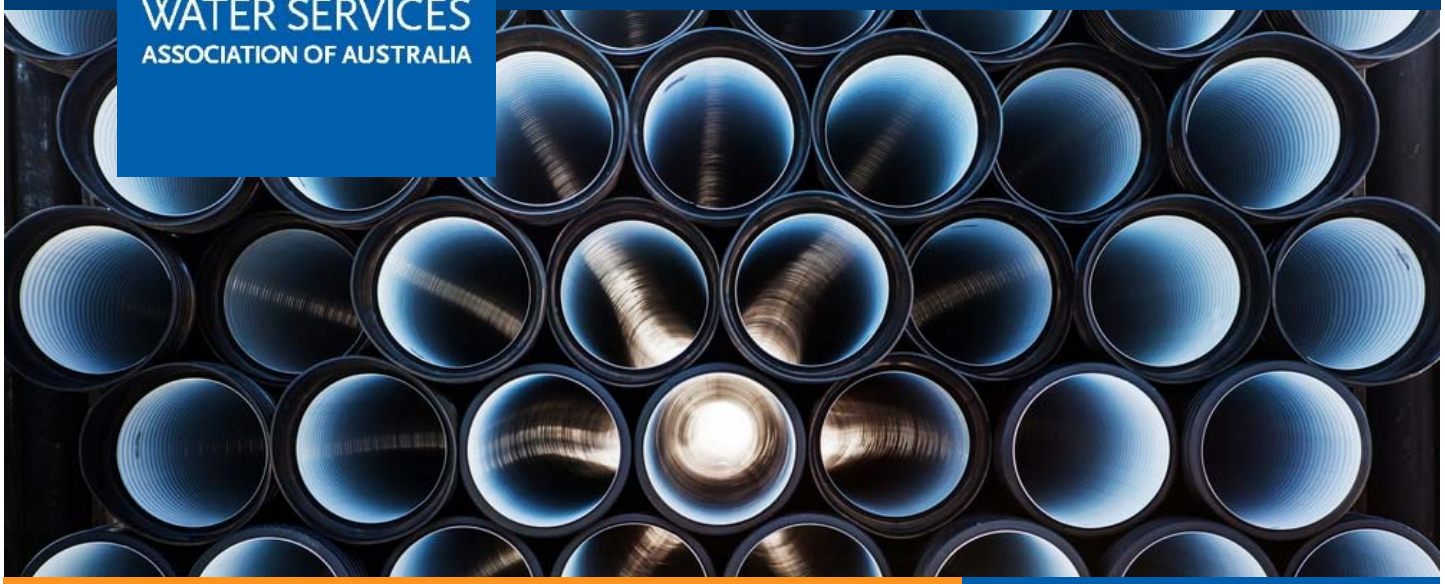
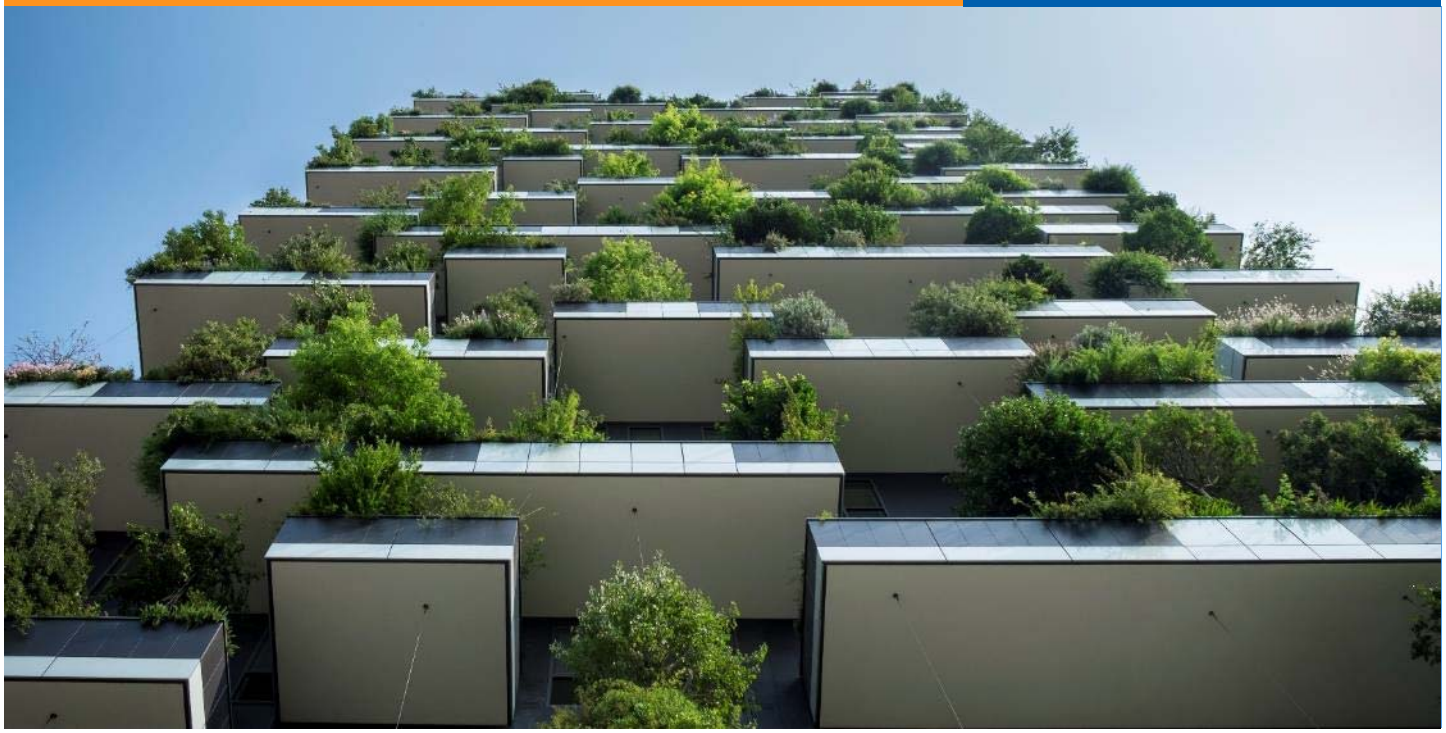
WATER SERVICES
ASSOCIATION OF AUSTRALIA



