Yarra Valley Water

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Mr Marcus Crudden
Acting Director, Water
Essential Services Commission
Level 2, 35 Spring Street
Melbourne VICTORIA 3000

Dear Marcus,

RE New Customer Contributions (NCC) for the 2013/14 to 2017/18 regulatory period

The Commission issued a guidance paper on NCCs in August 2012 which provided water companies with 2 options relating to their NCC submission. As you are aware, Yarra Valley Water decided on the staged submission option where

- the water plan included capital expenditure, gifted assets, NCC revenue based on existing framework and a default negotiating framework, and
- by 7 December 2012 submit forecasts of capital expenditure, gifted assets, revised NCC revenue, standardised charges, negotiating framework and transition plan

The attached document is the second stage of this requirement.

There are many competing objectives to be considered when setting developer charges and the application of NCCs is more about public policy and balancing between housing affordability and cost of living than deriving a pure economic or financial answer. Ultimately it is critical that the Commission's NCC determination for the 2013/14 to 2017/18 regulatory period provide sufficient guidance so that the NCCs of the Victorian water businesses are fair, reasonable and acceptable to all customers and stakeholders.

We are concerned that the Commission's instructions to include sunk assets only as far back as 2008/09 unfairly favours developers over existing customers. New connections utilise assets that are sized to cater for growth and recently further capacity has been created by the water conservation efforts of our current customers. As these network assets are not included in the Commissions model for the NCC calculation, the current customer base is paying for this built in capacity.

We are committed to working with the rest of the water industry, development industry and the Commission to ensure charges for NCCs are sustainable over the water plan and beyond.

If you wish to discuss this matter or require further information, please contact Steve Bumpstead on 9872 1616.

Yours sincerely,

Brett Mathieson
Manager, Regulation and Planning

New customer contributions

New customer contributions (NCCs) are contributions made by developers towards the cost of providing major sewerage, water and alternative water infrastructure for new connections. The infrastructure can be for the expansion of the existing networks into the growth corridors, the augmentation of existing networks in our inner areas or existing infrastructure that has been sized to cater for new connections.

Over the past year Yarra Valley Water, other water utilities and representatives from the development industry have worked with the Essential Services Commission (ESC) to develop guidelines on the application of NCCs for the 2013/14 to 2017/18 Water Plan period. The ESC issued a guidance paper and contribution calculation model in August 2012.

ESC Guidance Paper

The guidance paper provided 2 options for the water companies:

1. a complete submission in the water plan incorporating capital expenditure, gifted assets, NCC revenue, standardised charges, negotiating framework and transition plan; or
2. a staged submission which as a minimum the water companies must:
    a. in the water plan must include capital expenditure, gifted assets, NCC revenue based on existing framework and a default negotiating framework
    b. by 7 December 2012 submit forecasts of capital expenditure, gifted assets, revised NCC revenue, standardised charges, negotiating framework and transition plan

Yarra Valley Water opted for the second option, providing in our water plan a summary of our proposed approach and a commitment to refining this prior to 7 December 2012.This submission revises our water plan forecasts based on the methodology described below.

The Commissions guidance paper sets minimum pricing principles that the NCC must be greater than avoidable cost, less than stand alone cost and have regard to the cost of providing the service and future revenues that will be earned from customers at that connection. The guidance paper gives the water companies flexibility to:

- have individual charges for developments and/or standard charges;
- set standard charges based on catchments (zones) or based on water company area;
- choose charging units that are fit for purpose for each connection type
  e.g. per connection for standard residential development, capacity of system used by the connection for non-residential and non-standard residential development; and
- apply bring forward costs, in addition to NCCs, where the water company is required to provide assets earlier than would otherwise be expected.

Yarra Valley Water position

Our overarching principle is that NCCs should reflect the cost of providing water, sewerage and alternative water infrastructure for new connections and not be set so low that our existing customer base is subsidising development costs The Commission's model is based on the principle that the revenue required from NCC's is determined from the costs associated with augmenting networks offset by the net revenue (revenue less incremental costs) received from the new customers that will utilise the augmented network.

