

Review of New Customer Contributions

Consultation paper

15 August 2024



Acknowledgement

We acknowledge the Traditional Owners of the lands and waterways on which we work and live.

We acknowledge all Aboriginal and Torres Strait Islander communities, and pay our respects to Elders past and present.

As the First Peoples of this land, belonging to the world's oldest living cultures, we recognise and value their knowledge, and ongoing role in shaping and enriching the story of Victoria.

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1. Overview

The Essential Services Commission (commission) has commenced a review of new customer contributions (NCC) in Victoria's water sector.

Since 2013 the commission has applied a principles-based NCC framework which aims to:¹

- send signals to developers about the costs of developing in different locations
- share the costs and benefits of growth between new and existing customers
- administer new customer contributions in a transparent way.

We consider these objectives remain sound, and subject to stakeholder feedback, do not propose to revisit these as part of our review.

Our review aims to address implementation issues that arose during the 2023 price review to better support the achievement of these objectives.

During the 2023 price review, we found the price submissions of some water businesses did not sufficiently justify the costs allocated to NCC, while many appeared to favour common pricing arrangements even where costs differed significantly across different areas or locations. Other matters are explored further in the paper (a summary is provided below with detail in Chapter 5).

Clarification of the NCC framework we apply may be needed in these areas, given the departures from our expectations for NCC and their justification. Accordingly, the review will inform the NCC guidance we issue for the 2028 water price review. The guidance will set out our assessment framework and expectations for the justification of NCCs by water businesses.

We are seeking feedback on the implementation issues we have identified and how these might be addressed by the commission. We are interested in views on the need for additional guidance or prescription that we could provide to better support compliant submissions and achievement of the objectives noted above. There may be other matters stakeholders identify.

The review covers NCCs levied by regional urban water authorities² and metropolitan water corporations³ (referred to as 'water businesses') for new connections to their water, sewerage, or

¹ Essential Services Commission 2013, *New customer contributions: Explanatory Note*, December, p. 5, cl 1.2.

² Regional Urban Water Authorities are defined and listed in section 4A(1) of the Water Industry Act 1994 (Vic). They collectively comprise twelve (12) government owned water business providing urban water, sewerage and recycled water services in regional Victoria.

³ Metropolitan water corporations are defined in section 3(1) of the Water Act 1989 (Vic) and comprise Greater Western Water Corporation, South East Water Corporation and Yarra Valley Water Corporation.

recycled water networks. The review does not cover Melbourne Water as we assess their NCCs under different principles. We will consider Melbourne Water's NCCs at their 2026 price review.

We recognise the many interests in NCCs from a policy, industry, customer and community perspective. We have provided substantial time to consult on key issues before we confirm our approach to assessing NCCs in guidance to be issued for the 2028 water price review.

What are new customer contributions?

New customer contributions, also known as developer charges, are one-off charges levied by water businesses on a property owner applying to connect to a water business's works or applying to receive increased services. These charges are a contribution towards the costs of works used directly or indirectly for the provision of the services that will benefit the property.⁴

Generally, NCCs are levied on property owners when subdividing land on the urban fringe or redeveloping sites within built up areas.⁵ They may also be levied when an existing property owner changes the way land is used so that increased or augmented water, sewerage or recycled water services are required at the property.⁶

NCCs establish how much a connecting party pays upfront, versus what will be paid through ongoing charges by the connecting party and all other customers. This latter approach is given effect by the inclusion of relevant costs in a water business's regulatory asset base. Accordingly, as well as determining who pays, this means NCCs also influence when a water business recovers relevant costs.⁷

In recent years, the water businesses covered by this review have together generated around \$200 million in NCC revenue (cash basis) each year, which is around 4.8 per cent of their total regulated revenue. This excludes gifted assets provided by developers to support their connection, which have grown by around 14 per cent each year on average over the past ten years, totalling around \$400 million in 2022-23 financial year alone.⁸

⁴ Water Act 1989 (Vic), see s 268 and s 269.

⁵ Water Act 1989 (Vic), s 268.

⁶ Water Act 1989 (Vic), s 269.

⁷ As noted in Appendix A, whether costs are recovered upfront or via the regulatory asset base, the business recovers the same total costs in net present value terms. By including costs in the regulatory asset base, costs are recovered by a water business over a relatively long period, in line with assumptions about asset lives.

⁸ Sources: 2023 final decision financial models, water business annual reports, water business regulatory accounts 2012-23.

Why is our guidance important?

The Water Industry Regulatory Order 2014 (WIRO) specifies the prescribed services provided by water businesses that are subject to regulation by the commission.⁹ These include NCCs (noting the WIRO calls these developer charges).

The guidance we issue under the WIRO before each price review sets out our NCC framework. It includes requirements for the calculation of proposed NCCs and information to be contained in price submissions for our assessment.¹⁰ Price submissions must comply with our guidance.

Our framework for NCCs was set out in the guidance we issued for the 2023 water price review.¹¹

The 2023 guidance specified pricing principles which we required water businesses to use in calculating their NCCs (Box 1.1). It also referenced the explanatory note we issued in December 2013 which sets out detail on the types of NCCs (standard or negotiated) and how to interpret and apply the pricing principles. The explanatory note formed part of the guidance.

Box 1.1 New customer contributions pricing principles

Standard and negotiated new customer contributions will:¹²

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

As it sets out our NCC framework, the guidance must be clear on the assessment criteria and the information water businesses need to provide to support their proposals. Given the issues that arose at the 2023 water price review, we may need to consider additional or clarified guidance on implementation issues summarised below. Our 2023 guidance is available [here](#).

⁹ Water Industry Regulatory Order 2014, cl 7.

¹⁰ Water Industry Regulatory Order 2014, cl 13.

¹¹ Essential Services Commission 2021, 2023 water price review: Guidance paper, 26 October, p.58.

¹² Essential Services Commission 2013, *New customer contributions: Explanatory Note*, December, p. 2, cl 1.2.

What are the implementation issues that we want to address?

Our last review of the new customer contributions framework was undertaken in the lead up to the 2013 water price review. The review led to a principles-based framework, providing flexibility in how NCCs are calculated and applied - a change from the more prescriptive approach that had been in place before then.

Following changes to the Water Industry Regulatory Order applying from 2014, we consulted on a new pricing approach for water and sewerage services (this resulted in the implementation of PREMO, a framework that seeks to incentivise best offers in price submissions, from 2018). At that time, we noted the NCC framework was not a matter that needed a review.¹³

We consider the principles-based NCC framework worked well for the decade leading up to the 2023 water price review. At the 2023 price review, some water businesses provided good justification for their NCC proposals. However, many put forward NCCs that we consider did not support the objectives of our framework. Key issues included:

- Unjustified costs to be recovered from new customer contributions. This included lack of documentation and justification by some businesses on the allocation of costs between growth and non-growth assets.
- Variation in approach to the inclusion of costs relating to assets, leading to different practices across the water sector (including proposals to reflect 'sunk' costs).
- Some businesses proposing common pricing over relatively large areas even where costs may differ markedly within the area.
- Information provided to stakeholders often lacked transparency.

More detail is provided in Chapter 5.

How can you be involved in our review?

We are seeking feedback from stakeholders to inform our review, including perspectives on the key issues we have identified, and other information we should consider.

Submissions responding to our consultation paper should be made via Engage Victoria by 15 November 2024. Box 1.2 below sets out questions to guide feedback. Submissions will be published on the commission's website, except for any information deemed commercially sensitive or confidential. This is in accordance with our submissions policy. Submissions should clearly identify which information you consider sensitive or confidential, and the basis for your reasons.

¹³ Essential Services Commission 2015, Review of Water Pricing Approach Consultation Paper, April, p. 20.

Alternatively, you may send comments by email or mail.

- Email: water@esc.vic.gov.au
- Mail: The Water team, PMaR, Essential Services Commission, Level 8, 570 Bourke Street, Melbourne Victoria 3000

To help you prepare your feedback, Chapter 2 provides an overview of the legislative and regulatory framework applying to NCC and our role. Chapter 3 provides an overview of the flexibility available within the principles-based framework, and a brief history of NCC. Chapter 4 sets out what we see as good practice under the principles-based framework, with more detail on implementation issues that arose at the 2023 water price review provided in Chapter 5.

We have also outlined in detail the economic principles supporting our NCC framework in Appendix A – Technical concepts. A separate paper “Connection contributions frameworks in other regulatory regimes” is published on our website which summarises connection frameworks in other sectors or jurisdictions. This is intended to provide a single source of information for stakeholders to compare different connections frameworks.

Box 1.2 Questions for interested parties

We are seeking views on the following questions:

1. **What are your perspectives on the matters identified by the commission at the 2023 water price review (see Chapter 5)? Are there other matters we should consider?**

2. **What changes should the commission consider in terms of the guidance we provide water businesses on new customer contributions?**

This might include the level of prescription in relation to the treatment of different costs or assets for the purposes of calculating NCCs. You may also wish to comment on the objectives for the framework we apply (listed above on page 1).

