

22 May 2008

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

Attention: Sean Crees

Dear Sir,

**RE: 2008 WATER PRICE REVIEW
REGIONAL AND RURAL WATER BUSINESSES WATER PLAN
2008-1013 DRAFT DECISION**



We refer to the 2008 Water Price Review for Regional and Rural Water Businesses, the draft decision for Western Water, and our letter to you on this subject dated 7 May 2008. That letter provided background on the impact that the draft decision would have on the Eynesbury Estate, and recommended changes to Table 19 in the Draft Decision to help mitigate the undesirable impacts.

Further to the points made in our 7 May letter, it is suggested that the Commission give consideration to the following points, each of which is discussed further in this letter:

1. Arrangements are required that provide incentives for developers to reduce community costs, including the cost of externalities borne by the community. Whilst the New Customer Contributions Industry Proposal put forward by VicWater claims to target this outcome, there is no analytical evidence presented to support the proposal. The proposal provides for insufficient rigor in its application to a range of development arrangements to establish confidence that it will reward desirable urban design practices and punish undesirable practices. Further development of the proposal by VicWater, in partnership with the Urban Development Institute of Australia, would be appropriate.
2. Lot-size may have been a reasonable indicator of water supply and sewerage servicing cost some years ago, but urban design practices and community habits have changed substantially in recent years and no evidence has been presented to substantiate the ongoing relevance of lot-size. Lot-size should be abandoned as the indicator of servicing cost, or augmented with additional specific assessment criteria. This should be an outcome of further development of the proposal, as recommended in point (1) above.
3. Adverse regulatory changes during the payback period of long-term private investments raise investment risk and thereby hinder future investment. A 120% step-increase in price for a substantial cost item is a highly undesirable outcome of a regulatory decision. The problem is exacerbated where the increase is of questionable legitimacy. Clear and stable expectations, and long lead-times for the notification of changes, are important. Deferral in the application of the increase would be appropriate, during which time the analysis and development recommended in point (1) can be undertaken. Should the analysis support a price increase, this should be phased-in over several years for estates where major investment commitments have already been made.

Providing Appropriate Incentives and Reliance on Lot Size

The prices charged by water authorities for servicing land development should provide incentives to developers that are aligned with appropriate and desirable resource management outcomes. Cost impacts on the community should be reflected in the prices charged.

The New Customer Contribution Industry Proposal states that charges should be “scaled according to the water sensitivity of particular developments and the demand for future infrastructure”. This general position is supported. The proposal also notes that many water sensitive features are controlled at the building construction stage of development, and uncertainty will exist at the planning permit stage about the ultimate take-up of these features. On this basis the proposal concludes that lot size, which is known at the planning permit stage, should be used as an indicator of servicing cost.

Issues associated with this proposition include:

- Whether lot size is an accurate guide to water supply and sewerage servicing cost
- Whether other criteria are more appropriate
- The level of sophistication required in specification of a pricing rule to ensure appropriate practical application in a variety of situations

Lot size has been used by water authorities over many years as an indicator of the cost of providing new water and sewerage services. Urban design practices and community habits have changed substantially in recent years however. A particularly significant change has been the installation of recycled water supplies via a third pipe within a number of residential subdivisions. This has a major impact on potable water use, and hence on the upstream costs of potable water supply. This impact applies particularly to outdoor use of potable water, which might otherwise correlate well with lot size where recycled water is not available and restrictions on use do not apply.

The most obvious impact of lot size is on length of reticulation main, but this infrastructure is gifted to water authorities by developers.

In light of the recent changes that have occurred in urban design, it would only be appropriate for lot size as a criterion for new customer contribution charges if supported by analysis of its application to a variety of current urban development scenarios. No evidence has been presented to substantiate the ongoing relevance of lot-size. No supporting analysis for the New Customer Contributions Industry Proposal has been published, and hence it is not possible to assess whether the application of the proposal to specific developments has the intended impact.

The pricing rule established must have sufficient clarity to ensure that its application in practice will align with the original intent. Those applying the rule in practice will not typically be the same people who developed the rule, and vague guidelines for application of the rule provide the opportunity for inappropriate application to specific situations.

The New Customer Contribution Industry Proposal states under Further Points “*The intent is for these guidelines to easily cover 95% of applications. More complex applications will require additional investigation and assessment.*” Reference to this has apparently been lost in the draft decision. In addition, although the intent to reward water sensitive development is stated with the proposed prices, the sole criterion available for assessment remains lot size. In relation to the Eynesbury Development preliminary indications from Western Water support the view that prices will in practice be applied based on lot size without reference to other criteria.

To ensure the appropriate application of the prices a more sophisticated test, possibly a decision tree, should be established.

Further development of the New Customer Contributions Industry Proposal would be appropriate. In particular this should provide for:

- Assessment of the servicing cost of a range of current urban design scenarios
- Development of additional explicit criteria to fine-tune application of the prices to specific situations
- Engagement with the land development industry through the Urban Development Institute of Australia (UDIA)
- Publication of the assessment workings and results.

Managing Sovereign Risk

Land development is a long-term business with payback on the up-front investment typically taking more than a decade. Developers are left with limited discretion to respond to regulatory changes after the initial infrastructure decisions have been taken. Land development is similar in this respect to a range of other private business investments with long payback periods, and costs to the community associated with sovereign risk apply. Management and reduction of this risk assists the community by increasing investor confidence and reducing the cost of capital.

Adverse regulatory changes during the payback period of long-term private investments increase investment risk. In the case of the Eynesbury Estate, the price increase proposed is from \$500 per lot per service to \$1,100 per lot per service. This represents an increase of 120% over the original agreed price under which the key investment decisions were made. The draft decision would impose this increase as a step-change with little notice provided of its introduction.

Clear and stable expectations, and long lead-times for the notification of changes, are important. The Energy and Water Ombudsman (Victoria) in a submission dated 15 January 2008 to the Commission's Water Plans Issues Paper noted the importance of this issue. The EWOV submission stated:

"EWOV reiterates its earlier comment that there needs to be clear notification about any price increase and when it will come into effect, so as to avoid the unfortunate transitional effects that occurred when the charge was decreased to \$500. If the Final Determination of the Water Price Review is released shortly before 1 July 2008, it is suggested that the new charges should not come into effect until 1 January 2009 to allow time to notify consumers of the change."

In light of the severity of the increase proposed, it would be appropriate to defer application of the increase so that reasonable prior notice of the increase is provided. During this time the additional analysis and development of the New Customer Contributions Industry Proposal suggested above could be undertaken. A period of 12 months would be appropriate. Should the analysis ultimately support a price increase, this should be phased-in over several years for estates where major investment commitments have already been made.

Yours faithfully,
GEO Property Group


Nick Deed
General Manager Southern Region