While the Commission permits the depreciated value of growth assets constructed during the second regulatory period to be included in the model, we believe it is still highly favourable to developers and new customers in that they do not make a contribution to assets constructed prior to 2008/09 nor to existing and future Melbourne Water assets provided for growth.

We understand the "economic" arguments for using incremental costs as a price signal but this objective needs to be balanced against considerations equity and certainty for developers and the water industry. If used to set individual NCCs rather than determine the total revenue required from NCCs, the Commissions model can produce outputs that are not sustainable. Setting NCCs using the model may, in five years' time, result in Yarra Valley Water having catchments where all growth assets have been built but one catchment has a $0 NCC and the other a $6,300 NCC.

Section 14(1)(v) of the Water Industry Regulatory Order 2012 requires developer charges to provide appropriate incentives and signals to customers or potential customers about the costs associated with servicing new development at a particular location. We propose having two location based charges. By defining development areas as either greenfield or brownfield and having NCCs that more than 300% higher in greenfields than brownfields, we are clearly providing signals to developers that it is more costly to develop in greenfields areas.

Our proposal has a minimum brownfields charge of $500 per service. However we would support an increase in this charge to further reduce the greenfield charge.

Reticulation assets

In determining the capital expenditure to be included in the model it is first important to define those assets that will be provided by developers and gifted to Yarra Valley Water.

Under the current Commission guidelines (May 2011), reticulation assets are defined as the minimum sized asset required to service a development. We believe this causes difficulties in the development of capital expenditure proposals for water plans and for inputs into the NCC model. Large assets are planned to service a catchment and it is often not known at that stage if a catchment is owned by one or many developers and thus is not known whether an asset is a reticulation asset.

We propose to revert to the simple to understand and apply industry accepted practice that had been in place prior to the Commission's regulation of the water industry, that is using a size criteria to determine what are reticulation assets.

Our proposed definition is:

> *A reticulation asset is defined as a water main or recycled water main that is 150mm or less in diameter and a gravity sewerage main that is 225mm or less in diameter, and all associated assets including:*
>
> - *Sewer pump stations, emergency storages and rising mains (where the gravity sewer inlet to sewer pumping station is less than or equal to 225mm diameter)*
> - *Water or recycled water pump stations (where the pump discharges into water or recycled water mains of 150mm diameter or less)*
> - *Pressure Reducing Valves (where connected to water or recycled water mains of 150mm diameter or less)*
> - *Water and Recycled Water Tanks (where outlet main is 150mm diameter or less)*

Model Results

We agree with the underlying principle used in developing the Commission's model that in setting the NCC, the cost imposed by growth should be offset by the incremental revenue generated by the growth. Using the Commission's 35 year model, we have input forecasts of capital expenditure, gifted assets, revenue, operating expenses and bulk charges for each service. We have calculated that the total revenue required from NCCs is $30m per annum (2012/13 dollars) being the sum of the revenue required from NCCs for water, sewer and recycled water. This approach allows for the negative sewer NCC to offset some of the required water and recycled water NCCs.

We believe this offset is a reasonable approach as the provision of one service can often impact the cost of delivering another service. The use of a local sewage treatment plant and third pipe recycled water system can often provide fit for purpose services at the lowest community cost. It can reduce the required size and thus cost of potable water infrastructure and eliminate the need for long and expensive sewerage infrastructure to connect to the

existing sewerage system. Treated in isolation, the calculated NCC for sewer and potable water may be negative and thus set at zero while the NCC for recycled water may be very high due to the little revenue received to offset the costs.

Application of NCCs

The Commission's model shows that Yarra Valley Water requires $30 million in NCC revenue per annum to be collected from developers.

There are many competing objectives that should be considered when determining where the required NCC revenue should come from

- Price reflectivity – why should NCC revenue come from "brownfields" when costs are incurred in servicing "greenfields"? Price reflectivity would suggest all of the NCC revenue should come from greenfields development and be heavily weighted towards recycled water,
- Equity between developments - why should brownfields development have a lower charge than greenfields?
- Intergenerational equity – why are existing customers are paying for spare capacity that will be used for future development, both brownfield and greenfield?
- Housing affordability – first home buyers tend to purchase in greenfields development and significant increases in NCCs will reducing housing affordability.