3. **How do you think the commission can support connection applicants and water businesses in their engagement on new customer contributions?**

4. **Are there other issues or information we should consider during our review, having regard to the commission’s role in new customer contributions?**

We are interested in matters or information the commission should be aware of from a policy, industry or community perspective that might inform our review.

5. **What are your views on a change in terminology from our current use of ‘new customer contributions’ to an alternative such as ‘developer charges’?**

6. **Any other relevant matters.**

During our review, we will engage extensively with stakeholders. Our engagement approach will evolve depending on the issues that are raised during our review. However, we anticipate issuing additional papers and holding workshops and forums to progress specific issues. We will also meet with individual stakeholders to discuss feedback.

You can contact water@esc.vic.gov.au for more information.

Below, we summarise the key milestones in our review and indicative dates.

Indicative activity	Indicative date
Release of consultation paper	15 August 2024
One-on-one meetings with stakeholders about our review and build our understanding of key issues	September – October 2024
Due date for submissions on the consultation paper	15 November 2024
Additional targeted consultation on key issues identified through initial consultation (details to be confirmed) - training of the water sector	During 2025
Guidance for 2028 water price review	Mid 2026

2. New customer contributions and the regulatory framework

The commission regulates new customer contributions (NCCs) in our role as the economic regulator of Victoria's water sector. This section provides an overview of the overarching economic regulatory framework which sets out the commission's role, and the NCC framework established by the commission.

Overarching economic regulatory framework

Three legislative instruments set out the overarching economic regulatory framework in which the commission operates (see blue shaded area in Figure 2.1). A short overview of the key provisions of these instruments is provided for context, noting they are not the focus of this review. This review focuses on making commission's requirements for assessing NCCs to be set out in guidance to be issued for the 2028 water price review (see yellow shaded area in Figure 2.1).

Essential Services Commission Act 2001 (Vic)

The Essential Services Commission Act 2001 (Vic) (ESC Act) provides the commission with functions and powers to regulate prices for prescribed goods and services supplied by or within regulated industries.¹⁴ Victoria's 18 water businesses are a regulated industry¹⁵ for purposes of the ESC Act, and the services provided by these water businesses, including developer charges (also known as NCCs), are prescribed services¹⁶ for purposes of this Act.

This means the commission is vested with functions and powers to regulate developer charges (NCCs). It does so through a price determination made for each water business under the ESC Act.¹⁷ A price determination is binding on the water business specified in the determination.¹⁸

¹⁴ Essential Services Commission Act 2001 (Vic), s 10(a) read with s 32.

¹⁵ Essential Services Commission Act 2001 (Vic), s 3, see definition of 'regulated industry', read with Water Industry Act 1994, s4A – see definition of 'regulated water industry'. This constitutes Melbourne Water Corporation, metropolitan water corporations, Regional Urban Water Authorities and Rural Water Authorities.

Water Industry Act 1994 (Vic), s4B. See definition of 'regulated entity'. This constitutes Melbourne Water Corporation, metropolitan water corporations, Regional Urban Water Authorities and Rural Water Authorities.

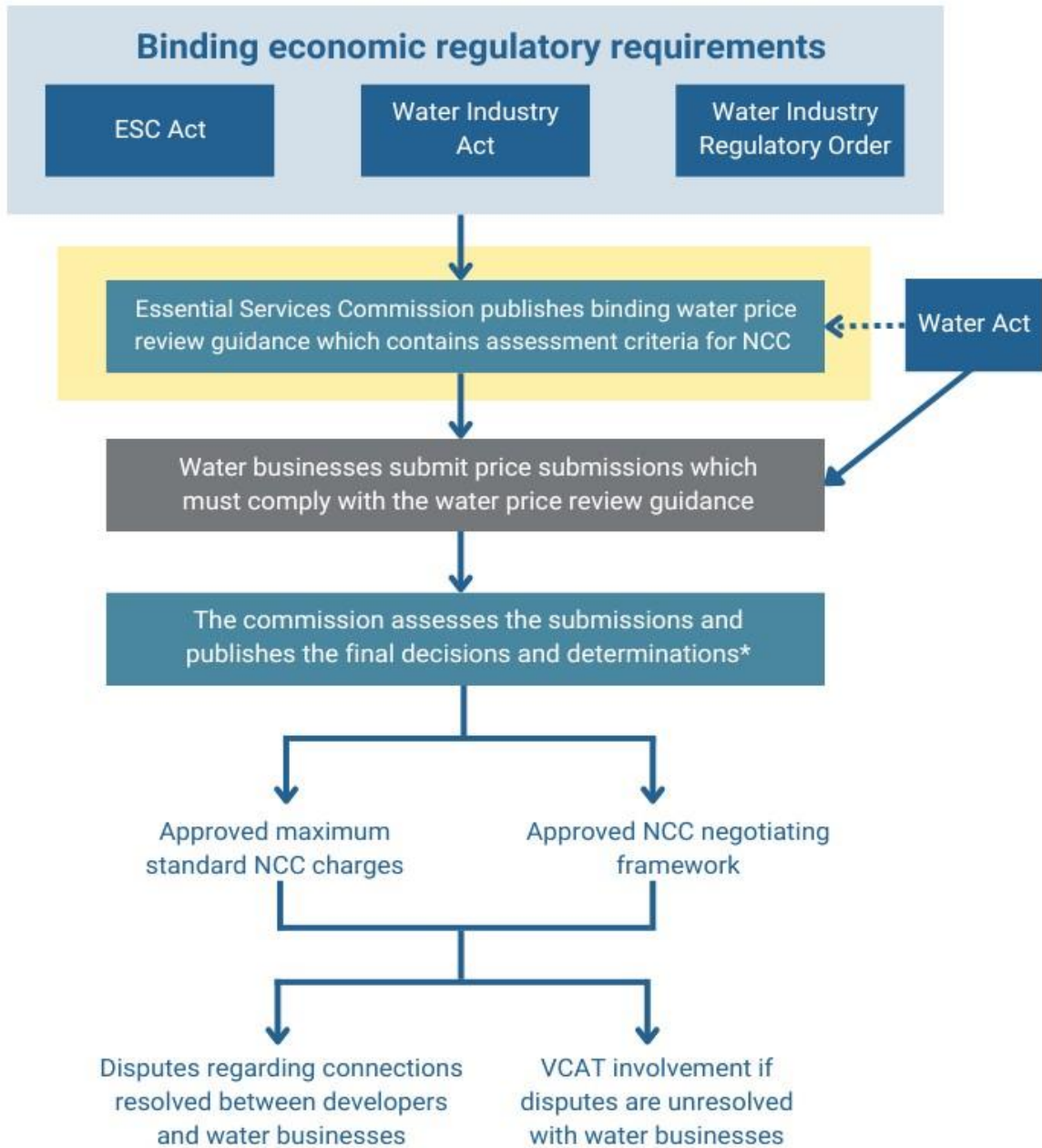
¹⁶ Essential Services Commission Act 2001 (Vic), s 31A, see definition of 'prescribed goods and services', read with the Water Industry Regulatory Order 2014 (WIRO), cl 7(b), see definition of 'prescribed services'.

¹⁷ WIRO, cl 10.

¹⁸ Essential Services Commission Act 2001, s 35(7).

Figure 2.1

Victorian New Customer Contribution Regulatory Framework for metropolitan and regional urban water businesses



**A person may apply to VCAT for a review of the commission's decision or determination as per section 55 of the ESC Act 2001.*

Water Industry Act (Vic)

The Water Industry Act 1994 (Vic) (WI Act) provides the broad enabling framework for price and service standard regulation of Victoria's water industry. It identifies 18 water business as 'regulated entities' for these purposes.¹⁹ It provides for the making of a Water Industry Regulatory Order by the Governor in Council which sets out the detailed framework for the regulation of prices for prescribed services, and the role of the commission.²⁰

Water Industry Regulatory Order 2014

The Water Industry Regulatory Order 2014 (WIRO) specifies the prescribed services provided by the water businesses that are subject to price regulation by the commission.²¹ These include services to which new customer contributions (NCCs) apply.

The WIRO sets out the objectives to be pursued by the commission when performing its functions and exercising its powers in relation to the regulated water industry,²² and specifies several matters that we must have regard to. For price determinations, clause 11(c) specifies that we also must have regard to matters specified in the guidance we that we issue under clause 13.

The WIRO also provides a propose-respond model under which a water business must submit a price submission to us. We must then follow a process to make a final decision and issue a price determination. The commission must, in its determination either:

- approve the maximum prices a water business may charge for prescribed services or the manner in which the regulated entity's prices are to be calculated, determined or otherwise regulated²³, as proposed by the water business in its price submission; or
- specify the maximum prices or manner for calculating these prices²⁴.

The commission may only specify the maximum prices, or manner in which prices are to be calculated, determined or otherwise regulated, if a price submission does not, in the commission's opinion, comply with the guidance it provides under clause 13 of the WIRO or have adequate regard for the matters specified in clause 11. We may also specify maximum prices, or manner in

¹⁹ Water Industry Act 1994 (Vic), s4A – see definition of 'regulated entity'.