DEVELOPER CHARGES AND BACKLOG SEWERAGE CHARGES FOR METROPOLITAN WATER AGENCIES 2017

WSAA's submission to IPART's review



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1. INTRODUCTION AND OVERVIEW

The Water Services Association of Australia (WSAA) is the peak body that supports the Australian urban water industry. Our members provide water and sewerage services to over 20 million customers in Australia and New Zealand and many of Australia's largest industrial and commercial enterprises.

WSAA facilitates collaboration, knowledge sharing, networking and cooperation within the urban water industry. The collegiate approach of its members has led to industrywide advances to national water issues.

WSAA welcomes the opportunity to provide a brief submission to IPART's *Review of developer charges and backlog sewerage chargers for metropolitan water agencies*.

IPART's inquiry into its method of setting developer charges takes place against a background of the partial application of the method to NSW metropolitan water businesses. In 2008 the Government set water, sewerage and stormwater developer charges for Sydney Water and Hunter Water to zero. Developer charges remain for the Central Coast.

It is this context that this submission primarily addresses. It sets out WSAA's view that a well-designed system of developer charges and contributions is an important element for funding growth.

We acknowledge that it is not within IPART's scope in this review to reimpose developer charges in Sydney or the Hunter. Nevertheless, we consider that the purpose and effect of developer charges should not be forgotten or overlooked. We therefore support Sydney Water's suggestion that there would be merit in undertaking a broader review of infrastructure funding arrangements including:

- exploring the advantages and disadvantages of different funding mechanisms, including developer charges, user fees, and value capture; and
- identifying and removing any material barriers to competition.

