



25 January 2013

Ron Ben-David  
Chairman  
Essential Services Commission  
Level 37, 2 Lonsdale Street  
Melbourne VIC 3000

Dear Dr Ben-David,

### **Water Price Review 2013-2018 for Wannon Water**

Thank you for the opportunity to comment on the Water Price Review 2013-18 for Wannon Water. This submission relates to the standardised New Customer Contributions (**NCCs**) that have been proposed by Wannon Water.

I am a director of Rodger Constructions Pty Ltd and Rodger Properties Pty Ltd (together, **the Rodger Group**). I make this submission on behalf of the Rodger Group as well as Harris & Stapleton and Herbert & Howard, who are other developers in the Warrnambool area.

The Rodger Group is a significant owner and developer of land in Wannon Water's catchment area and has been involved in land development in the area for the last 45 years. Moreover, the Rodger Group together with Harris & Stapleton and Herbert & Howard will be involved in a 12 –15 year development program in the area involving 1400 – 1600 lots of land. As such, the Rodger Group makes a substantial contribution to Warrnambool and surrounding areas by providing the community with affordable housing, as well as employment for local individuals and businesses. The impact of our activities, and of other developers like the Rodger Group, is extremely important to Warrnambool and the surrounding communities.

Like other developers, the Rodger Group is a private enterprise, operating for profit. We develop land and construct new dwellings where it is feasible to do so profitably. If the cost of development, whether it be the cost of labour and materials or the impact of authority fees and charges, rises substantially, the incentive for private developers to maintain their development activities reduces significantly.

I make this submission because I am concerned that the feasibility of future residential development in the Warrnambool area will be seriously compromised if the standardised NCCs proposed by Wannon Water are approved by the Essential Services Commission (**ESC**).

I consider that the standardised NCCs proposed by Wannon Water exceed what is fair and reasonable and are inconsistent with the regulatory framework established by the ESC.

#### **1. Summary**

On the basis of expert economic analysis undertaken for the Rodger Group by Peter Jacob of Marsden Jacob Associates, it is clear that the standardised NCCs proposed by Wannon Water do not comply with the core NCC pricing principles identified by the ESC in its NCC Framework and Approach Paper dated May 2012.

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In particular, Mr Jacob's main findings are:

- *Use of average costs instead of incremental costs:* The core NCC pricing principles require NCCs to be based on incremental costs, both in relation to capital expenditure as well as operating expenditure. Wannon Water has not done this. Instead, Wannon Water has used average costs to calculate operating expenditure. If incremental costs had been used by Wannon Water to calculate its operating expenditure rather than average costs, the standardised NCC charges would have been significantly lower than those proposed by Wannon Water, possibly approaching zero or close to zero.
- *Average costs do not include depreciation:* Even if the use of average cost to calculate operating expenditure were to be authorised by the ESC, which in my submission it should not, the calculation of standardised NCC charges is still inflated because of the inappropriate inclusion of depreciation in the calculation of average operating costs.
- *Tax effects not properly accounted for:* Wannon Water has used the ESC model to calculate NCCs, which assumes that the entity is a tax-paying entity and effectively increases the calculated NCCs. However, Wannon Water does not currently pay tax because of accumulated tax losses and is unlikely to do so for a significant period of time. Setting the tax rate to zero for Wannon Water would act to further reduce the NCCs.

A more detailed explanation of these findings is set out below.

## 2. Standardised NCCs proposed by Wannon Water

On 7 December 2012, Wannon Water wrote to the ESC providing supplementary information to its Water Plan for 2013 – 2018 (**Water Plan 3**). In that letter, Wannon Water stated that:

*Wannon Water has consulted with local Developers on the indicative standardised NCC charges set out in the table below. Subject to the outcome of further consultation with Developers, Wannon Water intends to submit the following standardised NCC charges to the Commission for authorisation in compliance with the NCC pricing principles:*

Standard Connection	Residential	Water	Sewer	Water	Sewer
		Lot >= 450sqm	Lot >= 450sqm	Lot < 450sqm	Lot < 450sqm
	Warrnambool, Allansford, Koroit, Portland, Hamilton and Port Fairy	\$4,000	\$1,500	\$2,000	\$750
	All other areas	\$1,000	\$1,000	\$500	\$500

*The Wannon Water modelling produced:*

- A lower bound incremental cost of \$0 for both water and sewerage
- A combined minimum upper bound stand alone cost for water and sewerage services of \$40,000.

