

**SUBMISSION TO THE
ECONOMIC REGULATION AUTHORITY'S
INQUIRY INTO DEVELOPER CONTRIBUTIONS
TO THE WATER CORPORATION**

16 May 2008

INTRODUCTION

This submission represents the Water Corporation's response to the Economic Regulation Authority (ERA) on the recommendations made in the Draft Report: *Inquiry into Developer Contributions to the Water Corporation (14 April 2007)*.

It follows the Corporation's original submission to the ERA following the release of the issues paper. In the previous response the Corporation highlighted the strengths of the current arrangements with alternatives proposed that sought to build on the virtues of the current approach.

This response adds to the Corporation's position initially conveyed in its earlier submission, by responding specifically to the ERA recommendations contained in the ERA's Draft Report.

Executive Summary

The Water Corporation offers this submission in reply to the Economic Regulation Authority's Draft Report: *Inquiry into Developer Contributions to the Water Corporation (14 April 2008)*.

The Corporation's specific response to each of the ERA's draft findings are detailed in the following pages. As a summary, the Corporation gives it's "in principle support" to the majority of the ERA's findings. In particular, the Corporation noted the ERA's support for the current suite of non-standard charges, their calculation methodology and the arrangements that underpin when they apply. In addition, it is pleasing to note that the ERA's draft findings conclude that a modified version of a Corporation proposal has merit.

In almost all aspects, the current developer charging arrangements when combined with the recommendations made by the Corporation in its previous submission will deliver the outcomes recommended by the ERA. There is, but one notable exception which is the ERA's preference for the scheme based charging alternative as opposed to a state-wide uniform Standard Headworks Charge (SHC).

The Corporation's preference is for a uniform SHC as this retains the benefits of simplicity, provides certainty for developers and supports the Government's regional development objectives. In reaching this preference, the Corporation acknowledges that a scheme based charge may send a more efficient pricing signal. However, in circumstances where standard charges typically apply, the absence of a pricing signal is unlikely to result in community welfare loss as the price elasticity of demand is minimal. Developers are unlikely to change their decision as the SHC represents a small proportion of the total development cost. Prior to making any change to a scheme based charge, the benefits delivered by differential charges should be clearly demonstrated.

A modified alternative from the Corporation's original proposal which takes into account a system's spare capacity has merit. In making capacity adjustments however, the ERA is encouraged to consider a number of issues that would need to be resolved.

Finally, the Corporation recognises the virtues of the ERA's regulatory practice principles and notes that these are largely instilled in the existing arrangements. In particular, the current arrangements with the Urban Development Advisory Committee (UDAC) ensure the involvement of key industry stakeholders in developing pricing policy. The only noted absence recommended by the ERA is that of an independent regulator. The Corporation considers that regulatory scrutiny does not need to be applied to specific charges, but could be limited to policy setting and overall revenue requirements.

Water Corporation's Response to the Draft Recommendations

The ERA's findings are listed in normal font, with the Corporation's initial comments shown in *blue italics*.

General Principles and Findings for Developer Charges	
1	<p>Source costs are likely to be better recovered through tariffs than through developer charges.</p> <p><i>Agreed – now that the Corporation's metropolitan water usage charges are changing to reflect the cost of new sources and bulk water conveyance, it is appropriate that the Standard Headworks Charges (SHC) excludes these items.</i></p>
2	<p>The costs of enhancements to the transmission network are also likely to be better recovered through tariffs than through developer charges, to the extent that all connected customers contribute to the need for these costs to be incurred.</p> <p><i>Agreed, provided the reference to the transmission network is limited to bulk water conveyance assets as these are more appropriately linked to water source development. A further point of clarification: this approach should not relate to a very large customer where assets might be underutilised if they cease business.</i></p> <p><i>There is a weaker argument for sewer mains to be included in annual charges, however it may also be justified as sewer mains supply a very large number of customers over many years with annual charges being a simpler approach to apportioning the cost.</i></p> <p><i>The need for initial capital investment and subsequent upgrades in the remaining conveyance network (i.e. excluding bulk water and wastewater transfers) is directly linked to the demand created by new lot development. This includes the need for smaller conveyance assets required for new developments in the short term, as well as larger distribution and collections mains constructed for medium/long term growth. As all of these assets are required to service new development, they should all be included in the calculation of developer charges.</i></p>