While IPART's method has a number of strengths, a major weakness is that when it previously operated in Sydney it generated zero developer charges across significant parts of the city. This represents a failure of the method to capture relevant infrastructure costs rather than the absence of such costs. WSAA considers it could be overcome by setting a minimum developer charge as part of the method.

2. THE GROWTH CHALLENGE

Many of the challenges the industry faces in providing better services to its customers and the community coalesce around servicing new growth. Rapid growth reveals impediments in the current arrangements for planning and funding new services, allowing for new entrants, and delivering integrated water cycle solutions.

Medium level projections from ABS show Australia's population growing from 22.3 million in 2011 to 30.5 million in 2031. The majority of this growth is projected to be in Sydney, Melbourne, Brisbane and Perth, increasing by 5.9 million people to 18.6 million in 2031. Population growth drives a rising demand on our infrastructure services. This growth will impose additional demands on urban infrastructure which is already under pressure. As was stated in Infrastructure Australia's Australian Infrastructure Plan last year:

"Growing communities need places to live, work and enjoy our great Australian way of life, placing pressure on existing infrastructure networks. But if we plan for this growth now, we can further develop our cities as thriving, world-class centres of growth and prosperity."

Today, Greater Sydney is one of the top 10 fastest growing regions in the Western world, in the past 25 years it has grown by 1.3 million to reach 4.7 million people. By 2036 it will be home to another 1.7 million people, and 3.2 million more people by 2056. Supporting this growth and demographic change, while improving liveability, is the most pressing challenge for the region. There is a growing need to accelerate housing supply to meet this demand and to improve housing affordability.

Currently, the Greater Sydney Commission (the Commission) is forecasting that there is a minimum requirement for 725,000 additional dwellings by 2036. The Commission is leading metropolitan planning to make Greater Sydney more productive, sustainable and liveable. Late last year the Commission prepared their draft Greater Sydney Region Plan setting out a vision for a metropolis of three cities that will rebalance growth and deliver its benefits more equally and equitably to residents across Greater Sydney (Box 1). According to the Commission in *Towards our Greater Sydney 2056*:

"We are at a transformational point. We have an opportunity to shift Greater Sydney's spatial structure in a way that benefits all existing and future citizens."

We have great visions for our growing cities, to make them great liveable places where people want to be. Urban water businesses are in a unique position to contribute to green space, amenity, waterway health and recreation alongside growth. Through an appropriately funded, holistic planning framework we will be better enabled to achieve overall growth objectives.

Box 1 – Greater Sydney Commission

The Greater Sydney Commission are looking to a shift away from thinking of Greater Sydney as a place anchored by an economically strong single central business district and instead looking at the outstanding assets in three cities and the many local places and connections between these cities.

The three cities envisaged are the established Eastern City, the developing Central City and emerging Western City. Each of these three cities will have their own unique identity and each must be planned to maximise liveability, productivity and sustainability.

The GSC's draft Greater Sydney Region Plan is a 20 year plan with a 40 year vision. The plan contains four themes whose delivery is guided by ten directions for achieving their vision for Sydney.

- **Infrastructure and Collaboration**
    - A city supported by infrastructure – infrastructure supporting new developments
    - A collaborative city – working together to grow a Greater Sydney
- **Liveability**
    - A city for people – celebrating diversity and putting people at the heart of planning
    - Housing city – giving people housing choices
    - A city of great places – designing places for people
- **Productivity**
    - A well connected city – developing a more accessible and walkable city
    - Jobs and skills for the city – creating the conditions for a stronger economy
- **Sustainability**
    - A city in its landscape – valuing green spaces and landscape
    - An efficient city – using resources wisely
    - A resilient city – Adapting to a changing world

3. THE ROLE OF DEVELOPER CHARGES

Developer charges are an important mechanism for funding growth infrastructure and have been applied in the urban water industry for many years across Australia.