Ultimately the principles for charging NCCs is more a public policy decision than a regulatory / financial consideration

Currently NCCs are applied per service basis and apply evenly to all new connections (postage stamp pricing). Taking into consideration the competing objectives above, our proposal is to have different charges for brownfield development and greenfield development.

We reiterate that a total of $30m per annum in NCC revenue is required by Yarra Valley Water irrespective of from whom it is collected.

Proposal for NCCs for standard development

While in most cases brownfield development does not currently require the augmentation of networks, there is increased load on the network due to increased customer numbers using assets and when renewed the assets are sized to allow for growth. Further this type of development utilise either built in capacity of the network (assets were sized to cater for growth) or capacity that has been made available by the reduced demand by existing customers. Existing customers are paying for these assets via return on assets and depreciation and we believe that brownfield development should make a nominal contribution of $500 per service. It is forecast that NCC revenue from brownfield development will halve to about $6m per annum.

The remaining $24m of the required NCC revenue would then be collected from greenfield development. This type of development is the major cause of capital expenditure for growth and, as mentioned earlier, the cost of providing one service is often dependant on the provision of other services.
We propose a $1,300 NCC for recycled water which is indicative of the cost an end customer would pay for a rainwater tank to meet the requirements of the 5 star standard for new homes and thus the total cost of a house with recycled water is similar to that of a house without recycled water.
The balance of the required NCC revenue will be collected via NCCs of $2,500 each for water and sewer.

Proposal for NCCs for non-standard and high demand development

Our water sewerage and recycled water networks are designed to cater for peak demands and often non-residential connections impose greater demands on the networks than standard residential connections. To reflect this we are proposing that non-residential connections be converted to equivalent residential connections using calculations

based on water meter size. The meter size is a good indication of the instantaneous peak load an individual customer can place on our networks.

Table 2 – Conversion of non-residential connections to equivalent residential connections

General service tapping size	Equivalent residential connections
20mm	1.0
25mm	1.6
32mm	2.6
40mm	4.0
50mm	6.3
80mm	16.0
100mm	25.0

Transition

A major concern of the development industry is that land development requires long term decisions based on current information. That is when decisions are made to purchase development land current charges are used as an input into the calculation of an appropriate purchase price of the land. This can occur many years ahead of when development actually occurs and significant changes in NCCs can tip a borderline viable development to unviable.

Recognising that NCCs for a greenfield lot will more than double, we propose to transition the increase over 3 years. The NCCs for brownfields development reduce by half and we propose to also transition this change over 3 years.

Table 1 – current and proposed NCCs (2012/13 dollars)

	2012/13 NCC	Proposed 2013/14 NCC	Proposed 2014/15 NCC	Proposed NCC for 2015/16 to 2017/18
Brownfield				
Water	$1,217.30	$978.00	$739.00	$500.00
Sewer	$1,217.30	$978.00	$739.00	$500.00
# Recycled Water	$608.64	$572.00	$536.00	$500.00
Greenfield				
Water	$1,217.30	$1,645.00	$2,072.00	$2,500.00
Sewer	$1,217.30	$1,645.00	$2,072.00	$2,500.00
# Recycled Water	$608.64	$839.00	$1,070.00	$1,300.00

Currently it is actually the water NCC that is reduced but for clarity we have shown the recycled water NCC reducing

Definition of a connection

The definition of what type of property is required to pay a NCC has been the subject of much discussion over the past few years. We are of the firm belief that each new tenement (residential and non-residential) benefiting from a service should pay the relevant NCC. We believe the definition in the Commission's amended determination (May 2011) reflects this and we propose to retain this definition.

"The scheduled charge applies on a "per lot" basis. Which means (only for the purposes of applying the scheduled charge to new customer contributions) that may be levied on any connection of a new customer that is separately titled or is, or can be, individually metered."