3	<p>The setting of all charges (including developer charges) needs to be mindful of the need to achieve an optimal utilisation of the existing network (technical efficiency).</p> <p><i>Agreed, without losing sight of the long term objectives of sustainability planning and future looking activities.</i></p> <p><i>Service providers are usually dependent on the overall land planning activities. Optimising the use of both existing and new networks requires timely and effective strategic land planning. The extent to which a service provider is involved in the land planning process can influence the ability for assets to be optimally utilised.</i></p>
4	<p>Developer charges, if set efficiently, should at least cover the direct forward-looking costs of providing services to each new development.</p> <p><i>Agreed in principle, however for reasons of equity, it is also important that part of the cost of assets that indirectly service a new development should also be included in the charge.</i></p> <p><i>Furthermore, given the relatively weak responsiveness of land development to developer charges, the setting of efficient prices may only be appropriate in a limited number of circumstances. These circumstances are typically covered by the Corporation's non-standard headwork charges (Special Development Contributions Areas).</i></p>
5	<p>Any risks associated with additional costs due to the over-sizing of assets to meet future demand growth should be borne by the utility, and the costs recovered from those for whom the spare capacity was provided.</p> <p><i>Agreed in principle, provided the "costs recovered from those for whom the spare capacity was provided" includes a reference to:</i></p> <ul style="list-style-type: none"> <i>(i) the Corporation's customer base; and/or</i> <i>(ii) future land developments that were anticipated at the time the spare capacity was created.</i> <p><i>Further to point (ii), as discussed in the ERA's draft findings, apportioning the cost of spare capacity over future land developers for whom the spare capacity was required is justified on the basis of equity. The Corporation not only supports this</i></p>

	<p><i>view, but extends it to say that new developers who are using spare capacity provided for by existing assets should also contribute to the cost of those existing assets – justified again, on equity grounds. If these customers do not make a fair contribution, the costs will need to be recovered from the Corporation’s general customer base which may receive no benefit from the assets.</i></p>
6	<p>While developer charges are unlikely to be a dominant consideration in the location decision for new developments, such charges are necessary so as to avoid the need for development costs to be recovered from other customers, thereby sending inappropriate signals to those customers and reducing community welfare.</p> <p><i>From an economic perspective: agreed in principle.</i></p> <p><i>However, the extent to which community welfare is reduced depends largely on the responsiveness of land development to developer charges. If (as appears to be the case) development does not respond to a pricing signal, there is no reduction in community welfare. The issue becomes largely one of equity.</i></p> <p><i>The lack of an efficient pricing signal will only result in potential community welfare loss in a handful of circumstances – typically in high cost country towns, without spare capacity, where non-standard charges don’t apply. In these instances, the matter becomes one for the Government’s to decide whether subsidising a development is appropriate in the context of its broader social objectives (e.g. regional development plans). Subsidisation may well be justified based on the longer term (potentially intangible) benefits of regional development.</i></p> <p><i>The Corporation would be reluctant to change to a scheme based charge unless the benefits of that change are demonstrated.</i></p>
7	<p>Developer charges should cover the costs associated with bringing forward new developments ahead of a development schedule.</p> <p><i>Agreed.</i></p> <p><i>This is achieved through the Corporation’s Special Development Area Charge for distant development and/or through pre-funding arrangements.</i></p>

8	<p>The correct determination of out of sequence development costs depends on the existence of a clearly defined development schedule.</p> <p><i>Agreed.</i></p> <p><i>The ability to achieve this is often dependent on the extent to which accurate strategic land plans are completed in a timely manner.</i></p>
9	<p>The benefits of implementing a developer charging methodology should outweigh its administrative costs, including transition costs.</p> <p><i>Agreed</i></p>
<p>Equity</p>	
10	<p>The Authority is of the view that the intent of the Uniform Pricing Policy is that households should have access to affordable water for essential needs, and not that developer charges should be uniform.</p> <p>It is a matter for government to determine whether developer charges in regional areas should be subsidised in the interests of regional development. However, it is important to note that such decisions come at a cost: any gains from moving away from cost reflective pricing in one area will be offset by welfare losses in other parts of the wider community.</p> <p><i>It is a matter for government to determine whether:</i></p> <ul style="list-style-type: none"> <i>• The Uniform Pricing Policy applies to developer charges; and</i> <i>• The extent to which regional areas should be subsidised</i> <p><i>The existence of non-standard developer charges does not necessarily mean that the Uniform Pricing Policy cannot apply to developer charges. The policy may be interpreted to mean that uniformity applies in the absence of unusual (or non-standard) circumstances.</i></p> <p><i>The Corporation's preference is for uniform pricing for Standard Headwork Charges as this retains the benefits of simplicity, provides certainty for developers and supports the Government's regional development objectives. There is little to be gained by having a scheme specific charge if land developers do not respond to the pricing signals.</i></p>