The costs of servicing growth — particularly greenfield growth — are significantly higher than the costs of servicing existing areas. For example, in their Price Plan 2016-20 Sydney Water states that currently “the cost of servicing greenfield lots is on average 5-6 times higher than for servicing infill lots”. For infill growth, existing capacity means that redevelopment can increase density at modest costs. However, in the long term all customers are responsible for using the capacity of the water and wastewater systems and eventually the costs of upgrading capacity in existing areas also involves significant costs.

However, utilities do not charge higher prices to customers in new growth areas. Overwhelmingly utilities in Australia (and the rest of the world) operate under a system of postage stamp pricing system whereby the same customers across the area of operations pay the same charges regardless of the cost of delivery.

As a consequence of postage stamp pricing, water and wastewater revenue recovered from new customers, is less than that required to cover the cost adding them to the network.

The traditional role of developer charges has been to partially or fully fund that gap. In this way cities can grow without putting significant pressure on existing water bills. The elegance of IPART’s method is that it explicitly seeks to recover the shortfall between the costs of servicing growth and the ‘profits. That is, the gap between the infrastructure cost per property and the future revenue stream from postage stamp service charges. Most other jurisdictions do not employ such an explicit formula for setting the developer charges, or seek to apply it at such a granular level. However, most jurisdictions relate the developer charge to the additional average long term costs of servicing new development.

All water utility infrastructure costs must be recovered. Without a developer charging framework, the additional costs of new growth will necessarily be recovered through water and wastewater service charges from existing customers. Over the longer term with continued strong population growth this will place additional pressure on general water and wastewater prices. It will also mean that developer charges cannot play a role in supplementing planning decisions by providing a price signal on where to develop. The pattern of development may be different in the absence of developer charges, and utilities could be required to develop on more fronts simultaneously than is optimal.

4. COST RECOVERY AND VALUE CAPTURE

Governments have been increasingly looking at forms of value capture to fund infrastructure.

Developer charges are an attractive funding source because, if well-designed, they recover the additional costs of servicing new growth through a form of value capture.

While developer charges are payable by the developer, they neither reduce their profits nor are they passed on to the homebuyer. Instead developer charges will affect the amount a developer will pay for residential land. When agricultural land is rezoned for houses, industrial land is rezoned for residential, or residential land rezoned for higher levels of density, its value will increase significantly. In each case the existing landowner will make a windfall gain or profit. Developer charges remove part of that profit to fund infrastructure. Knowing that they will pay a developer charge, developers will pay less for rezoned land than they would if there were no developer charges. In this way developer charges capture part of the increase in land value when land is rezoned to higher value residential uses.

As such developer charges do not place significant pressure on housing prices or affordability. This is an important conclusion, and is well supported in the economic literature. The rationale is set out in Abelson 1999, but also more recently in the Henry tax review. (Attachment 1 is based on this analysis). As Ableson said:

"If, as seems generally plausible in Australian cities, demand is elastic and supply is inelastic, the main incidence [of developer charges] will be borne in lower raw land prices."

This does not mean that Governments do not have to be mindful of the level of the total imposts initially levied on developers. If these total imposts exceeded the value uplift in raw land then developers could not afford to pay more than the value of the land in its existing use. If too high, developer charges will constrain the supply of viable development land[1]. Any formula needs to take this practical factor into account.[2]

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[1] **This is different to the role developer charges can play in signalling where development should take place and deterring development in areas where costs make development prohibitive.**

[2] **IPART may wish to consider capping developer charges in areas that are a priority in Government growth plans to avoid developer charges becoming an impediment to growth. Water services are only one element determining the optimal growth path.**

5. COMMENTS ON IPART'S METHODOLOGY

WSAA has not undertaken a detailed study of developer charges, nor the intricacies of IPART's method. However, we have a number of high level comments based on our observation of the range of approaches employed across Australia.

A striking feature about the developer charge regimes across Australia is their diversity. All seek to recover the costs of development but in widely different methods. These range from a single charge across an area of operations to IPART's formula for area specific charges. These regimes are not the product of long standing practice or history; a number are relatively new or have been reviewed recently. Most regimes contribute materially to the revenue of water utilities. The message WSAA takes from this diversity is that different approaches can work well.