²⁰ Water Industry Act 1994 (Vic), s4D.

²¹ WIRO, cl 7(b).

²² WIRO, cl 8.

²³ WIRO, cl 14(a)(i).

²⁴ WIRO, cl 14(a)(ii).

which prices are to be calculated, determined or otherwise regulated, if a water business has not submitted a price submission to the commission.

Commission's guidance

Guidance issued by the commission pursuant to the WIRO²⁵ sets out our regulatory framework for NCCs. The guidance needs to capture the matters we expect water businesses to consider and provide clarity about the information they must provide us in support of their pricing proposals. Our guidance also needs to consider the binding requirements that the Water Act 1989 (Vic) imposes on water businesses in relation to new connections requiring payment of an NCC.

Our framework for NCCs was set out in guidance we issued for the 2023 water price review.²⁶ Under our guidance, NCCs can be either standard or negotiated:

- standard charges are proposed by the water business and approved by the commission
- negotiated charges are negotiated between the water business and the connection applicant on a site-specific basis.

Standard charges apply to new connections in areas where infrastructure requirements and growth rates are relatively well known and designated by the water business. Standard charges reduce the administrative burden and improve the timeliness and predictability of costs faced by developers.

Negotiated charges may apply where standard charges would not be fair and reasonable or where a new connection is outside the areas or connection conditions eligible for standard charges. While we do not approve individual negotiated charges, we do approve each water business' framework for negotiating these charges at each price review.

The 2023 guidance also set out pricing principles which we required water businesses to use to calculate their NCCs (Box 2.1). It referenced the explanatory note we issued in December 2013 which sets out detail on the types of NCC (standard or negotiated) and how to interpret and apply the pricing principles. The explanatory note formed part of the guidance.

²⁵ Water Industry Regulatory Order 2014, cl 13.

²⁶ Essential Services Commission 2021, 2023 water price review: Guidance paper, 26 October, p.58.

Box 2.1 New customer contributions pricing principles

Standard and negotiated new customer contributions will:²⁷

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection²⁸
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

We consider these pricing principles represent the minimum requirements for new customer contributions to be considered fair and reasonable as required by the Water Act.

The first two of these principles establish that the cost recovery threshold for determining upfront contributions (versus ongoing recovery through the regulatory asset base) is a net incremental cost approach, and the third requires that resulting contributions fall within efficient pricing bands. Appendix A explains the technical definition of each of these principles in more detail.

The explanatory note also encourages water businesses to have negotiation protocols, and to make certain information available to connection applicants, to inform negotiations and decisions regarding new customer contributions.²⁹ The explanatory note considered that reasonable industry practice will also see water businesses prepare and publish:

- Development servicing plans that show the water business's forecast timing and sequencing of infrastructure that will be required to service new customers.
- Negotiation protocols including references to pricing principles and dispute resolution details.
- Explanations of where and when standard NCC applies, and circumstances in which a developer or water business may introduce a negotiated NCC.

Information requirements

Our price review guidance papers also outline certain information requirements that must be met by water businesses. For example, our 2023 and 2024 price review guidance papers required that water businesses' pricing proposals must:

²⁷ Essential Services Commission 2013, *New customer contributions: Explanatory Note*, December, p. 2, cl 1.2.

²⁸ Statutory cost categories means costs for works imposed under Division 6 of Part 13 of the Water Act 1989.

²⁹ Essential Services Commission 2013, *New customer contributions: Explanatory Note*, December, Chapter 3, pages 9 to 12.

- Specify the proposed NCCs and how they are to be applied – for example by service (customer class) (e.g. water, sewerage, recycled water), location or development type (e.g. infill, greenfield).
- Provide the model(s) used to calculate the maximum NCCs, including accompanying notes describing the data sources and input assumptions used, in order for us to assess that proposed [standard] NCCs have been established in accordance with the NCC pricing principles and that the same financial parameters have been used as those in the regulatory building block revenue and RAB model (the financial model template).
- Provide evidence of consultation with connection applicants and how their views have informed the proposed charges, particularly if proposed standard NCCs are significantly higher than the existing NCCs.
- Provide details about how the forecast NCCs in the financial model template have been derived and explain how past outcomes for contributions have been considered, and assumptions about future connections growth.
- Provide a copy of the negotiated NCCs framework to be applied for the forthcoming regulatory period, including any proposed changes in track changes from the framework approved in the prior period.

These requirements for information to be provided to us are in addition to those that water businesses are already required to meet for customers when they issue a notice to a connection applicant to charge a contribution. Specifically, the Water Act³⁰ requires that such notices include:

- the amount of the payment required
- the reason why the payment is required
- any works or services that have been or will be provided
- the property in relation to which payment is required
- if payments are required in relation to a group of properties, the amounts required in relation to each property
- the right of the owner to object and apply for a review by the water business in the first instance and then VCAT if they desire
- that details of the proposed services and the costs are available for inspection, free of charge, at the water business' office during normal business hours.

Charging an approved NCC does not remove these statutory obligations on water businesses.

³⁰ Division 6 of Part 13 of the Water Act 1989, section 268(4).

Water Act 1989 (Vic)

The Water Act 1989 (Vic) governs water businesses' rights and obligations in relation to new customer contributions and new connections. It requires that contributions are fair and reasonable, taking into account the benefit to that property relative to the benefit to other properties.³¹ As noted above, the pricing principles in our guidance represent what we would expect to see for new customer contributions to be considered fair and reasonable as required by the Water Act.

The Water Act also outlines requirements for information to be provided to connection applicants when issued with a notice by a water business requiring payment of NCCs.³²

The Water Act further provides a process to resolve disputes between a water business and a connection applicant when any objections raised in relation to NCCs on the grounds specified in the Water Act.³³ This includes a mechanism to have the dispute independently reviewed and decided by the Victorian Civil and Administrative Tribunal.³⁴

The Water Act also provides arrangements for control over connections to a water business's works.³⁵ This is only possible on successful application to and approval by the water business.³⁶ It is an offence to connect to a water business's works without the required approval.³⁷ NCCs are usually required to be paid when a connection applicant applies to a water business to make a new or augment an existing connection to a water business's works.

³¹ Water Act 1989 (Vic), s 268(3), s 269(2) and s 270(2).

³² Water Act 1989 (Vic), s 268(4) and s 269(3).

³³ Water Act 1989 (Vic), s 271.

³⁴ Water Act 1989 (Vic), s 271.

³⁵ Water Act 1989 (Vic), s 145.

³⁶ Water Act 1989 (Vic), s 145.

³⁷ Water Act 1989 (Vic), s 145A.

3. A principles-based new customer contributions framework

Our new customer contributions (NCC) framework is a principles-based framework, that is a hybrid of levying charges on new developments and water businesses recovering its infrastructure costs through water and sewerage charges.

The principles-based NCC framework promotes a flexible arbitrate and negotiate connection regime in line with the provisions in the *Water Act 1989* for requesting contributions from a property owner for increased services.³⁸

With the principles-based framework water businesses, based on development and connection circumstances, can choose:

- when to negotiate versus propose a standard developer charge, noting customers rights to dispute both forms
- how many standard NCCs to propose and which eligibility circumstances each will apply, noting that having multiple approved NCCs can facilitate greater cost reflectivity. A single applicable standard developer charge may increase the need for more negotiated connections or augmentations to support cost reflectivity
- what incremental costs to attribute to NCCs
- what incremental benefits to attribute to NCCs either as incremental revenue or as costs avoided by the water business
- what time horizon to assess incremental costs and benefits over.

Purpose of new customer contributions

Water businesses earn revenue mostly from the fixed and variable charges levied on water and sewerage customers to pay for water and sewerage infrastructure and associated services. NCCs are calculated to earn the difference between the cost of servicing a development in a specific area and the future revenues from the water and sewerage charges from customers over the life of the infrastructure.

Providing water and sewerage infrastructure and related services to a new development typically involves investing capital in two main areas: the internal network within the development itself and the connection to, and possibly expansion of, the broader distribution network.

³⁸ Water Act 1989, section 269.

The internal network, or reticulation network, is often constructed by the connection applicant and later usually handed over to the water business to operate and maintain as a gifted asset. That network typically includes elements such as pipelines and sewerage systems within the development boundaries.

However, meeting the needs of new developments also frequently requires the water business to invest in new or expanded assets. These investments may encompass localised assets tailored to the specific development, such as water storage facilities and local treatment plants. Additionally, they may involve distribution assets that serve multiple developments, like water mains and sewerage systems. There could also be investments in headworks, which are treatment and storage facilities benefiting the wider customer base.