### **3. Evidence of compliance with core NCC pricing principles**

Wannon Water also states in its letter to the ESC dated 7 December 2012 that the indicative standardised NCCs were calculated on the basis of the core NCC pricing principles, namely:

- NCC charges must have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection.
- NCC charges must have regard to the incremental future revenues that will be earned from customers at that connection.
- NCC charges must be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

However, while Wannon Water's letter to the ESC of 7 December 2012 asserts that its indicative standardised NCCs comply with the core NCC pricing principles, the letter does not contain information to evidence that assertion.

In this regard, I note that section 4.1.1 of the Guidance Paper on New Customer Contributions, issued by the ESC in August 2012 states (at page 22) that water businesses are to submit to the ESC supplementary information to their respective Water Plans containing, among other things, any standardised NCC charges and "evidence of their compliance with the core NCC pricing principles".

I have made several requests of Wannon Water to provide evidence that its proposed standardised NCCs comply with the core NCC pricing principles. I have not had a satisfactory response.

In communications dated 31 December 2012 and 9 January 2013, I asked Wannon Water to provide me with copies of the financial model(s) upon which the proposed NCCs are based. Both requests were refused.

Wannon Water did agree to allow an expert nominated by the Rodger Group to go through relevant Wannon Water documents with a representative from Wannon Water's office.

Accordingly, I requested Peter Jacob of Marsden Jacob Associates to meet with a representative of Wannon Water on Thursday, 17 January 2013. A copy of Peter Jacob's letter to me outlining his analysis and main findings regarding the standardised NCCs proposed by Wannon Water is **attached** to this letter together with Mr Jacob's curriculum vitae.

### **4. Economic analysis of proposed standardised NCCs**

In summary, Peter Jacob found that the standardised NCCs proposed by Wannon Water do not comply with the core NCC pricing principles for the reasons set out below.

#### *Use of average costs instead of incremental costs*

The core NCC pricing principles require NCCs to be based on incremental costs, both in relation to capital expenditure as well as operating expenditure. However, while Wannon Water has used incremental costs to calculate capital expenditure, it has used average costs to calculate operating expenditure. This approach is clearly inconsistent with the core NCC pricing principles.



Based on Peter Jacob's modelling, if, as required by the core NCC pricing principles, incremental costs had been used by Wannon Water to calculate its operating expenditure rather than average costs, the standardised NCC charges would have been significantly lower than those proposed by Wannon Water, possibly approaching zero or close to zero.

This finding appears to be confirmed by Wannon Water itself in its letter of 7 December 2012 to the ESC, which states that modelling undertaken by Wannon Water indicated "a lower bound incremental cost of \$0 for both water and sewerage".

*Average costs do not include depreciation*

Another flaw in Wannon Water's approach identified by Mr Jacob is the inclusion of depreciation in the calculation of average operating costs.

Mr Jacob has found that, even if the use of average costs were to be authorised, which in my submission they should not, the calculation of standardised NCC charges is inflated because of the inappropriate inclusion of depreciation in the calculation of average operating costs.

*Tax effects*

Peter Jacob has informed me that Wannon Water has used the ESC model to calculate NCCs, which assumes that the entity is a tax-paying entity and effectively increases the calculated NCCs. Mr Jacob has also informed me that Wannon Water does not currently pay tax because of accumulated tax losses and is unlikely to do so for a significant period of time. Accordingly, setting the tax rate to zero for Wannon Water would act to further reduce the NCCs that have been proposed by Wannon Water.

## 5. Conclusions

Based on Peter Jacob's analysis, it is clear that the standardised NCCs proposed by Wannon Water do not comply with the core NCC pricing principles. Indeed, the NCCs are excessive and are far from fair and reasonable. If Wannon Water were permitted to apply the standardised NCCs that they have proposed, this will seriously compromise the ability of the Rodger Group, and the other land developers upon behalf of whom this submission has been made, to deliver affordable housing to the community.

I respectfully submit that the ESC carefully consider the above, and Mr Jacob's report, when assessing Wannon Water's proposal. I trust that the inconsistency between, on the one hand, the core NCC pricing principles and, on the other hand, the standardised NCCs that have been proposed by Wannon Water will be addressed in the ESC's draft decision on Wannon Water's Water Plan 3.

If you would like any further information from me or Peter Jacob in relation to our analysis of Wannon Water's proposed standardised NCCs, please let me know.

In addition, if it would assist you to hear further from me, or to better understand the likely impact of Wannon Water's proposals on the other land developers on behalf of whom this submission has been made, I would be pleased to attend a meeting with you accompanied by the other interested land developers.

