



15th May, 2008

Essential Services Commission
Level 2, 35 Spring Street
Melbourne VIC 3000

2008 WATER PRICE REVIEW RESPONSE TO DRAFT DECISION

We thank you for the opportunity to respond to the Draft Decision. The urban development industry regards the outcome of the Water Price Review as critically important in terms of its impact on housing affordability.

1. BACKGROUND

We understand that the Draft Decision sets out the Essential Services Commission ('the Commission') views on whether to approve the prices proposed by the water businesses in their Water Plans and, moreover, the degree to which the proposed pricing satisfies the principles set out in the Water Industry Regulatory Order (WIRO). The Draft Decision also sets out the Commission's reasons for non approval of certain water business proposals as well as amendments to the proposals it has considered.

Following consideration of submissions to the Draft Decision the Commission will release a 'Final Decision' which will detail the prices that each of the water businesses will charge for water, sewerage and other related services for a period of five years commencing on 1 July 2008.

Finally we understand the Commission has been advised (by the Department of Sustainability and Environment) that any decisions it makes in regard to the New Customer Contribution (NCC) as well as recycled water and other miscellaneous charges as part of the current review (this review) will apply to the metropolitan retailers and Melbourne Water.

2. ABOUT US

The Urban Development Institute of Australia (Victoria) ("UDIA") is an independent association of over 270 organisations directly involved in the production, financing and marketing of all facets of property development.

UDIA is:

- A forum for discussion of industry problems and objectives
- An active political lobbyist for industry causes and goals
- An active collator and disseminator of information and data relating to urban development
- A monitor of Government and Public Authority activities that affect urban development and the viability of the industry.

As Victoria's key industry association representing the residential land development industry, key issues contained in the Draft Decision including those relating NCC's (effectively a developer charge) are of vital interest to our members.

3. RESIDUAL MATTERS FROM THE 2005 PRICE DETERMINATION

In responding to the Draft Decision we draw the Commission's attention to several matters key matters we noted in our submissions to the 2005 Water Price Review. We believe these points are worth revisiting as they are relevant to our submission to the current Draft Decision.

While the UDIA expressed qualified support to the approach taken by the Commission in the 2005 Price Determination, a specific concern raised by our organisation in our submissions to that process has, we believe, been borne out.

3.1 Bring Forward Costs

The issue of sequencing, or specifically the financing of bring forward costs, has been a particular matter of concern for the urban development industry. While the approach of the Commission to this issue is understood, the practical reality of determining what is, and what is not, out of sequence development has been far more difficult to determine.

In certain growth areas several development fronts have been simultaneously active, while the determinants of "sequencing" have in several instances been unrelated to water infrastructure.

Similarly, and as foreshadowed in our 2005 Submission and subsequent discussions with the Commission, land ownership patterns and intentions have in other instances altered what might have otherwise represented a logical sequencing of development. In short, there are times when what appears to be a logical sequence is simply not possible for a variety of reasons. In such instances we would expect common sense to prevail. Instead there appears to be an increasingly familiar pattern of debate between the relevant water company and developers industry culminating in a request for a determination by the Commission.

Hence, despite the best efforts of stakeholders, there remains - three years after the 2005 Price Determination - no accepted, or in our view fair and

reasonable, methodology to determine an equitable apportionment of bring forward costs, if and when, they occur.

We note that these concerns have been recognised by the Commission in the Draft Decision. We provide comments on the proposed action to address these concerns in section 4.3 of this submission.

3.2 New Customer Contributions

The UDIA again expresses its philosophical opposition to the principle of NCC (or upfront infrastructure charging) due to its direct impact on the cost of development and therefore the affordability of new homes.

As noted in our submissions prior to the 2005 Price Determination, there is a strong view that new home buyers are today financing infrastructure through upfront charges, in contrast to earlier generations which were afforded the same infrastructure through general usage charges.

In the UDIA's previous responses to the Commission we questioned the NCC itself on the basis that (as applies with gas infrastructure assets) new customers are effectively expanding the business of the water companies and, as such, the cost of new infrastructure should be recovered in the retail price of water. Furthermore, we argued, there is no better way to send price signals about the efficient use of water than through higher charges for the actual use of water (albeit with appropriate protections in place for low income households).

Additionally, we argued, the established areas of Melbourne are effectively dealt with in this way as infrastructure is maintained and frequently replaced by revenues raised from retail water charges. Why should the residents of new urban areas be treated differently?

We believe there is still a case to be made for this today, whereby the cost of infrastructure should be recovered over the life of the infrastructure; that is through the retail price of water.

Home owners in established areas are afforded infrastructure upgrades and maintenance through the revenues raised by the retail price of water, a situation at odds with that of the new home buyer. Under current arrangements a homebuyer in a growth area development has built into the lot price the cost of providing all local reticulation and infrastructure for water and sewer. It is important to note that this represents brand new infrastructure which has been built with a design requirement that will see low maintenance and no anticipated replacement cost for a period of 50 years or more. A buyer in an established suburb however, with older infrastructure, often requiring high maintenance costs and potential replacement in the near future, has all infrastructure costs covered by the general water tariff

Although we raised this matter in our submission to the 2005 Water Price Review, we feel it is relevant to restate it as in our view it highlights the inequity inherent in the system of NCC's.