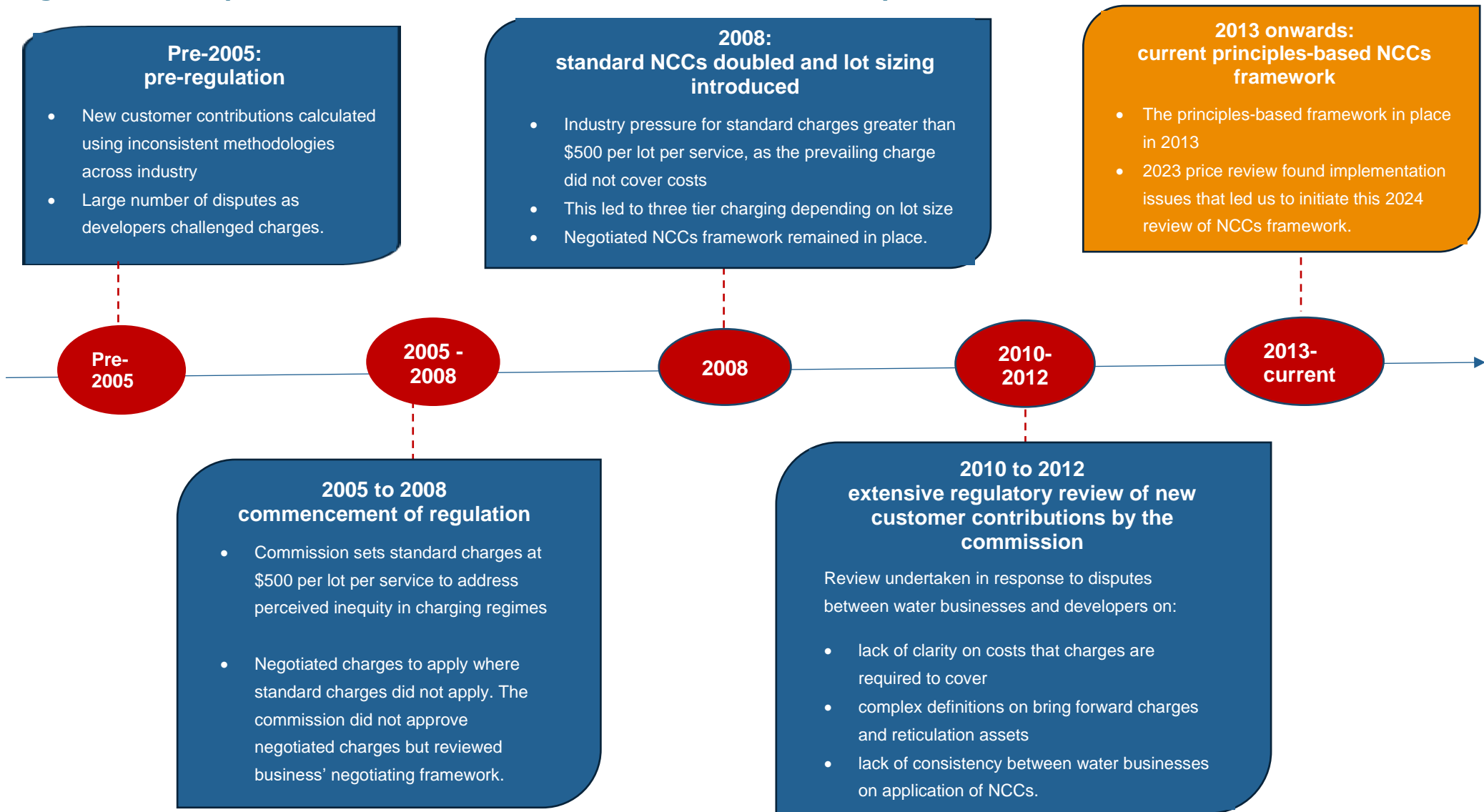
An alternative to levying NCCs is to fully cost recover infrastructure costs for locational specific development through general water and sewerage charges.

One implication of this option, however, is that it could distort signals for efficient investment. It may also require a move away from the current uniform or 'postage stamp' pricing for water and sewerage services to prices that reflect the growth of specific areas.

Prior to adopting the principles-based approach from 2013, NCC price regulation involved a fixed schedule of charges that proved problematic for its lack of flexibility, uncertain interpretation, and frequent disputes.

We have provided a timeline in Figure 3.1 of various NCC pricing approaches, and the evolution to the principles-based framework in 2013. Since the principles-based framework came into place in 2013, there have been relatively few disputes between connection applicants and businesses over the calculation of new customer contributions compared to the past regimes

Figure 3.1 History of new customer contributions in the Victorian water industry



3. A principles-based new customer contributions framework

4. Good implementation of new customer contributions within a principles-based framework

Our principles-based new customer contribution (NCC) framework affords water businesses significant flexibility within the requirements of the binding statutory instruments.

We worked closely with water businesses over two years from 2010 to 2012 to consider the implementation of NCCs based on a principles-based framework through workshops and technical papers. We found active participation from both developers and water businesses was critical in the implementation of charges that met our current framework objectives.

In this section we outline what we consider good implementation of new customer contributions looks like under our principles-based framework, which promote the aims set out on page 1.

Locational cost reflectivity

This is reflected in standard NCCs that account for the geographic scale and nature of the water business's service area and water systems. Examples include separate NCCs by water system or for greenfield and infill areas where there is significant greenfield growth. Negotiated NCCs should be used where the standard NCCs do not reflect a fair and reasonable approximation of the costs and benefits involved in a particular connection application's location, timing and service scale.

Incremental cost reflectivity

Incremental cost reflectivity means that the costs attributed to NCCs should:

- relate to separate (not bundled) services with separate contributions payable for water, sewerage and recycled water
- be applied consistently over time and across developments, with any variations justified
- if shared costs are attributed, be based on reasonable causal cost allocations, following documented and replicable cost allocation processes
- only include reasonable allocations of past investments made to accommodate expected connections growth, if any, and recognise these at their present-day residual cost
- account for any other connection fees and charges levied separately to the contribution and explain differences in the activities and costs that each charge funds.

Transparency

Both the Water Act requirements and our guidance entitle customers to transparency about costs attributed to any contributions water businesses charge them. We expect:

- costs attributed to new customer contributions and the projections of connections growth underpinning them are justified and disclosed to us and customers, and are consistent with assumptions in the regulatory building block revenue and regulatory asset base pricing models
- water businesses' development sequencing is clearly set out, committed to, up to date, and readily accessible
- that the assets that connection applicants and water businesses are responsible for are clearly explained and readily accessible, including explaining the process and obligations for asset gifting
- connection application processes, information requirements, and fees are easily assessable, clearly explained and predictable
- water businesses must respond to enquiries by a connection applicant within a set timeframe and with their information requirements
- connection applicants' rights, including to dispute resolution, are clearly explained
- water businesses' policies and thresholds for when to apply negotiated or standard new customer contributions are clearly set out, and customers are made aware of their right to negotiate irrespective of whether they may be eligible for a standard new customer contribution.

Flexibility

The use of standard and negotiated NCCs should be applied flexibly over time to help ensure that the costs and benefits of growth are fairly shared between connection applicants and existing customers, including when dealing with unforeseen demand or with developments that have materially different costs to other connections.

Engagement

Engagement by water businesses on NCCs should meet the engagement expectations of our guidance and of the water businesses' customers and development stakeholders. This includes fit for purpose engagement with both connection applicants and customers where information is provided to enable meaningful feedback, for example:

- cost information justifying the reasonableness of proposed standard new customer contributions

4. Good implementation of new customer contributions within a principles-based framework

- transition periods justification and subsidy consequences in the case of proposed new customer contribution caps and transitions to improved cost reflectivity.

The next chapter outlines what we found in most proposals by water businesses on the calculation and implementation of charges. We highlight where we found departures from good practise regarding the implementation of NCCs.

4. Good implementation of new customer contributions within a principles-based framework

5. Key implementation issues to address

At our 2023 water price review, we identified varied practice across water businesses regarding their price submission proposals for new customer contributions (NCCs) that we consider did not reflect our guidance or the objectives we established for NCCs.

Some water businesses provided good justification for their NCCs proposals. However, many put forward proposals that in our view could be improved to better support the objectives of the framework we administer. A summary of the issues is provided below.

Unjustified cost attribution

Our 2023 water price review guidance required water businesses to include accompanying notes describing the data sources and input assumptions used, for us to assess whether proposed NCCs had been established in accordance with the new customer contributions pricing principles.³⁹

At the 2023 water price review, initially some water businesses did not have sufficient documentation available on their methodology and approach to calculating and implementing new customer contributions, including how capital expenditure was incorporated into proposed charges. This was despite some water businesses proposing relatively large increases in NCCs.

Prior to our draft decision, we engaged a consultant to assess the allocation of capital expenditure to new customer contributions for seven water businesses. Our consultant noted:

[the documentation provided by the businesses it reviewed] was not sufficient to allow for a complete assessment of capital expenditure. It was apparent that no policy documents had been developed by these seven water businesses prior to submitting their pricing proposals to the commission. What was provided by these water businesses was mainly developed in response to our request for supporting information. None of these water businesses could articulate how it had implemented a pre-determined methodology.⁴⁰

While this was addressed during our review and additional information was provided to inform our final decisions, we expect this information would be available to inform water business consultation and therefore, available to us at the time a price submission is lodged. It would cover issues such

³⁹ Essential Services Commission, *2023 Water Price Review: Guidance paper*, October 2021, p. 59.

