funding and delivery of the remaining water infrastructure to the North West Growth Centre. These works are estimated at over \$1.4 billion and will deliver water services to a further 60,000 lots over the next 20 to 30 years.

Australian Water's future strategy

Australian Water/RHIC is interested in expanding its role in the water services market and becoming an owner and operator of water and wastewater infrastructure in the NWGC. We believe that there are significant synergies in being both an infrastructure provider and owner/operator, which would lead to the efficient and cost-effective provision of water and wastewater services and ultimately benefit consumers.

Likewise, Australian Water wishes to build on the expertise and experience of RHIC and deliver innovative and cost-effective water infrastructure to other growth areas in Sydney, such as the South West Growth Centre.

In particular, we believe that we are well placed to help realise the following key objectives of the WICA:

- private sector participation and innovation in the water and wastewater services market; and
- the development of alternative sources of water at least cost (eg, recycling), and hence enhanced water security.

IPART'S CURRENT REVIEW OF DEVELOPER CHARGES

As we aim to become a provider of water and wastewater services, we intend to develop a number of Development Servicing Plans (DSPs) for parts of the North West and South West Growth Centres and are therefore a very interested stakeholder in your current review of developer charges.

Our comments on the review and regulation of developer charges are outlined below.

Regulatory oversight

In general, we support IPART's current approach to the regulation of developer charges. We believe that the process of determining a methodology, rather than specific charges, and then ensuring that a utility's application of this methodology is as transparent as possible (via the exhibition and registration of DSPs) achieves the appropriate balance between prescription and certainty to stakeholders on the one hand and flexibility on the other. We note that the process for dispute resolution via arbitration provides an appropriate 'safety net' for both developers and utilities. We therefore see no advantage in IPART providing additional regulatory oversight to the developer charges process.

The Water Industry Competition Act

In light of the *Water Industry Competition Act* and the Government's aims of enhancing efficiency and innovation in the provision of water and wastewater services, we support the comments in the Issues Paper that the developer charges methodology and regulatory process should be able to be applied to monopoly private sector suppliers (in addition to the established publicly owned water utilities).

We stress, therefore, that the current review of developer charges should be conducted with this in mind. It should ensure that any new supplier of water and related services should be able to recover its efficient costs and achieve an

appropriate rate of return through a combination of developer charges and periodic charges.

We note that developer charges revenue would play a particularly important role for new water utilities in greenfield areas, providing essential cash flow to finance their upfront infrastructure investment.

Development Servicing Plan (DSP) boundaries

We support the practice in the current determination of allowing DSPs to be determined by individual agencies, as each utility is best placed to make decisions about the aggregation of assets into a DSP area.

If DSP areas are too large, they diminish a key function of developer charges, to signal to developers and home buyers the cost of developing and locating in a particular area. If DSP areas are too small, developer charges could vary significantly (even between adjacent areas) and add undue regulatory/administrative burden to utilities as well as developers.

Allowing utilities to aggregate or disaggregate neighbouring DSP areas as they see appropriate can help to ensure that developer charges are sufficiently cost reflective, while also helping to mitigate the effect on developer charges (and hence lot affordability and rates of development) of some smaller, higher cost areas.

Review of DSPs

Given that there may be some uncertainty associated with forecasting costs and revenues well into the future (particularly for greenfield areas), we believe that it is important that utilities have the opportunity to review their DSPs where actual costs prove to be greater than expected or where a utility has reason to revise its forecasts. We acknowledge, however, that this process should be as transparent as possible. It should ensure an appropriate balance between providing certainty and equity to developers, while also allowing utilities to review (and if necessary adjust) their calculation to ensure that they recover the efficient costs of servicing new development.

The current determination allows for utilities to review their DSPs once, and only once, every 5 years (and as a consequence of IPART making a periodic pricing determination). However, rather than being constrained by a particular limit or timetable for review, we believe that the developer charges regulatory regime should allow utilities to review their DSPs and revise their developer charges calculations whenever there are reasonable grounds to do so. This would add sufficient flexibility to the process and recognise the fact that situations can occur that justify a revision of cost and revenue forecasts.

Valuation of assets

For assets already commissioned, the developer charges methodology requires agencies to calculate asset values at efficient market costs for future assets and at Modern Engineering Equivalent Replacement Asset Values (MEERA) for those already commissioned.