Yours sincerely,

Graeme Rodger  
Director

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25 January 2013

Mr Graeme Rodger  
Rodger Constructions Pty Ltd  
790 Hopkins Highway  
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Email: [doreen@rcon.com.au](mailto:doreen@rcon.com.au)

Dear Graeme

## **New customer contributions**

### **1. Scope**

This letter sets out our preliminary advice relating to the calculation of New Customer Contributions (NCCs) by Wannon Water under the proposed regime established late last year by the Essential Services Commission (ESC). The advice is termed preliminary because:

- we have not had access to, nor reviewed, any of the NCC models developed by Wannon Water; and
- it is based on an initial discussion with Steven Kearns, Branch Manager Retail Services from Wannon Water, together with two input spreadsheet models supplied by Wannon Water detailing capital and operating cost assumptions for the Warrnambool Water and sewerage schemes only.

In deriving its proposed NCCs, Wannon Water has developed separate water and sewerage models for four separate growth areas – Warrnambool, Hamilton, Portland and Port Fairy. The reported NCCs for water and sewerage are a weighted average of the four towns. We understand from our discussions with Wannon Water that the calculated water and sewerage NCCs for Warrnambool are \$5,944 and \$864 per lot respectively. These compare to the reported average NCCs of \$4,000 and \$1,500 per lot for water and sewerage.

### **2. ESC framework**

The ESC has specified three minimum pricing principles underpinning the proposed NCC regime. These are reproduced in Box 1.

**Box 1: Minimum NCC pricing principles**

NCC must:

- i. have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection
- ii. have regard to the incremental future revenues that will be earned from customers at that connection
- iii. be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Source: Essential Services Commission, 2012. Guidance Paper, New Customer Contributions, August.

From the perspective of the actual calculation of the NCC, the concept of incremental costs and benefits is paramount. Simply put, the NCC calculation takes into account the incremental capital and operating costs associated with servicing new customers together with the additional revenues (benefit) derived from the new customers connecting to the system. The calculation also takes into account the impact of taxation on the incremental cash flows.

In other words, the NCC charges are designed to offset the net incremental costs associated with growth, thereby leaving existing customers in a cost neutral position, i.e., existing customers are not bearing any of the costs associated with servicing new customer growth.

**3. Assessment**

In our preliminary assessment we comment on three key issues relating to the calculation of NCC charges by Wannon Water. These are:

- use of average costs;
- inclusion of depreciation in average cost; and
- tax effects.

**Use of average costs**

Wannon Water in its calculation of NCCs has used incremental capital expenditure required to service growth but has used **average operating costs** rather than incremental operating costs. This therefore fails to meet one of the guiding principles established by the ESC.

The use of average rather than incremental operating costs acts to increase the calculated NCC. In fact, our calculations indicate that use of incremental operating costs would result in a very substantial reduction in the calculated water and sewerage NCCs for the Warrnambool system. The magnitude of the valuations would only be able to be confirmed through accessing the actual models and related input data and assumptions used by Wannon Water.

**Inclusion of depreciation**

Wannon Water has included accounting depreciation in its calculation of average costs which is considered inappropriate. This is because economic depreciation on existing and new assets is already included in the allowable regulatory revenue which is recovered via the fixed and variable components of the water and sewerage tariffs.

Exclusion of depreciation would reduce the estimate of average costs which, in turn, would result in a reduction in the calculated NCCs. We are not able to confirm the impact which exclusion of depreciation may have on the calculated NCC charges as we have only detailed breakdown of costs for the Warrnambool system, but no breakdown for other elements making up the total average cost (overheads, Otway Wholesale system and treatment in the case of water; and overheads, bulk sewerage and treatment in the case of sewerage).

#### Tax effects

The final point we make in relation to the NCC calculations is that we understand that Wannon Water has used the NCC template provided by the ESC. The default in this template assumes that the water business is a tax-paying entity. Wannon Water does not currently pay tax under the National Tax Equivalent Regime (NTER) as a result of accumulated tax losses. Moreover, we understand that it will be some significant period before it is likely to be paying tax under the NTER.

The tax effects built into the ESC template act to increase the calculated NCC. Accordingly, setting the tax rate to zero would act to further reduce the calculated NCC. However, we acknowledge that the NCC revenue will result in a bring-forward of the period when Wannon Water may be liable for tax payments. It would be legitimate theoretically therefore to include some present value estimate of this bring forward cost. However, this cost is not likely to be material, especially when compared to:

- the use of average vs incremental operating costs; and
- the inclusion of depreciation in the estimate of average operating costs.