11	<p>The Authority considers that there are unlikely to be net welfare gains across the State from subsidising developer charges in regional areas.</p> <p><i>Unable to determine: depends on the intangible benefits of broader social objectives such as regional development. Equally, with low price elasticity, there is likely to be very little welfare loss from a uniform charge.</i></p>
12	<p>When implementing changes to developer contributions policies, service providers should mitigate the impacts on customers, particularly those on low incomes, for example, by phasing in changes to tariffs over time. However, any delay in the move to efficient pricing would incur welfare losses.</p> <p><i>Agreed in general. While this may be appropriate for annual charges, specific consideration should be given as to whether this is necessary for developer charges.</i></p>
<p>Good Regulatory Practice</p>	
<p><i>Water Corporation general comments:</i> Any potential changes to the current governance arrangements must stand up to the two important tests of being both effective and efficient.</p> <p><i>An effective regulatory system must remain focused on the primary purpose of the regulator of the industry, which is to ensure customers receive good-quality, efficient service at a fair price.</i></p> <p><i>An efficient regulatory system operates when the costs of complying with regulator requirements do not exceed the benefits received. Where onerous compliance costs are imposed on industry suppliers, these costs ultimately result in all stakeholders being worse off.</i></p>	
13	<p>The setting of developer charges and developer charging policies should involve effective public consultation.</p> <p><i>Agreed, however it is the development community (and not necessarily the general public) which is affected most by headwork contributions. Public consultation will be more effective when targeting appropriate stakeholders. The current arrangement with UDAC is a good example of this.</i></p>

	<p><i>Public consultation effected through a representative body helps to achieve efficiency within the process. Care should be taken to ensure the representative body appropriately reflects the stakeholders' concerns without allowing special interest groups to disproportionately influence the pricing process.</i></p>
14	<p>Developer charges and developer charging methodologies should be subject to independent regulatory scrutiny.</p> <p><i>Agreed in principle, however regulatory scrutiny does not need to be applied to specific charges, but could be limited to policy setting and overall revenue requirements. Furthermore, such independent regulation may only be required at periodic intervals, say every 3 to 5 years.</i></p>
15	<p>Service providers should be accountable for money raised through developer charges, through independent scrutiny and public consultation.</p> <p><i>Agreed in principle – at least, in so far as independent scrutiny is concerned. Public consultation may inform, but should not direct the operations of the service provider nor their pricing policy. The current accountability with developer contributions is that services will be available for frontal development when a developer is ready to develop land.</i></p> <p><i>Service providers should be accountable for their performance as directed by their Operating Licence requirements. This could include the use of an independent regulator advising on the revenue required to carry out this functional efficiently.</i></p>
16	<p>Developer charges and developer charging methodologies should be transparent to stakeholders.</p> <p><i>Agreed</i></p>
17	<p>Developer charging policies should incorporate a mechanism for appeals against the charges and their coverage.</p> <p><i>Agreed in principle, provided the appeals mechanism is itself efficient, and not inordinately cumbersome. Provided the public are consulted in the setting of the pricing policy, an appeals mechanism should be limited to instances where an aggrieved party believes the policy was incorrectly applied.</i></p>

Water Corporation's Standard Headworks Charges	
18	<p>The alternative methods proposed by the Corporation for determining headworks charges are an improvement over the current approach in that they are based on distribution costs and exclude the costs of source development.</p> <p><i>Agreed</i></p>
19	<p>Of the two options proposed by the Corporation, Option 2 is better than Option 1 in terms of economic efficiency, as it provides scope for setting headworks charges which reflect development costs at each location.</p> <p><i>Option 2 may be better in terms of economic efficiency in the limited circumstances where a pricing signal from a Standard Headworks Charges can be effective.</i></p> <p><i>Option 1 (the Corporation's preferred option) has benefits in terms of simplicity, provides certainty for developers and supports the Government's regional development objectives.</i></p>
20	<p>A modified Option 2, which takes into account existing spare capacity, in combination with the Minor Works Cost Sharing policy, would be a more efficient approach to setting headworks charges. This approach would be less administratively complex than other approaches, such as those adopted by IPART or Western Power, while potentially representing a reasonable approximation of the forward-looking development costs in each scheme.</p> <p><i>Agreed - a modified Option 2 which takes into account existing spare capacity would be more efficient than the original proposal. However, this acknowledgment is subject to the qualification noted in point 19 – that is, Option 1 remains as the Corporation's preferred alternative.</i></p> <p><i>The concept of "spare capacity" requires greater consideration with a number of issues to be resolved prior to finalising any modified alternative. They include:</i></p> <ol style="list-style-type: none"> <i>1. Appropriate level of spare capacity required as a prudent reserve;</i> <i>2. Accounting for capacity "purchased" by major consumers but not utilised;</i> <i>3. How to adjust charges for a scheme's changing circumstances;</i>