⁴⁰ See for example, FTI Consulting, *Review of new customer contribution-related capital expenditure for Coliban Water 2023 Water Price Review*, May 2023, p.7.

as the types of assets and costs included in new customer contributions, and projections for connections growth underpinning them. Forecasts should also be consistent with assumptions in the regulatory building block revenue and regulatory asset base pricing models.

Some water businesses sought recovery of costs for assets including treatment plants, headworks and bulk water assets, with some also proposing to recover historic (or sunk) costs associated with assets for the first time at the 2023 water price review. These decisions can impact which customers pay for services, and when. It indicates additional guidance may be needed on the nature of costs recovered via new customer contributions.

Appendix A (section A.3.2 and Table A.1), sets out in more detail considerations for the scope of recoverable costs, with examples of how other regulators have given guidance on these costs.

A preference for standard pricing

Our principles-based new customer contributions framework promotes a flexible negotiate and arbitrate connection regime as envisaged by the legislation and set out in our 2012 guidance.⁴¹ We chose the principles-based framework in response to the issues that arose for connection applicants and water businesses prior to the 2013 new customer contributions framework.

The framework established from 2013 provided for flexibility regarding new customer contributions. Under the framework, the commission assesses and approves pricing principles, any standardised charges and a negotiation framework for each water corporation.

As noted earlier, standard NCCs were intended to apply to connections in areas where infrastructure requirements and growth rates are relatively well known, making the costs for connections across some areas predictable and reasonably common. They serve an administratively efficient alternative to more location-based arrangements, where both parties consider the standard charges to be fair and reasonable in the circumstances.

In our 2023 water price review, we observed what appears to be a preference among water businesses for more common pricing. This included proposals for the application of standard NCCs over relatively large areas, even where costs may have differed materially within the areas. We also observed a preference for the application of standard charges versus negotiated arrangements for specific locations.

⁴¹ Essential Services Commission, Guidance paper – New customer contributions, August 2012.

While the use of standard NCCs has benefits, there may be instances where it is more appropriate to have several standard NCCs within a water businesses region, or to negotiate new customer contributions through the negotiation framework.

The use of standard NCCs where more locational based arrangements are more appropriate may result in connection applicants in one system or location subsidising other connection applicants on another water system. It could also send incorrect signals on the allocation of investment by connection applicants, which may lead to over or under investment in particular areas.

We also observe that few water businesses proposed NCCs that reflected the type of growth (infill versus greenfield development) in their service area.

We are interested in the observations from stakeholders on the use of standard and negotiated NCCs and how any changes in their use or application might better support the objectives of the framework we administer.

Negotiating framework requirements inadequately met

A water business' negotiating framework explains connection applicants' rights and obligations, information requirements, the service charging model, applicable pricing principles and the negotiating process.

During the 2023 water price review, we reviewed each water businesses' negotiating framework. We observed water businesses provided varying degrees of information to connection applicants, which meant the negotiating frameworks differed across water businesses. Some frameworks were not publicly available and some included references inconsistent with the explanatory note we issued in 2013.

We observed that connection applicants have not accepted the provisions in some water businesses' negotiating frameworks, which has led to a series of complaints and disputes between connection applicants and water businesses.

Further, and based on several queries we have received over time from connection applicants (as well as questions raised by water businesses), for some businesses we have observed negotiating frameworks incorrectly reflect our NCC pricing principles.

Engagement issues

Our water price review guidance required water businesses to provide evidence of consultation with connection applicants and how their views have informed the proposed charges, including the business' use of standard contributions over negotiated contributions, or postage stamp charges over location-based charges.⁴²

Our PREMO framework requires water businesses to undertake good engagement with both customers and developers on pricing decisions that affect them. This includes when water and sewerage customers are required to pay for material shortfall in funding from new customer contributions over a significant period.

Water businesses should undertake fit-for-purpose engagement with both connection applicants and water and sewerage customers. To enable meaningful feedback, businesses should provide customers with information justifying the reasonableness of proposed standard NCCs and information on the transition to improved cost reflectivity, the subsidy consequences of cost allocation decisions and any proposed NCC caps.

Some water businesses have demonstrated this good practice. However, our 2023 water price review process and feedback from the development community in some locations revealed that some water businesses did not follow good practice in their engagement.

In many instances the proposed changes to NCCs and its impact were not well communicated to connected applicants, and water and sewerage customers. Customers were not provided with information justifying the reasonableness of proposed standard new customer contributions.

The NCC framework we administer is a cost-based framework. Notwithstanding this, we understand that sometimes consideration may need to be given to transition plans that may apply within a regulatory period, where there is a relatively large gap between calculated new customer contributions and current charges. In these instances, transparency is critical.

At the 2023 water price review, where NCCs were proposed to be capped below the calculated cost reflective charge, some water businesses did not provide a transition plan or what we considered a reasonable plan to achieve cost reflectivity.

Application of an average incremental cost approach

Under our current framework, new customer contributions have historically been calculated based on the net incremental costs of providing infrastructure and associated activities to

⁴² Essential Services Commission, 2023 water price review: *guidance paper*, August 2022, p. 59.

connection applicants. We consider that specifying the use of net incremental cost of connection supports fairness between new and existing customers and between connection applicants in different locations and at different times of connection. It also accords with connection pricing regulation and practice across Australian water and energy utilities.⁴³

During the 2023 water price review, five water businesses proposed an alternative approach to calculating NCCs based on average incremental cost, rather than the net incremental cost approach adopted by our framework.⁴⁴

We noted in our 2023 review that the net incremental cost approach enables water businesses to address issues they sought to address through using an alternative approach. This included: risks with changes in development; cost reflectivity and transparency; and flexibility to negotiate different charges for different developments or growth areas.

We consider the businesses did not demonstrate they had used the discretion afforded them within the existing principles-based charging framework to address their concerns with it. Nor do we consider it has been demonstrated to be a better approach than the net incremental costs and how it works within the overall framework administered by the commission.

However, a key issue at the draft decisions stage was that businesses using the alternative methodology had not provided us with adequate information or justification to enable us to be satisfied proposals comply with our guidance requirements. Additional information provided by businesses following our draft decision informed our final decision and ultimately, we approved the proposals where we considered they had sufficiently addressed the aims of the new customer contributions framework.

Stakeholders may wish to comment on alternatives to the net incremental cost approach.

Uncertainty around gifted or reticulated assets

Connection assets can be gifted by the developer to the water businesses, lowering overall connection charges.

Water businesses have the discretion to determine which assets are to be gifted (provided their actions are fair and reasonable), and to characterise the gifting as a condition of connection to the

⁴³ Appendix B sets out the use of the net incremental cost method in NSW water, Tasmanian water, national electricity distribution, and national gas distribution.

⁴⁴ The average incremental cost approach calculates the new customer contribution charge by dividing the capital and operating cost of a growth area by the number of connections in that area. The net incremental cost approach applies the incremental revenue less incremental cost to estimate the new customer contribution charge.

water business' infrastructure. We set out in our 2013 water price review final decision and our new customer contributions (NCC) – explanatory notes, that water businesses should:

- make clear to potential connection applicants which assets a connection applicant will be responsible for providing and gifting, and which will be provided by the water business
- confirm any negotiated new customer contributions will be undertaken in accordance with the water business' published negotiating framework
- exclude the value of gifted assets for the purposes of calculating net costs, where the connection arrangement requires assets to be gifted.⁴⁵

We also stated in 2013 that we would monitor the gifting arrangements imposed by the water businesses and that if stakeholders raised concerns, we would consider developing principles to guide the classification of gifted assets.⁴⁶

Since 2013, we have received several inquiries from connection applicants about gifted or reticulated assets. The main concern seems to be lack of clarity or transparency in terms of the definition of gifted or reticulated assets. We are interested in stakeholders' feedback on the additional information needed in our guidance on gifted or reticulated assets.

Timing of development and development servicing plans

We set out in section 3.4 of our 2013 new customer contributions (NCCs) explanatory note our views on development servicing plans (sometimes called infrastructure sequencing plans).

We stated that while these plans are not regulated instruments and are not formally approved by us, reasonable industry practice will see water businesses prepare and publish these plans.⁴⁷

We described a development servicing plan as a publicly available plan prepared by a water business that:

- describes the water business' expected timing and sequencing of developments and infrastructure provision – at a point in time
- can be used as a basis for deriving standard new customer contributions during price reviews
- can be used by a water business to communicate and describe assumptions underpinning its standard new customer contributions

⁴⁵ Essential Services Commission, *New customer contributions: Explanatory Note*, December 2013, p. 10; Essential Services Commission, *Price review 2013: Greater Metropolitan Water Businesses – Final decision*, June 2013, p.201.