Why such diversity? Developer charges are one instrument that is designed to meet a number of objectives: cost recovery, providing locations specific investment signals, and more recently to facilitate competition. Inevitably one instrument cannot meet multiple objectives perfectly and trade-offs will be necessary[3]. Pragmatism and flexibility in regime design are necessary.[4]

5.1 IPART's method

The robust conceptual grounding of IPART's developer charges method is its strength: it offers location specific charges that are designed to overcome the lack of signals provided by postage stamp pricing. But making the method operational reveals some of its limitations. Most of these limitations relate to the data intensity of the method.

The level of data required to generate theoretically accurate location specific charges are unlikely to ever be available. It would entail having past capital expenditure and decades of future capital expenditure, operating costs and development rates available on a consistent basis. Because IPART recognises that this is not feasible it sensibly constrains the data required. There are adjustments to the inclusion of past capital expenditure and only a relatively short period of future capital expenditure is used in the model. This is likely to have some unintended consequences for calculated developer charges.

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[3] **For example efficient investment signals will be provided by forward looking incremental costs where past capital expenditure is excluded. However, this clashes with cost recovery which needs to cover all past and future costs associated with growth.**

[4] **One common feature is that the customers benefit from developer charges. Typically, developer charges revenue is deducted from the regulatory asset base, thus reducing the increase in capital costs covered in water prices.**

5.1.1 The existence of zero charges

One consequence of IPART's method is that it can generate zero developer charges. This occurred in large parts of Sydney when the charges were in place. WSAA does not claim to fully understand why this was the case. It considers that all growth uses capacity on systems which is costly to install or upgrade[5]. Most jurisdictions apply developer charges to all growth areas whether brownfield or infill.

However, it is likely that limiting forward capital expenditure to only 5 or 10 years in the future is one reason the formula generated zero charges. Given lives of network assets of up to 120 years, 5 to 10 years is very much the short run, major upgrades linked to the development required any time later this are not considered.

WSAA considers that the answer is not to make the formula more complex by requiring longer future capex plans, but to recognise this limitation by setting a minimum developer charge, which recognises the formula does not capture all relevant costs.

5.1.2 Developer charges are more likely to face legal challenge

Paradoxically, the effort to improve the accuracy of developer charges increases rather than decreases the chance of them being challenged. The broad costs of servicing growth are well understood by utilities, including how those costs are likely to vary depending on different circumstances such as terrain or treatment levels required for wastewater. This allows jurisdictions to set charges which have a nexus to the cost of servicing growth

However, a methodology that relies on specifying exactly what infrastructure is going to be built at what time in a defined area more open to challenge by developers as future forecasts will never be completely accurate. Flexibility is required for utilities to accelerate or delay their capital plans in response to changes in the market. Yet this could render a set charge “inaccurate”. The method could create a tension with the desire for flexible and adaptive capital investment plans.

5.2 Developer direct

WSAA notes that Sydney Water suggests that its Developer Direct service should not be regulated by IPART. Sydney Water’s argument that it is operating in a competitive market is a strong rationale.

More broadly, WSAA has pointed out previously that IPART is one of the few regulators to set actual prices, rather than setting allowed revenues. In its work on economic regulation we have argued that setting individual prices is not best practice economic regulation. We consider this is another argument that the Developer Direct service need not be regulated.

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[5] **If a sheep pen holds 100 sheep we wouldn’t say the 95th to 100th sheep were responsible for using up the capacity in the pen. All sheep fill the pen. Having zero developer charges is analogous to arguing some new entrants impose no costs on the system, where there is clearly a nexus between the services they receive and the costs of infrastructure.**

ATTACHMENT 1: WHO PAYS DEVELOPER CHARGES?

The following figures show that the incidence of developer charges is on the original landowner, not the developer or homeowner. It assumes the supply of housing land is fully inelastic, which is an extreme assumption. However, as noted in the Henry Tax Review "the value of agricultural land at the fringe of cities generally exceeds its opportunity cost in agricultural production, reflecting restrictions in the supply of land for housing."