#### 4. Concluding comments

As stated at the outset, it is not possible to provide more definitive advice on the magnitude of the impacts unless we have access to the actual models and associated inputs used by Wannon Water.

Notwithstanding this caveat, we are able to confirm that the use of incremental costs rather than average costs would result in a very significant reduction in the calculated NCC charges and may even result in such charges being reduced to zero or close to zero.

Please do not hesitate to contact the writer should you require further clarification on any matter raised in this letter.

Kind regards,



**Peter Jacob**  
Managing Director  
Marsden Jacob Associates Pty Ltd



# Peter Jacob

## Managing Director

Peter has over 25 years experience in providing strategic financial and economic advice to a wide range of government and private clients, with special emphasis on infrastructure projects for the regional urban and rural water sectors. These projects have typically involved Peter having a lead project management role and often encompass detailed cost benefit assessments, long term financial modeling, pricing and assessment of regional impacts.

### Regional experience

Peter has extensive experience advising on regional infrastructure projects across Australia drawing on his economic and financial modeling skills as well as strategic problem solving, understanding of infrastructure delivery methods and community consultation. Recent relevant examples include:

- Preparation of Growth Strategy for Western Water involving functional review of the organisation, review of capital planning and delivery processes, establishing key planning metrics, development of financial models, tariff assessments and evaluation of major capital programs.
- Project evaluation of major irrigation projects for Tasmanian Irrigation Pty Ltd, including project delivery arrangements and project risks) as part of development of cost benefit assessments and Business Cases for submission to State and Commonwealth Governments.

### Skills

- Project evaluation and justification
- Benefit-cost analyses
- Economic and financial business assessments
- Pricing and revenue determinations within regulatory frameworks

### Qualifications

B.Ag.Econ (UNE)

### Employment history (recent)

1996-Present – Managing Director, Marsden Jacob Associates

### Professional Memberships

Victorian Institute of Water Administration

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- Business Case for the South East Irrigation Scheme, involving constant amendments to the structure of the project to ensure risk mitigation and value for money. Facilitated risk workshop. (Client: Tasmanian Irrigation, 2010-12)
- Conceptual and modelling advice to Western Water on NCCs involving discussions with the ESC. Client Western Water 2010-11)
- Review and advice on ESC proposed NCC models using models developed for Western Water culminating in the development of NCC models for use in Water Plan 3. (Client Western Water 2011-12)
- Development of NCC models supporting Central Highland Water's Water Plan 3 submission to the ESC. (Client: Central Highlands Water 2011)
- Assessment of Supply Options for the Central Towns. (Client: South Gippsland Water, 2012)
- Socio-economic and business case preparation for new irrigation schemes in Tasmania including the Midlands, South East, Dial Blythe, Upper Ringarooma, Lower South Esk, Shannon Clyde, Kindred North Motton and Sasafrass Wesley Vale Schemes together with strategic advice on value of entitlements, pricing, tender arrangements, risk workshops. (Client Tasmanian Irrigation, 2009-12 ongoing)
- Review of motor vehicle policy for Central Highland Water involving review of current processes, costs of procurement and usage and recommendations on changes to current practices. (Client: Central Highlands Water, 2012).
- Assessment of the cost of drawing down major storages in SEQ to lessen the threat of flooding during the wet season using portfolio models that integrate with stochastic hydrology models of the SEQ Water Grid. (Client: Queensland Water Grid Manager, 2011-12).
- Development of regulatory planning framework and templates for justifying strategies and projects for upcoming Water Plan Three. (Client: Central Highlands Water, 2010-11).
- Development of portfolio models examining the economics of alternative combination of source options for water supply in SEQ. Studies have also included the examination the economic cost of alternative Levels of Service (LOS) in SEQ using the portfolio modelling framework utilising outputs from probabilistic hydrological modelling. (Client QWC, 2008-10)
- Business case for the Sunraysia Modernisation Project including Gateway Review process. (Client: Lower Murray Water, 2008-11).
- Business case for Connection to the Melbourne Supply System (Client: South Gippsland Water, 2008-11).
- Business Case for the Midlands Irrigation Scheme. (Client: Tasmanian Irrigation, 2009-10, 2011-12)
- Business Case for the Upper Ringarooma Irrigation Scheme. Facilitated risk workshop (Client: Tasmanian Irrigation, 2011-12)
- Preliminary Findings Report for the Great Forester-Brid Irrigation Scheme (Client: Tasmanian Irrigation, 2012)
- Pricing for multiple sources of supply in the water industry – a presentation and workshop held for the QCA. (Client: Queensland Competition Authority, 2009)
- Socio-economic benefit cost assessment for Traveston and Wyaralong Dams as part of the EIS process. (Client: QWI, 2007-09)
- Development of long term company financial model and advice on regulatory pricing and capital structures (Client: LinkWater, 2008-09)
- Socio-economic assessment of Connor River Dam. (Client: SunWater, 2010).
- Socio-economic assessment for the Water for Bowen Scheme. (Client: SunWater, 2009)
- Financial adviser for the Townsville Water Supply Upgrade Project. As adviser provided advice on the Public Sector Comparator and undertook all financial modelling relating to the evaluation of tenders (Client: 2008-09)
- Cost Benefit Analysis of dual pipe schemes using Ripley as a case study. (Client: Queensland Water Commission, 2009)
- Energy Intensity of the SEQ Water Strategy, (Client: Queensland Water Commission, 2008-10)
- Development of water, involving the integration of stochastic hydrological

