



Department of Treasury and Finance
Government of Western Australia

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Dear Mr Rowe

INQUIRY INTO DEVELOPER CONTRIBUTIONS TO THE WATER CORPORATION: SUBMISSION TO DRAFT REPORT

Thank you for the opportunity to provide comment on the Economic Regulation Authority's (ERA's) Draft Report for its Inquiry into Developer Contributions to the Water Corporation.

This inquiry is an important final step in the independent review of every major aspect of the Water Corporation's charges and the draft report provides a very good model for developer contributions in Western Australia.

As you would be aware, the National Water Initiative is largely silent on the issue of developer contributions but for water storage and delivery pricing more generally, clause 65 (ii) requires "...full cost recovery for water services to ensure business viability and avoid monopoly rents".

The draft principles proposed by the ERA provide further guidance on this matter and a sound basis for the development of alternative developer contribution charges for Western Australia.

As it is these principles that underpin the 11 draft findings and five draft recommendations of the report, it is those aspects which the Department of Treasury and Finance (DTF) has provided comment on in the attached.

The key points in this submission are:

- developer contributions should be subject to greater regulatory scrutiny by the Authority, which should involve the inclusion of developer contributions (both standard and commercial arrangements) in the major periodic pricing inquiry;
- source and transmission costs are more appropriately recovered through users charges than developer contributions;

- support for the introduction of the proposed Option 2 for setting headworks contribution, involving scheme specific costs of distribution assets and removal of the costs of excess spare capacity;
- support for the introduction of the Minor Works Cost Sharing Policy; and
- the general intent to minimise the subsidisation of developer contributions and any consideration of such subsidisation to be undertaken on a case by case basis.

Furthermore, and in regards to the treatment of developer contributions for tax and dividend purposes, the DTF wishes to clarify that the 85 per cent dividend payout ratio of the Water Corporation is not based "...on the assumption that cash revenue from developers would average 15 per cent of net profit". Rather, the dividend payout ratio of the Water Corporation is set for the purposes of competitive neutrality and seeks to balance the impact of its tax equivalent and community service obligation payments.

I trust this information will further assist in the development of the Final Report for this important inquiry. If you have any queries on this submission please do not hesitate to contact David Murphy, Principal Policy Officer, Commercial Policy, on 9278 6742, or by email at david.murphy@dtf.wa.gov.au.

Yours sincerely

David Morrison
DIRECTOR
STRUCTURAL POLICY

28 May 2008

COMMENTS ON THE DRAFT RECOMMENDATIONS

Recommendation 20: 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.

Based on the understanding that the Water Corporation has the capacity and ability to determine costs on a scheme by scheme basis and to also identify the spare capacity built into each of its scheme, this recommendation is supported.

While there may be an initial increase in costs to the Water Corporation to augment its current planning and reporting systems to accommodate this requirement, over time the benefits of increased cost reflectivity may outweigh those initial establishment costs.

However, the benefits of improved cost reflectivity of headworks charges (such as improved efficiencies and the removal of cross-subsidies) must be compared against the costs (which would be largely administrative) of determining those charges.

As the impact of headworks charges on development decisions is likely to be quite low in the majority of cases, excessively high administrative costs may not be warranted.

This is also the case in the determination of the forward looking costs and the usefulness of historic or even current costs in determining such charges. Going forward, it may be necessary for the Authority to undertake regular, periodic reviews of the Water Corporation's developer contributions to ensure its current costs represent a reasonable proxy for its forward looking costs. This would be consistent with the proposed increase in regulatory scrutiny over the developer contributions.

Recommendation 21: 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.

This draft recommendation is noted.

The Authority is requested to further investigate opportunities for the encouragement of water sensitive urban design (WSUD) features in a development, where those features can provide benefits to the scheme or system.

Such benefits can include the conservation of scheme water and the reduction of nutrient discharge to river ways.

Where this is the case and WSUD features can provide these benefits, a corresponding incentive based reduction in developer contributions could be a way to encourage such an outcome.

From an efficiency and equity perspective, the reductions in developer contributions should equate, on a net present value basis, to the benefits it produces to the wider scheme or system.

Recommendation 22: 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.

Any cap or subsidy must be considered on a case by case basis. Further modelling will be required to estimate the proposed developer contributions and the quantum of any subsidy deemed necessary.

That said, there may be some circumstances where a more cost reflective headworks contribution may be prohibitively expensive to the extent that it discourages development. In such a situation, the DTF supports the provision of a subsidy to avoid such an unintended outcome.

Recommendation 23: 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.

This recommendation is strongly supported. The application of good regulatory practice is paramount in the determination of an appropriate charging model.

To ensure appropriate independent review, the Authority's periodic major review of the Water Corporation's tariffs should be expanded to include developer contributions. Such a review such would also provide an opportunity for public consultation on the setting of developer charges and improved transparency in their development.