However, where it can be shown that a commissioned asset was delivered via a transparent and competitive tender process (i.e. a process ensuring that the asset was commissioned at 'efficient market costs'), we believe that its asset value should be its actual market cost rather than its MEERA value. This would ensure that the developer charges methodology enables utilities to recover their true, efficient capital

costs. It would also enhance transparency and avoid confusion associated with the use of MEERA valuations.

Projection of operating costs

The current developer charge methodology is designed to complement postage stamp pricing, by effectively providing utilities with sufficient revenue to cover the additional cost of servicing new development. This should be reflected in the use of area-specific operating costs in the operating surplus/deficit component of the developer charge methodology. If average, Sydney-wide, operating costs were used in the developer charges calculation and postage stamp retail prices still prevailed, a utility would not fully recover the additional cost of servicing a new, higher than average operating cost, development. We note that – to ensure that utilities adequately recover the additional cost of servicing new development – any change in the developer charges methodology would require re-consideration of the existing postage stamp retail pricing regime, and vice versa. We support maintenance of the existing postage stamp retail pricing regime, providing developer charges continue to provide a means of recovering the additional cost of servicing new development.

We also note that higher operating costs in new development areas are not necessarily a ‘perverse’ or inefficient outcome. Age of assets is only one determinant of operating costs. Others include customer density, terrain and required treatment standards. For example, most new development is in greenfield sites in western Sydney, which has lower population density and higher wastewater treatment requirements than older, more established areas.

Discount rate

The discount rate in the developer charges methodology is intended to reflect the cost of capital to a utility. The current rate for post-1996 assets (7 percent) was established in 2000. This was at a time before the *Water Industry Competition Act*, when it was envisaged that Sydney Water would be the only utility levying developer charges in the Sydney region. This rate was also set at a time when the cost of capital was considerably lower than it is now. Therefore, we believe that this rate, and the way it is regulated, requires review and adjustment to reflect the current cost of capital to utilities servicing new development.

Rather than being prescribed in the developer charges methodology to apply to all utilities, we believe that the discount rate used to calculate each utility’s developer charges should equate to the cost of capital for that utility. In this context, we note that the weighted average cost of capital (WACC) will vary between utilities. For example, a new utility supplying water and wastewater services in greenfield areas is likely to have a higher WACC, than an established, publicly owned utility with a deep customer base in established areas. This should be recognised in the developer charges methodology.

To ensure that the discount rate moves in line with the cost of capital to a utility over time, we also support periodic adjustment or review of this rate. We note that this is broadly in line with IPART’s recent determination on recycled water developer charges where, rather than the methodology specifying a particular discount rate, this rate was deemed to be equivalent to the WACC used to calculate water and sewerage periodic/retail charges (which, itself, is subject to periodic review).

Finally, we note that the current developer charges methodology uses a real discount rate. However, market rates (and therefore the cost of capital faced by a privately owned utility) are in nominal terms. To ensure that the discount rate adequately

reflects the true cost of capital to a utility, consideration should be given to expressing the discount rate in nominal terms.

Consumption per ET

To ensure that a utility adequately recovers the cost of servicing new development, accurate estimates of consumption per Equivalent Tenement (ET) should be included in the developer charges calculation. Furthermore, per our comment above on 'operating costs', such estimates should take into account differences in consumption levels between areas within Sydney (for instance, due to the presence of a 'third pipe' recycled water network, one location in Sydney may use significantly less potable water than another).

As suggested in the Issues Paper, we also note that, for new assets, lower consumption levels are likely to be reflected in system design and asset allocation, and hence lower than otherwise capital costs.


Demographic assumptions

Demographic assumptions and forecasts should be based on the best available information, which is usually via the Department of Planning. However, per our comments above on 'Review of DSPs', we believe that there should be a review mechanism available to utilities to enable them to review and recalculate their developer charges. This would recognise some of the uncertainty involved in forecasting future costs and revenues, and would enable estimates to be revised as better and more up to date information becomes available.

Where possible, we would welcome the opportunity to participate further in this review, including the public hearing scheduled for 10 March 2008.

Should you wish to discuss any aspect of our submission, please contact me on (02) 8884 7315.

Yours sincerely,


 Nick Di Girolamo
Chief Executive Officer
Australian Water Pty Ltd