Figure 1 Supply and demand for housing land

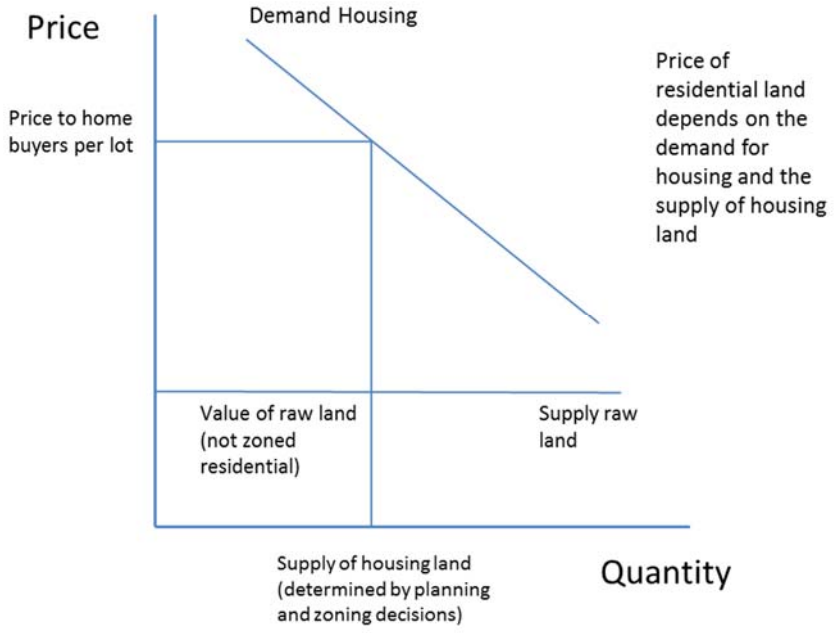

Figure 2 Value uplift with rezoning

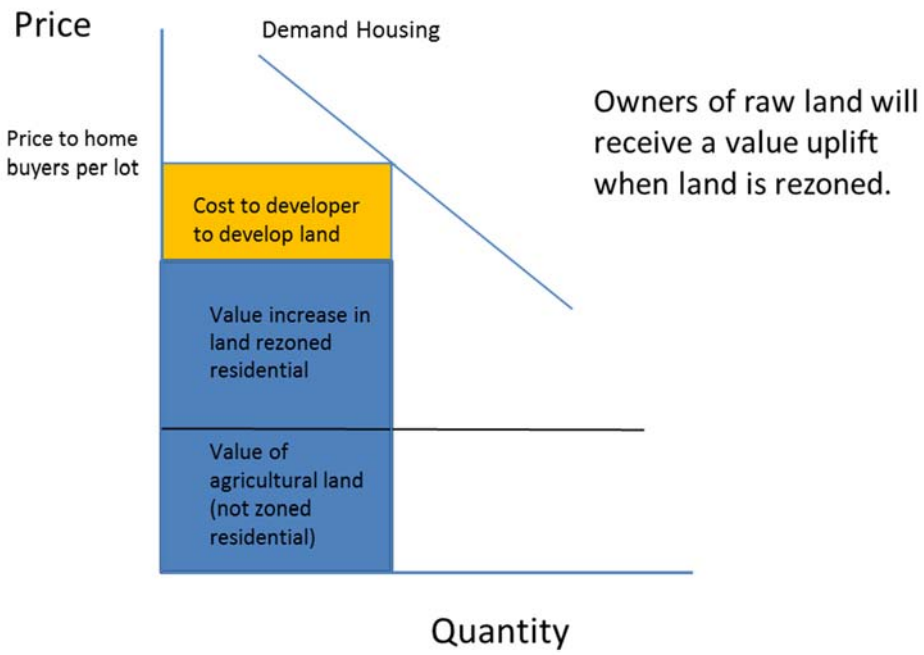

Figure 3 Impact of developer charges