4. THE DRAFT DECISION

There are four key issues in the Commission's Draft Decision that we address in this submission. They are:

- Scheduled Charges
- Allocation of costs for reticulation assets
- Allocation of costs for shared assets
- Capital works programs in the Water Plans

4.1 Scheduled Charges

The UDIA is **strongly opposed** to the approach advocated by the Victorian Water Industry Association and substantially supported by the Commission in the Draft Decision.

Whilst on face value a tiered NCC based on water use and efficiency may be a laudable objective, we believe the construct of the tiered NCC's as outlined above is based on a false premise.

The Commission has essentially accepted the key proposition, submitted by the Victorian Water Industry Association on behalf of the water businesses, that new customer contributions should be based on "*the potential impact of future water demand of the new development, generally using lot size as a determinant*" (page 181).

The Victorian Water Industry Association's submission proposed:

1. a minimum \$550 per lot per service for water, sewerage and dual pipe recycled water (total \$1,650 per lot) for developments which are designed in a manner that will have minimal impact on future water resource demands and can be catered for without additional investment to upgrade the medium-term distribution capacity. These developments are typically a lot with an area no greater than 450 square meters.
2. \$1,100 per lot per service for water, sewerage and dual pipe recycled water (total \$3,300 per lot) for water sensitive urban developments which will require further investment in infrastructure within a six year period to serve these developments. Or, where shared assets must be constructed ahead of schedule to service a new property or development and the calculated 'bring-forward' costs are greater than \$1000 per lot for water and sewerage the calculated charge shall apply. These developments are typically traditional Greenfield urban developments with lot sizes between 450 square meters and 1,350 square meters.
3. \$2,200 per lot per service for water, sewerage and dual pipe recycled water (total \$6,600 per lot) — for developments designed in such a way that properties will create demand for water resources over and above high-density, water efficient homes. These developments are typically Greenfield developments with lot sizes exceeding 1,350 square meters, for example, lots with potentially large outside water use, no recycled water and which will influence near term investment in infrastructure decisions.

In the Draft Decision, the Commission essentially supported this position with the exception of recycled water, which the Commission recommends be regulated by the Commission's proposed pricing principles for recycled water and assessed on a case by case basis.

The Commission's general support for the water businesses' proposal is based on the premise that tying NCC's to lot size and water efficiency provides customers with price signals about the sustainable use of water.

The following points outline our key concerns with this approach:

- a) For an average sized housing lot (550sqm) the proposal represents an effective doubling of the previous NCC regime. There has been no forewarning to industry of a cost increase of this magnitude. There must be no doubt in anyone's mind that there will be implications for housing affordability. This fact cannot be understated;
- b) Similarly there is no rationale provided for the quantum of increase in the proposed NCC to apply from 1 July 2008, nor any explanation as to the final figure. In simple terms, the basis of the NCC is not transparent. A lack of transparency was, we had understood, one of the key reasons the Commission introduced an (interim) flat charge in the 2005 Price Determination;
- c) There is no direct relationship between lot size and water use or efficiency. Matters such as landscaping and a range of water re-use or savings devices are a matter of initially, developer discretion, and ultimately household discretion;
- d) Beyond lot size itself the inclusion of qualifiers such as "*water sensitive urban development which will require further investment in infrastructure within a six year period*" are at best vague and provide little to no guidance as to how such things would be assessed. For example, the classification of what constitutes a water sensitive development will be open to interpretation and is likely to be the subject of ongoing challenges. The probable outcome is that where agreement over a category cannot be reached, the Commission will be called upon to make a determination. This provides for little early certainty in the development process;
- e) While the Draft Decision's recommendation that recycled water infrastructure is to be exempt from the proposed NCC regime may be a positive development, there again remains a lack of certainty. Costs associated with recycled water schemes (which in certain areas are to be mandated) are to have regard to a series of pricing principles as determined by the Commission and may potentially represent higher costs than under the Water Industry Association proposal. As the UDIA Victoria did in its submissions to the 2005 WPR we believe there is a strong case to be made that the use of recycled water in new urban areas provides a benefit to the wider community. Consequently those costs associated with related infrastructure should be subsidised either in whole or in part, or in our opinion absorbed into the retail price of water.

4.2 Allocation of costs for reticulation assets

The Commission has recommended changes in the allocation of costs of certain reticulation assets on the basis that there should be a mechanism through which developers can be reimbursed for their investment in shared infrastructure from which other developers may benefit in the future. Specifically, the Commission's recommendation provides that costs be allocated based on the portion of infrastructure required to service their particular development with the water business making up the balance, to be recovered from future development or over time through prices.

The proposal represents a sensible outcome and is supported by the UDIA.