Lot Size

We propose to retain the use of the lot size criteria as we believe this provides a proxy for the demand each lot places on out network. That is a small lot does have less garden to water than a standard lot and vice versa for a large lot. However the current lot size split does not reflect that over the past few years the average lot size has reduced significantly and now about 60% of lots are standard size with most of the rest small size. This has resulted in us collecting NCC revenue in 2011/12 of $22m, not $26m as you would expect from 10,000 new connections.

The table below shows our proposed lot size categories that when used with the brownfields / greenfields splits provides Yarra Valley Water with total NCC revenue of $30m per annum.

Table 3 – Proposed lot size criteria

	Current	Proposed	Forecast distribution
Small new lot	< 450 m2 50% of standard charge	< 300 m2 50% of standard charge	10% of lots
Standard lot	450m2 to 1350 m2 Standard charge	300 m2 to 900 m2 Standard charge	80% of lots
Large lot	> 1350 m2 200% of standard charge	> 900 m2 150% of standard charge	10% of lots

Bring Forward Cost (BFC)

In developing the growth capital expenditure forecast and timing for our water plan we considered the location of future development and formed a view on the prudent delivery of individual assets required to service the future development. These same forecasts are used in the Commissions model to calculate the required revenue from NCCs.

Where development proceeds ahead of forecast, we are required to provide assets earlier than forecast and thus there is a financing cost associated with bringing the expenditure forward. We propose to retain the concept of BFCs but to move away from the current block approach back to a year by year approach from the 2005 determination.

The Commission's approach to BFCs in the current determination encourages disputes over growth and asset planning forecasts as there is a large prize in disputing timing. A developer may argue that assets are being brought forward less than 5 years (0% of the asset cost as a BFC) whereas a water company may argue that assets are being brought forward more than 5 years (40% of the asset cost as a BFC).

We propose to revert back to the calculation methodology in the 2005 determination which works on a year by year basis and there is much less of a prize to be argued over (5% of the asset cost as a BFC for 1 year). We propose to revert

$$BFC = C - \left[\frac{C}{(1+r)^n} \right]$$

Where:

BFC is the charge to be paid by the developer representing the financing cost of requiring an asset ahead of plan and is an upfront charge

C is the estimated capital cost of the asset

r is the implied pre-tax WACC

n is the number of years that the asset has been brought forward.

Unlike in the 2005 determination, we propose the BFC will be:

- calculated on the timing of the asset in the water plan rather than when incremental development would have required the asset (onion ring approach), and
- charged in addition to the NCC as it is the financing cost of bringing that expenditure forward whereas the NCC is a contribution to the cost of the asset.

Consultation

Yarra Valley Water has 2 Urban Development Managers who constantly liaise with major developers and the future of NCCs is a frequent point of discussion. We also participate in regular meetings with the Urban Development Institute of Australia (UDIA).

Through VicWater, Yarra Valley Water co-funded an independent consultation process with key stakeholders such as developers, Growth Areas Authority (GAA) and Department of Sustainability and Environment (DSE). This consultation showed that while there was general agreement about the concept of user pays there were concerns about the potential increases in NCCs and how they can be equitably implemented.

Other findings included:

- concern over the complexity of the Commissions model and the certainty around input assumptions
- would like to see a less formal and more timely dispute resolution process as a precursor to VCAT.
- Feeling that the development of the NCC framework is being rushed.

We believe our NCC proposal addresses the concerns over potential increases and equity by collecting NCC revenue from all new connections, both brownfield and greenfield. Brownfield development will pay a contribution towards capacity in existing assets and this revenue offsets the amount that is required to be collected from greenfield development.

Information requested by ESC

Table 4 – Forecast capital expenditure, gifted assets and NCC revenue ($m in 2012/13 dollars)

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
# Capital expenditure	64.77	64.94	63.45	61.30	60.45	89.67	89.21	60.80	63.94	52.44
Gifted assets	19.55	21.56	22.37	21.92	21.38.	21.71	21.76	21.61	20.97	21.22
NCC revenue	25.60	29.37	31.24	30.40	29.59	30.03	30.14	30.11	29.17	28.96