That said, it is important to acknowledge the Water Corporation's existing governance model for developer contributions, through the utilisation of the Urban Development Advisory Committee, for targeted stakeholder consultation.

As for a mechanism for appeals, it is understood that the Department of Water is developing a proposal for a joint utility ombudsman to cover the water and energy sectors. Such an arrangement would provide the necessary appeals mechanism and is therefore strongly supported.

Recommendation 25: 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.

This recommendation is supported.

Any developer contribution policy must be flexible enough to accommodate situations where developers wish to bring forward projects ahead of the development schedule.

It is also appropriate however that the developers in this situation meet the additional financial costs of bring forward those necessary projects.

COMMENTS ON THE DRAFT FINDINGS

Finding 6: 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.

The DTF supports the draft finding that developer contributions ensure an appropriate allocation of resources by recovering the specific development costs using an impactor pays approach.

Recovering new development costs from existing end users through water, wastewater and drainage charges would unfairly burden existing customers and distort the pricing signal.

Finding 8: The correct determination of out of sequence development costs depends on the existence of a clearly defined development schedule.

This draft finding is noted.

Finding 10: 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. 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.

This draft finding is supported.

The uniform pricing policy is not intended to include developer contributions and should therefore be excluded from any further consideration on this matter.

Developer contributions are generally a very weak pricing signal for developmental locations and form only a relatively small portion of the total costs of land development. Therefore, it is not considered necessary or appropriate for the Government to subsidise such charges as a general rule and the existing level of support to rural developments through the Regional Headworks Program will be sufficient.

However, if the charges to a specific location were prohibitively expensive to development, then there would likely be an argument for a case by case consideration of subsidisation to ensure the headworks contributions do not distort development in certain locations.

Finding 11: The Authority considers that there are unlikely to be net welfare gains across the State from subsidising developer charges in regional areas.

This draft finding is noted.

Finding 18: 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.

This draft finding is supported.

It is agreed that with an efficient tariff structure based on long run marginal costs, the recovery of costs for source development through developer contributions would not be necessary.

However, during phase-in periods of long run marginal cost pricing and any potential reforms to developer contributions, the Authority is expected to ensure ongoing and sufficient revenue raising for the Water Corporation.

Finding 19: 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.

This draft finding is supported.

It is agreed that setting developer contributions to reflect location specific costs would lead to a more cost reflective charge.

However, given the minor impact such charges have on investment decisions for developers in most instances, the administrative costs of determining location specific charges must be considered against the potential benefits to the wider economy from more efficient prices and removal of any cross subsidies.

Further consideration of this matter will be important in the Final Report to allow the Government to consider such reforms to developer contributions in Western Australia.

If the determination of location specific charges is considered to be prohibitively expensive on a cost benefit analysis, there may be opportunities to consider the advent of such charging in areas where it can demonstrate the greatest benefit.

Finding 24: 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.

This draft finding is noted and requires further consideration of the potential impacts.

A four hectare property could sustain a commercial enterprise and therefore it would be inappropriate for it to automatically receive subsidies for the costs of subdivision. However, if the headworks charges calculated as a result of the potential reforms (recommended under Option 2) lead to a more cost reflective pricing arrangement, any potential subsidy would be reduced.

The DTF supports the Authority in its decision to further investigate the cost differential between the two categories of subdivisions.

Finding 26: 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.

This draft finding is supported.

The use of the notional cost method as a means to remove the potential inequities between developers over time is appropriate.

Consistent with the intention to improve the regulatory oversight of developer contributions, it is recommended that the notional cost approach for major customers be reviewed by Authority during its major, periodic pricing inquiry.

Finding 27: The charging method for major customers should be transparent (the way in which notional costs are calculated should be clearly understandable by stakeholders).

This draft finding is supported.

In theory, the same regulatory scrutiny of standard headworks charges should be applied to developer contributions from major customers. This should include a review of the Water Corporation's approach to charging its major customers in the major periodic pricing inquiry.

Finding 28: 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.

This draft finding is noted, as the DTF considers the Water Corporation's approach to charging major customers on a commercial basis is appropriate.

As suggested by the Authority however, improvements to the approach should involve greater regulatory scrutiny, improved transparency and possibly an improved method of appeals, through an Ombudsman arrangement.

Improved regulatory scrutiny would ensure that, consistent with the requirements of the National Water Initiative, that the charges (based on the assumed level of risk to the Water Corporation) recover a sufficient level of revenue but at the same time avoid the earning of monopoly rents.

Finding 29: 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.

This draft finding is supported in part.

The DTF agrees that any additional costs for temporary connections, like out of sequence developments, should be met by the developer on a commercial basis.

The DTF also agrees that the demands of future customers should be a relevant consideration in the charges for temporary connections.

However, in the instances where there are no future customers on which to rely, it is important that the Water Corporation is not disadvantaged by these temporary connections with, for example, stranded assets for which it is not appropriately compensated for.