	<p>4. <i>Whether capacity is measured as a % of the system's conveyance capability or based on the numbers of years before the next anticipated upgrade;</i></p> <p>5. <i>How is a capacity adjustment applied in an integrated scheme (particularly appropriate for the Goldfields and Agricultural Water Supply scheme)? Does it refer to the capacity of the overall integrated scheme, or the capacity of a town's localised infrastructure?</i></p> <p>6. <i>Is it based on the supply constraints related to specific infrastructure (for example, a specific pump station that is near capacity) or the average surplus capacity of the entire system?</i></p> <p><i>Finally, the Corporation notes that, once an adjustment is made for a system's spare capacity, the time period for consideration is a key element in recognising average historical costs as a proxy for forward-looking costs. The provision of water services requires asset investment decisions that consider the long term horizon. Whilst modular in nature, some conveyance infrastructure may still be installed in large, periodic instalments. When setting forward looking developer charges using historical costs, long time periods (for example 30 years) should be used. Furthermore, a meaningful comparison can only be made when comparing actual developer revenue to actual costs, if this is done over many years.</i></p>
21	<p>If Water Sensitive Urban Design principles result in savings to the Corporation in the distribution costs of new developments, these cost savings should be reflected in developer charges.</p> <p><i>Agreed.</i></p> <p><i>The savings in the distribution system would need to be permanent in nature. They are unlikely to be available if the standard scheme retains its full service capacity as a backup to the water sensitive design initiative.</i></p>
22	<p>A modified Option 2, if implemented, could be supplemented by explicit caps and subsidies to offset high charges in some regions through CSOs. However, such government subsidies should be evaluated against the welfare gains of alternative uses of government revenue.</p> <p><i>Agreed.</i></p> <p><i>Care should be taken in implementing a system of subsidies which reduces certainty for developers and/or delays the development process. The Corporation</i></p>

	<i>would be concerned if developments were delayed by the provision of water services. The need to apply for specific subsidies could potentially result in such delays.</i>
23	<p>A modified Option 2 should incorporate principles of good regulatory practice, including an independent review process, public consultation, transparency in design and application, and a mechanism for appeals.</p> <p><i>Agreed – subject to the comments on Good Regulatory Practice noted in points 13 to 17.</i></p>
Water Corporation's Other Headworks Charges	
<i>Rural Subdivisions</i>	
24	<p>The extension of the Standard Headworks Charge to rural subdivisions between one and four hectares may be appropriate if the development costs imposed on the Corporation are similar to those of smaller rural blocks. However, the Authority would like to further examine the Corporation's analysis of development costs for rural subdivisions.</p> <p><i>Agreed. Should the ERA request, the Corporation will endeavour to provide any additional information.</i></p>
<i>Out of Sequence Developments</i>	
25	<p>The Corporation's developer contribution policy should continue to provide for developers to bring forward projects ahead of the development schedule if the developers are willing to bear any associated additional financial cost and risk.</p> <p><i>Agreed</i></p>
<i>Major Country Customers</i>	
26	<p>A notional cost approach to setting headworks charges for major customers on a scheme by scheme basis could achieve an appropriate balance between cost reflectivity and administrative complexity.</p> <p><i>Agreed – this is the basis of the current approach.</i></p>

27	<p>The charging method for major customers should be transparent (the way in which notional costs are calculated should be clearly understandable by stakeholders).</p> <p><i>Agreed – information is provided to prospective customers on request.</i></p>
28	<p>The Authority seeks further comments from major customers and other interested parties regarding the advantages and disadvantages of the Corporation's charging approaches to major customers compared to alternative approaches, such as that applied by Western Power to its major customers.</p> <p><i>Water Corporation is not required to comment</i></p>
<i>Temporary Connections</i>	
29	<p>If there are substantial development costs required for a temporary connection, such as for the construction of assets specific to that connection at costs greater than average distribution development costs, then these should be charged to the developer making use of the temporary connection. Otherwise, temporary connection charges should be linked to standard headworks charges. The Authority is intending to investigate further the cost-reflectivity of existing charges for temporary connections.</p> <p><i>Agreed. If requested, the Corporation will assist the ERA with any additional information required.</i></p>