⁴⁶ Essential Services Commission, *Price review 2013: Greater Metropolitan Water Businesses – Final decision*, June 2013, p.202.

⁴⁷ Essential Services Commission, *New customer contributions: Explanatory Note*, December 2013, pp. 3, 11.

4. Key implementation issues to address

- if kept up to date, may help inform the calculation of incremental financing costs.⁴⁸

We consider that by showing the timing of a logically-sequenced expansion of a business' water, sewerage and recycled water networks, these plans help businesses explain new customer contributions to connection applicants, and to those involved in resolving disputes. We also consider it is best practice for any water business to consult with stakeholders and reviews its plans regularly.

We would like to understand the issues associated with the timing of developments and development servicing plans.

Guidance for new customer contributions

As noted in Chapter 2, guidance issued by the commission pursuant to the Water Industry Order sets out our regulatory framework for NCCs. Accordingly, the guidance needs to capture the matters we expect water businesses to consider and provide clarity about the information they must provide us in support of their pricing proposals.

We are interested in views from stakeholders about the changes that may be needed to our guidance to support the objectives of our framework, including how it might help to address the matters identified above.

As part of our review, we will also consider the form and presentation of our guidance.

The 2023 guidance included NCC pricing principles, assessment criteria, and requirements for the supporting information provided in submissions to inform our assessment of the NCCs proposed by water businesses. The guidance also referenced the explanatory note we issued in 2013 which provided more detail on how to comply with the pricing principles. This explanatory note formed part of the guidance.

Prior to the 2013 framework, we issued a greater amount of supporting information including 'how to' manuals and case studies for negotiated outcomes. These legacy documents are not a part of the current framework but we understand some water businesses are still referring to them. It may be appropriate for us to reincorporate similar material (updated to reflect the framework that will apply from 2028) in our guidance to assist in calculating NCCs.

⁴⁸ Essential Services Commission, *New customer contributions: Explanatory Note*, December 2013, p. 11.

Appendix A - Technical concepts

A.1 Purpose and structure of Appendix A

The purpose of this Appendix A is to inform water businesses and connection applicants of:

- the role and consequences of new customer contributions within the building block regulatory cost recovery model that applies to Victorian water businesses (Section A.2)
- concepts and principles for how new customer contributions are regulated and administered and trade-offs between the principles when transitioning to cost recovery charges (Section A.3 and Section A.4)
- the requirements and intent of Victoria's water policy content for new customer contributions regulatory framework (Section A.5)
- the commission's 2023 guidance (Section A.6)
- the discretion water businesses have when setting and administering new customer contributions (Section A.6)

A.2 Key functions of new customer contributions regulation

Charging new customer contributions has both a cost recovery role and a customer protection role.

A.2.1 Cost recovery

The cost recovery role of charging new customer contributions in building block regulation is to:

Establish the mechanism for sharing connection and growth costs across all customers versus charging the connecting party upfront.

New customer contributions therefore determine how much a connecting party should pay upfront versus what will be paid through ongoing charges by the connecting party and by all water and sewerage customers via inclusion in the regulatory asset base (RAB).

This involves:

- **a cost recovery threshold** to set the share of costs recovered up front versus over time, and
- **cost recovery mechanisms** to levy upfront and ongoing charges.

The cost recovery threshold seeks to consider the connection application costs and account for the benefit to the connecting or augmenting property relative to the benefit to other properties receiving

that service from a business.⁴⁹ This protects existing customers and connection applicants from unduly subsidising each other's costs (see section A.2.2).

The cost recovery mechanism works in the building block regulatory framework by:

- levying any upfront contribution (new customer contributions) to the connection applicant that is not recovered through the return on and return of assets elements of the building block revenue allowance, and
- adding the remaining amount of connection and growth expenditure to the business' RAB.

Whether costs are recovered upfront or via the RAB, the business recovers the same total costs in net present value (NPV) terms, after accounting for any differing tax cost consequences.⁵⁰

The gross capital expenditure for a business is added to the RAB annually and its annual new customer contributions amount is deducted. This means ongoing charges only recover the net capital expenditure after accounting for up front contributions. This can be seen in the RAB formula:

Opening RAB in year t = opening RAB in year t1	
+	Actual capital expenditure (gross) in year t1 ⁵¹
-	Actual contributions in year t1 ⁵²
-	Forecast regulatory depreciation in year t1
-	Proceeds from disposal of assets in year t1

This formula is administered over successive regulatory periods. It uses forecast data for future years and actual data for past years, and its purpose is to maintain an accurate record of the business' recoverable invested capital that has not yet been paid for by its customers.

⁴⁹ As required by Division 6 of Part 13 of the *Water Act 1989*.

⁵⁰ Note that under our guidance provided to date, customer contributions and gifted assets are treated as revenue when assessing the notional tax costs of water businesses. The future tax treatment of these is subject to a current review under the national tax equivalence regime applied to state owned entities. Outcomes of that review will be reflected in our future guidance.

⁵¹ This gross capital expenditure includes all expenditure from the water business, which may include expenditure recovered through a connection contribution or incurred by the water business to pay a developer to increase the size of its gifted assets above what is required for that development.

⁵² This covers financial contributions only. Gifted assets have zero value for the purposes of RAB administration because they did not involve a cost to the water business.

A.2.2 Customer protection

Regulation of new customer contributions also:

- protects the interests of both existing customers and connection applicants by ensuring (via a **cost recovery threshold**) that neither party is inefficiently subsidising the other
- sends **efficient cost and price signals** to connection applicants to ensure the water businesses incur efficient costs because customers choose to connect in the locations and at the service capacity scales that they value, having regard to the costs of servicing those locations and service capacity scales
- promotes fair and reasonable connection processes and outcomes.

Cost recovery threshold

The cost recovery threshold ensures that:

- existing customers who are paying for a business' RAB via ongoing usage charges are no worse off because of the new or amended connection than they would have been if the connection or augmentation had not occurred
- the connection applicant only funds the residual connection/growth/augmentation costs that will not otherwise be paid for through its ongoing payment of the business' usage charges.

Efficient cost and price signals

Efficient connection cost signals are delivered through efficient connection pricing signals, and they likewise serve dual purposes:

- They signal to the connection applicant the cost of their connection or augmentation on the water business. This ensures that customers only connect to the services, and in the locations and service capacity scales, where the value of the connection to the connection applicant is greater than the costs to the water business of providing those services. If the cost (signalled through the contribution) is more than the connection applicant is willing to pay, they may consider connecting elsewhere or at a smaller scale, or relying on self-provision of some of their service needs where permitted, e.g. water storage (tanks or dams) or standalone septic or recycling systems.
- They ensure water businesses only incur costs for services that their customers value, and do not inefficiently incur costs for services in locations or scales that the customer would not choose to buy if they faced the resulting costs. It also avoids recovery of costs from other customers and avoids the risk of distorting the water service usage decision of other customers.

Fair and reasonable connection processes

Water businesses provide services that have monopoly characteristics. Developer charge regulation seeks to avoid businesses misusing their relative market power to the detriment of connecting applicants.

Developer charge regulation can seek to ensure customers are afforded a fair and reasonable connection process which:

- avoids unwarranted discrimination⁵³ between connection applicants and types (ensuring like customers receive like treatment) – e.g. variation in the terms and conditions of connection or augmentation, or in the connection process and timelines, that are not reflective of differences in the underlying cost, complexity and risk involved in supplying that connection or augmentation
- affords connection applicants access to:
 - a predictable, timely and transparent connection process
 - fair and reasonable service commitments for the connection process
 - fair and reasonable terms for connection
 - transparency of any fees payable by them in the process
 - clarity of any obligations on them during that process – e.g. for information provision about the nature and scale of their connection needs
 - timely and effective dispute resolution
 - information to assist their participation in the connection process.

A.3 Key economic concepts

As noted in sections A.2.1 and A.2.2, the cost recovery threshold sets the share of costs recovered up front from connection applicants through new customer contributions and ensures neither party is inefficiently subsidising the other.

Setting an appropriate cost recovery threshold and subsequent new customer contributions rely on an understanding of the economic concepts outlined in sections A.3.1 to A.3.7.

A.3.1 Scope of the connection service

To deliver and apply a charge for a service, the scope of the service must first be defined. This ensures clarity on the costs to deliver the service and understanding by the customer of the nature of the service procured. For a connection service (new connection and connection augmentation

⁵³ Discrimination involving differential pricing may be warranted for the efficient price signal purposes identified above and measured in accordance with the cost recovery threshold.

services), this often involves outlining the assets used to deliver the service—e.g. dedicated connection assets, meters, extensions for new shared assets, upgrades to existing shared assets, and elements of shared assets previously constructed in anticipation of growth.

We have previously defined the Victorian developer charge service as:

Infrastructure and associated activities to connect an un-serviced property to the water services networks, or

Infrastructure and associated activities required to increase services to a serviced property⁵⁴

A.3.2 Scope of recoverable costs

The scope of costs applied to the cost recovery threshold is an important element of the new customer contributions regulatory framework. Costs attributed to the NCCs calculation should be transparent, consistently attributed and reflective of the underlying costs to ensure efficient pricing signals.