4.3 Allocation of costs for shared assets

The Commission has invited the views of business and other stakeholders on possible alternatives to the current methodology of determining and calculating bring forward costs. In the Draft Decision the Commission foreshadows the potential for a general application of bring forward costs as follows:

- 0-5 years: no bring forward
- 6-10 years: contribution defined as 35% of the as constructed cost of shared assets
- 11-15 years: 50% of the as constructed cost of the shared assets
- >15 years: 70% of the as constructed costs of the shared assets

The 'basis for consideration' contained in the Draft Decision is – potentially – a step in the right direction and if introduced and appropriately managed in a common sense manner may prove to be a satisfactory way forward.

Our concern however relates to the fact that as urban development is often impacted by rapid and unexpected surges in housing demand (sometimes triggered by changes in government policy), the baseline for which any determination of logical sequencing over a five year period may alter significantly within a five period itself.

For example, in regard to metropolitan Melbourne and Geelong the UDIA would argue the assessment of timing (informed by developer intentions) published in the Department of Planning and Community Development's Urban Development Program represents the most complete and widely accepted monitor of future broadhectare development. Even so it should be noted however that expectations regarding the anticipated timing of development can and do change quite significantly from one year to another in the Annual Report of the Urban Development.

If it is the intention of the Commission that a five year forward estimate of future development is to be "locked in" to determine the regime of 'bring forward' penalties as outlined above we express reservations about this approach as the cyclical nature of the urban development industry and the

government's own difficulties in estimating the true level of demand and hence land take up is not conducive to pre-determining timeframes for urban development over a five year period. That such timeframe estimates might then be employed to impose a significant proportion of the construction costs of shared assets on developers (and by extension the homebuyer) is a regressive step.

We contend that at the very least acceleration costs (or construction costs as proposed in the Draft Decision) should be reduced by the extent of any benefits derived by the water companies in earning retail based revenue earlier than otherwise expected.

Further, there seems little sense in charging the developer with the "constructed cost" of the shared asset in the event a project is 'brought forward' within a 0-5 year timeframe. A more sensible approach (if the overall approach is regarded as feasible in the first place) would be to charge the developer the acceleration costs associated with bringing forward a project from say a 7 year timeframe into the 0-5 year period (where there is no bring forward charge proposed). In this example, the 'penalty' would be the costs associated with bringing a project forward two years, rather than the current, and onerous, proposal that would see 35% of the constructed cost of the shared asset being absorbed by the developer (homebuyer).

To summarise our position on this proposal, we note that nowhere is it outlined as to what methodology might be established to determine probable developer timelines and therefore where a development sits in the "bringing forward" penalty framework.

We also note that while the Urban Development Program is available in metropolitan Melbourne and Geelong, there is no similar land supply monitoring tool currently employed, and accepted, in the regional centres.

5. CAPITAL WORKS PROGRAMS IN THE WATER PLANS

Another matter of some concern to the UDIA is whether the capital works programs outlined in the different water businesses' Water Plans have sufficiently accounted for the extent of future urban growth.

We are uncertain as to whether the household demand projections used by the water businesses (and apparently independently verified by Price Waterhouse Coopers) to determine their capital works programs for the period of the WPR have taken into account recent higher levels of population growth, nor is it clear whether the capital works plans have been mindful of supply driven growth (that is, developer intentions and by inference local government expectations).

We draw the Commission's attention to a reassessment of population and dwelling projections undertaken by the Department of Planning and

Community Development for the 2007 Annual Report of the Urban Development Program.

These projections, which provide an indicative guide to the likely direction of an updated set of official statewide government population and household projections due to be released in mid 2008, saw a 25% increase in dwelling projections in Melbourne's growth areas. The reasons for the magnitude of this increase are significantly higher levels of net overseas migration as well as a stabilisation in the fertility rate.

The overall effect is that Melbourne's population is now expected to increase by one million residents in around 2020, rather than in 2030 as had been previously predicted.

We therefore urge the Commission to carefully consider the basis of the household projections that underpin the Water Businesses' capital works programs over the next five years. Should the household projections that inform the Water Plans be based on the 2004 Victoria In Future projection series, we urge the Commission to consider their current validity with care as they may materially under-estimate the need for infrastructure in certain growth areas and regional centres.

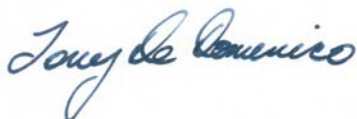
6. CONCLUSION

The UDIA once again thanks the Essential Services Commission for the opportunity to comment on the Draft Decision. The urban development industry is a critical industry and carries the almost sole responsibility for the delivery of housing to average Australians.

That housing affordability has become a serious economic, and political, issue cannot escape the notice of anyone involved in policy formation. The degree to which government related charges, levies and taxes continue to grow adds to the cost of development and by extension price of a home. While each levy or charge may appear insignificant on their own, the combination has become a major cost burden in development both as direct cost inputs and in adding to the complexity of development.

We urge the Essential Services Commission to take the comments provided in this submission into account in making its final decision.

Yours sincerely



Tony De Domenico
Chief Executive Officer