- modelling of water from two sources within a cost minimisation economic framework for power generation. (Client: Tarong Energy, 2007-08)
- Regulatory and financial issues for the recently merged Grampians Wimmera Mallee Water (GWM Water). MJA developed detailed financial and regulatory models of the merged business, nodal pricing models for the Wimmera Mallee Pipeline project, assessed regulatory impacts and assessed the entity's preparedness for economic regulation. (Client: GWM Water 2005-06)
  - MJA was engaged by the WA Economic Regulation Authority to assist with its inquiry on the Cost of Supplying Bulk Potable Water to Kalgoorlie-Boulder. MJA undertook the economic analyses underpinning the inquiry and was responsible for preparing drafts of the Draft and Final Reports. (Client: ERA, Western Australia 2005-06)
  - Financial Adviser to Central Highlands Water for its Ballarat North Water Reclamation Project. Responsibilities included development of the Public Sector Comparator benchmark project, development of assessment criteria and financial evaluation of tenders. (Client: Central Highlands Water, 2005-06)
  - Business Plan for the Western Corridor Recycled Water Scheme. MJA was a partner with Cardno in the development of a detailed Business Case for the treatment and transmission of recycled water from wastewater treatment plants in Brisbane and Ipswich to major power stations, industry, agriculture and drought contingency for SE Queensland. (Client: SEQWater, 2005-06)
  - Business Plan for Development of Ord Stage II. MJA has been retained by the WA Government to develop a detailed Business Case for the development of 30,200 ha of irrigation land in the Ord River Irrigation Area including identification of new crops, processing facilities, provision of all infrastructure, benefit sharing principles with the Miriwung and Gajerrong people and a public benefit assessments. (Client : Department of Industry and Resources, WA, 2004).
  - Financial adviser and analyst for the privatisation of the Papua New Guinea water sector (Client : PNG Privatisation Commission, 2001/02).
  - Developer charge assessments for Victorian water businesses including: Western Water, Goulburn Valley Water, Coliban Water, North East Water, East Gippsland Water (1992 to 2005)
  - MJA was engaged by the WA Economic Regulation Authority to assist with its inquiry on the Cost of Supplying Bulk Potable Water to Kalgoorlie-Boulder. MJA undertook the economic analyses underpinning the inquiry and was responsible for preparing drafts of the Draft and Final Reports. (Client: Economic Regulation Authority, Western Australia 2005-06)
  - Tariff Structure for the Supply of Wholesale Wastewater Services, Auckland New Zealand. This project reviewed tariff structure proposed by the LNOs and totally restructure the tariff arrangements based on sound and practical pricing principles. Detailed financial modelling was undertaken to demonstrate business impacts and risks. (Client: Local Network Operators supplied by WaterCare Services Ltd, Auckland, NZ, 2003).
  - Financial modelling and development of RAV estimates and basis for proposed pricing arrangements for Water Plan. (Client : Coliban Water, 2004).
  - Development of a Rising Block Tariff and customer impact assessment. (Client : Western Water, 2004).
  - Saline Outfall and Regional Treatment Plant Scheme to be incorporated by South Gippsland Water. Roles included the development of all pricing principles and models, business risk assessment, development of Business Case supporting submissions to State and Commonwealth Governments for external funding. (Client : South Gippsland Water, 1999-2004).