Key considerations for the scope of recoverable costs are summarised in Table A.1. These considerations need to be consistently applied by a business to achieve the customer protection role discussed above in section A. In some new customer contributions regulatory frameworks, some of these considerations are prescribed by the regulatory regime or in regulator guidance. This is illustrated with examples in Table A.1. Full case studies for the examples are provided in a separate paper “Connection contributions frameworks in other regulatory regimes”

⁵⁴ Essential Services Commission, [Guidance paper New customer contributions](#), August 2012, Box 2, p.12.

Table A.1 Considerations for the scope of recoverable costs

Consideration	Description and issues	Regulated examples
Costs by service type	<p>Costs attributable to a particular service should be attributed to it.</p> <p>Some regimes require that this be done in accordance with the business' cost allocation methodology (CAM).</p>	<p>Australian electricity distribution networks are required to comply with their regulator-approved CAM when attributing costs to different services and considering connection or augmentation costs in upfront contribution calculations.</p>
Costs by location	<p>Recoverable costs should consider costs relevant to the location of the connection service. Areas with sufficiently different costs to supply would not comply with the efficient price signal objective if their costs were not separately treated when calculating contributions for those areas.</p> <p>For example:</p> <ul style="list-style-type: none"> • Separate water systems that are not interconnected or have materially different costs to supply services • Greenfield versus infill areas • Gravity fed versus pumped areas • Connections to low pressure versus high pressure water infrastructure 	<p>The Australian National Water Initiative Pricing Principles support this with the principles for urban water tariffs stating:</p> <p><i>'Principle 7: Differential water charges Water charges should be differentiated by the cost of servicing different customers (for example, on the basis of location and service standards) where there are benefits in doing so and where it can be shown that these benefits outweigh the costs of identifying differences and the equity advantages of alternatives.'</i></p> <p><i>Notes: Differential pricing may be achieved by upfront contributions, including developer charges.'</i></p>

Continued next page

Table A.1 continued

Consideration	Description and issues	Regulated examples
Attributable benefits	<p>Are there cost-related connection benefits that should be considered? For example:</p> <ul style="list-style-type: none"> • Assets constructed by a connection applicant and gifted to the business • Upsizing of gifted assets required to service subsequent customers • Avoided costs – e.g. where a business upgrades the capacity of an asset it would have otherwise replaced soon, should the connection applicant only pay the difference to what the business would have otherwise incurred? 	<p>For extensions in SA, SA Water contributes 50 per cent of material costs if the extension benefits regulated customers. Otherwise, the connection applicant fully funds the extension.</p> <p>If SA Water requires pipework to be upsized to support future growth, it will pay the full materials cost of the difference between the connection applicant’s minimum needs and the extra work SA Water requires.</p>
Subsequent connections	<p>If an out of sequence development pays for system extension costs, should subsequent in-fill connections pay a rebate to remove first mover disadvantage among connection applicants?</p>	<p>Australian electricity distribution networks are subject to a pioneer rebate scheme for subsequent in-fill connections made within 7 years of the pioneer development subject to a \$1,000 materiality threshold.</p> <p>Rebates may also be payable in certain circumstances for NSW water contributions.</p>

A.3.3 Scope of attributable revenues

A new customer contributions regime must be clear on the revenues to be paid by each party involved and how they will be collected. A new customer contributions regime may also attribute revenues to its NCCs calculation that include either:

- upfront contributions only, or
- both upfront contributions and ongoing usage charges.

This needs to be consistent with the cost attribution approach and the regulated cost recovery mechanisms.

Case studies. In NSW, the IPART requires revenue projections based on charges under the prevailing IPART determination.

Australia's national regimes for gas and electricity connection require attribution of both upfront and ongoing revenues and specify how incremental revenues should be projected after the end of the present regulatory period. These require that:

- assumptions to determine connection contributions are the same as those in a current revenue determination, for example, the discount rate used is to be the same as the regulated rate of return in the businesses' current revenue determination
- prices used for the projected revenues beyond the current revenue determination period use a flat real price path with only inflation escalation.

A.3.4 Relevant time horizon

It is necessary to determine the time horizon that costs and revenues (where ongoing usage revenues are accounted for) are assessed over so that these horizons are consistently:

- considered across different new customer contribution calculations – unless specific connection service circumstances warrant departure
- applied to both costs and revenues when both form part of the new customer contributions calculation.

Considerations in choosing this horizon can include:

- the expected tenure of the customers' connection point
- the length of development staging strategies
- the businesses' growth planning horizon and life of assets involved in service provision
- the practicality of developing reliable forecasts for longer horizons
- the level of demand predictability.

Our 2012 New customer contributions guidance paper stated:

Incremental cost should be calculated over a period that aligns with the [water business'] growth planning or asset utilisation horizons, and for operating costs this should be the same as the revenue assessment period.⁵⁵

⁵⁵ Essential Services Commission, [Guidance paper New customer contributions](#), August 2012, Box 2, p.14.

That guidance specified a default assessment period of 30 years.⁵⁶

Case studies. In NSW, the IPART requires that revenue projections be for 30 years.

Australia's national electricity distribution connections regime provides guidance that this period be 30 years for a residential connection and 15 years for a business connection, although it affords businesses the ability to depart from this for business customers with reasons where special circumstances warrant it (for example, if a mine site has an extraction life of less than 15 years).

A.3.5 Efficient pricing signals

As noted above, efficient pricing signals let the connection applicant know the costs to provide different services depending on the location and service capacity scale. Pricing signals are efficient if the price of the service is equal to the marginal cost of providing the service.

In water services, key decisions that should be informed by marginal cost include the:

- upfront connection or augmentation decisions, and
- ongoing decisions about the amount of the service consumed.

Efficient price signals benefit both existing customers and connection applicants. They help minimise total water service costs over time by ensuring connection services only occur if and when they are valued by customers.

Behaviours that are supported through price signals for the connection applicants include:

- locational choices informed by the cost of servicing those locations
- orderly development decisions informed by the costs of extending or bringing forward growth investments out of sequence, which may be aided by pioneer schemes to avoid first mover disadvantage among connection applicants
- benefit and cost sharing which ensures existing customers can share in cost recovery of connection services to the extent that they benefit from those, and similarly, that efficient connections or augmentations are not discouraged through new customer contributions that are higher than they need to be.

For all customers it is important to efficiently set new customer contributions to minimise ongoing service usage charges. This will ensure ongoing decisions about the amount of the service to consume are not distorted by usage charges being higher than is efficient.

⁵⁶ Essential Services Commission, [Guidance paper New customer contributions](#), August 2012, Box 2, p.18.

Case study. The Australian National Water Initiative Pricing Principles for urban water tariffs state:

Principle 7: Differential water charges – Water charges should be differentiated by the cost of servicing different customers (for example, on the basis of location and service standards) where there are benefits in doing so and where it can be shown that these benefits outweigh the costs of identifying differences and the equity advantages of alternatives.

Notes: Differential pricing may be achieved by upfront contributions, including new customer contributions.

A.3.6 Efficient pricing bands

Water businesses' services involve shared use of very large assets with significant fixed costs, and often large infrequent investments in growth and capacity. In practice this means that:

- the marginal costs envisaged in the efficient price signals will require judgement and assumptions to estimate.
- the shared and fixed costs also need to be recovered, to ensure that the business recovers its total costs and remains financially viable.

This means both upfront and ongoing prices are informed by judgment about customers' (connection applicants and water and sewerage customers) share of fixed versus variable costs. In recognition of this need for judgment and broad range of possible outcomes, regulatory regimes often apply the efficient price bounds test as an additional customer protection to avoid uneconomic levels of cross-subsidy.

These bounds restrict efficient prices to fall between:

- a lower pricing bound of avoidable cost, and
- an upper pricing bound of standalone cost.

Pricing within the standalone and avoidable cost boundaries ensures no inefficient economic cross-subsidies occur within the prices for the following reasons:

- If customers were to pay above the standalone cost, it would be in those customers interests to switch to an alternative provider or service solution. It would also be economically feasible for an alternative service provider or solution to operate. This creates the possibility of inefficient bypass of the existing infrastructure.
- If customers were to pay below the business' avoidable cost, it would be economically beneficial for the business to stop supplying the customers as the associated costs would exceed the revenue obtained from the customer, and other customers must necessarily be subsidising them at inefficient levels.

Case studies. Our current new customer contributions guidance (Explanatory Note 2013 and 2023 guidance paper on water price reviews) applies these efficient pricing bounds to new customer contributions, and they are likewise applied in:

- the pricing principles that we must apply when regulating the Port of Melbourne⁵⁷
- Australia’s national gas distribution pricing rules⁵⁸
- Australia’s national electricity distribution pricing rules.⁵⁹

A.3.7 Cashflow outcomes

By determining the share of costs recovered upfront and the share of costs recovered over time, the cost recovery threshold and resulting new customer contributions affects a business’ medium to long-term cashflows. If the relative weight of upfront versus ongoing cost recovery is not being sustainably managed over time, a business’ financial position can be affected.

The cashflow implications can be illustrated by the book end examples:

If a business relied solely on upfront payments, when the time comes for replacing those assets it would need capital to pay for the assets. Often businesses rely on their depreciation allowance as a source of capital to fund capex renewals, along with debt funding. Depending on the scale of capex renewals required, the business may have to seek equity funding.

If a business relied solely on ongoing charges, depreciating all the investment over say 85 years, it may not have the cashflows needed to sustain large growth investments when they occur. Again, the business may need to draw down debt and / or rely on an equity injection.

For these reasons, businesses need to consider their new customer contributions within the context of their long-term asset plans and long-term financing strategies.

To date, in addition to the cashflow interplay between upfront recoveries and RAB recoveries over time, the level of upfront contributions also affects the amount of tax compensation allowed in the

⁵⁷ Pricing Order, cl.2.1.1(b)(i) and (ii)

⁵⁸ National Gas Rules, rule 94 (3)(a) and (b)

⁵⁹ National Electricity Rules, rule 6.18.5.e.

building block revenue requirement. This approach relies on capital contributions being treated as revenue for taxation purposes.⁶⁰

A.4 Key trade-offs

The design and administration of new customer contributions regulation necessarily involves trade-offs between benefits, cost and complexity. Some key trade-offs that new customer contributions regimes need to provide for include:

- **Cost effective to administer versus fit for customer scale and complexity.** There are trade-offs between separately calculated efficient connection service price signals and the costs of administering these for lots of connection applicants. This is why the case study regimes provide for both standard and negotiated charges.
- **Transparent, predictable and non-discriminatory versus flexible for circumstances.** Some may see a trade-off existing between the transparency and predictability afforded through regulator-approved standard charges and individually negotiated charges.
- **Economic efficiency versus policy objectives.** There can be a trade-off for accommodating social and economic policy directions versus sending efficient price signals.
- **Allow flexibility to support project economics on desirable connections.** There can be a trade-off between standard approaches, and approaches that recognise specific benefits a connection can bring to the business' cost to serve and to the communities it services.

A.5. Victorian water policy context

A.5.1 What are the applicable policy principles?

In addition to the objectives and other requirements of the statutory instruments noted in section 2 we also have regard to Victoria's water policy commitments.

In 2004, the Council of Australian Governments agreed to the National Water Initiative as the national blueprint for water reform. Under the initiative, governments made commitments to best practice water pricing which were captured in the National Water Initiative Pricing Principles.

Relevantly, these principles specifically address principles for connection and augmentation contributions.

⁶⁰ We note that this assumption no longer holds for privately owned regulated businesses and the National electricity and gas regulatory regimes have stopped providing a tax allowance for the revenue treatment of connection and augmentation contributions. We are awaiting the outcome of a decision about whether an equivalent approach will be followed for the National Tax Equivalent regime which we rely upon when assessing water businesses' required notional tax compensation.

A.5.1.1 National Water Initiative pricing principles for urban water tariffs

Principle 7: Differential water charges

Water charges should be differentiated by the cost of servicing different customers (for example, based on location and service standards) where there are benefits in doing so and where it can be shown that these benefits outweigh the costs of identifying differences and the equity advantages of alternativesⁱ.

Notes: i. Differential pricing may be achieved by upfront contributions, including new customer contributions.

Principle 8: Setting new customer contributions

New customer contributions should reflect the investment in both new and existing assets required to serve a new developmentⁱ and have regard to the manner in which ongoing water usage and service availability charges are set.

Notes: i. Where there are benefits beyond the boundary of the development, the developer charge should have regard to the share of capacity required to serve the development.

Principle 9: Capping new customer contributions

New customer contributions should not exceed the costs of serving new developments which includes investment in both new and existing assets required to serve a new development.

Principle 10: Revenue from new customer contributions

To avoid over-recovery, revenue from new customer contributions should be offset against the total revenue requirement either by excluding or deducting the contributed assets from the RAB or by offsetting the revenue recovered using other mechanisms.

A.5.2 Who is affected by Victoria's development charges framework?

Parties affected by Victoria's contributions framework are:

- **Connection applicants** – Parties seeking to connect to the water network or materially alter the characteristics of an existing connection point. These can be green field or brown field, first in an area or, subsequent applicant(s) in that area, residential or commercial uses at a connection point, connection applicants or final occupant customers.
- **Water authorities (termed water businesses in this paper)** – Own and operate the network, specify connection requirements and costs, manage the whole network for expansion, reinforcement and augmentation planning and works delivery.
- **VCAT** – Resolves disputes between water authorities and connection applicants (being connection applicants and / or property owners)

- **Essential Services Commission** – Needs to know the costs regulated under each WIRO prescribed service (therefore needs new customer contributions service and cost definition), manages the information requirements that affect the level of transparency around investment planning and timing, and can intervene in the new customer contributions regulatory model and charges (and has done so to date via its binding price review guidance and determinations).

A.5.3 How are disputes handled?

If there is a dispute between a connection applicant and a water business (whether in relation to a standard or negotiated developer charge), connection applicants may use the dispute resolution offered by a water business as part of its new customer contributions negotiating framework.

In addition, connection applicants may follow the *Water Act 1989* process to object and seek internal review by the water business, and to pursue unresolved matters through the VCAT.⁶¹

A.6 What discretion do water businesses have?

Water businesses have flexibility through our principles-based new customer contributions framework to negotiate charges based on their business, development and connection circumstances among other things. For details, see Chapter 3.

A.6.1 How does this compare to other utilities?

We have summarised key features of the equivalent contribution frameworks for other Australian utilities in the paper “*Connection contributions frameworks in other regulatory regimes*”. Some similarities in the discretion afforded to regulated utilities in these regimes are evident in the:

- use of the net incremental cost method in NSW water, Tasmanian water, national electricity distribution, and national gas distribution
- application of the efficient pricing bounds in the pricing principles that the commission must apply when regulating the Port of Melbourne,⁶² Australia’s national gas distribution pricing rules,⁶³ Australia’s national electricity distribution pricing rules⁶⁴
- provision for standard and negotiated charges in NSW water, SA water, Tasmanian water, Western Australian water, national electricity distribution, and national gas distribution

⁶¹ Water Act 1989, section 271.

⁶² Pricing Order, cl.2.1.1(b)(i) and (ii)

⁶³ National Gas Rules, rule 94 (3)(a) and (b)

⁶⁴ National Electricity Rules, rule 6.18.5.e.

- attribution of both new and existing assets is permitted in NSW water, SA water consistent with the Australian National Water Initiative Pricing Principles for urban water tariffs *Principle 8: Setting New customer contributions:*

New customer contributions should reflect the investment in both new and existing assets required to serve a new developmentⁱ and have regard to the manner in which ongoing water usage and service availability charges are set.

Notes: i. Where there are benefits beyond the boundary of the development, the developer charge should have regard to the share of capacity required to serve the development.⁶⁵

We also observe that some of these principles-based regimes provide additional prescription on how aspects of the net incremental cost approach should be applied. Areas where we see more specific prescription by regulators include:

- **Attributable costs** – For example, IPART applies the following principles to attributable costs:
 - MEERA (modern engineering equivalent replacement asset) approach is used to value existing assets and estimated efficient costs is to be used as the basis for assets yet to be commissioned
 - Shared assets are apportioned between Developer Servicing Plan areas using expected utilisation based on equivalent tenements
- **Prescribing the forecasting horizon** – IPART requires 30 years, and the Australian Energy Regulator (AER) requires 30 years for residential and 15 years for non-residential
- **Prescribing how price extrapolation works** – IPART and the AER require this be based on the prices in the current price determination
- **Pioneer rebates** – IPART and the AER require businesses to have a policy for when rebates are payable to a developer who has funded an out of sequence development of extension that is subsequently connected to and used by others within a period specified in the pioneer scheme rebate policy.
- **Developer payment schemes** – IPART’s 2018 determination also allows the payment of new customer contributions on an instalment basis of up to 20 years for (a) connecting new services to an existing property and (b) upgrading an existing service to an existing property.⁶⁶
- **Security fees** – The AER permits electricity networks to charge developer security fees based on their customer-specific risk assessments to ensure the incremental revenues used in their

⁶⁵ [National Water Initiative Pricing Principles \(dcceew.gov.au\)](https://www.dcceew.gov.au)

⁶⁶ IPART, Maximum prices to connect, extend or upgrade a service for metropolitan water agencies: Sydney Water Corporation, Hunter Water Corporation, Central Coast Council – final determination, October 2018, Schedule 2, section 2; Schedule 3, section 2.

net incremental cost calculations are earned and the existing customer base is no worse off if a connection has lower usage or is disconnected early.⁶⁷

⁶⁷ AER, Connection charge guidelines for electricity customers Under chapter 5A of the National Electricity Rules, version 3.0, April 2023, section 10.