

PRICING CONNECTION FOR VICTORIAN DEVELOPERS



URA Information Brief – August 2023

Background

As part of the 2023 PREMO water price review, five regional water businesses proposed and had approved an alternative method to calculating developer charges, known as new customer contributions (NCCs), based on an average incremental cost (AIC) approach.

The AIC approach allows businesses to develop cost reflective tariffs and to signal to developers the costs associated with the timing and location of their developments through a charge that is intuitive and relatively easy for stakeholders and customers to understand.

URA was engaged by the businesses, through VicWater, to support them in their review of NCCs and in the development of their 2023 PREMO NCC proposals.

Driver for change

Over the last ten years there have been significant changes in the nature of development across the towns serviced by regional water businesses. This includes high and accelerating rates of development that occurred during the COVID-19 pandemic, with significant migration from metropolitan Melbourne to regional Victoria.

The level and pattern of development experienced could not have been anticipated when the ESC established its framework in 2012.

To manage the ongoing risks related to these changes in growth, regional water businesses considered several alternative approaches and determined, through a robust qualitative and quantitative assessment process, that an AIC based approach best met good practice pricing principles.

GOOD PRACTICE PRINCIPLES

Regulatory consistency – The framework and approach should align to the ESC’s NCC Guidance, the Water Industry Regulatory Order (WIRO) and the PREMO framework.

Revenue adequacy – The NCC framework should allow each business to recover the efficient costs of servicing development.

Efficiency – NCCs should maximise net community benefits from the timing, location and size of the connection to the network.

Equity – Customers want to face the same price as other customers who face the same (or similar) circumstances and/or the same (or similar) cost structures.

Ease of understanding – The NCC and the method of its calculation should be readily understandable by developers (or potential developers) and customers.

Flexibility – NCCs should cater for a suitable set of feasible development circumstances and development scenarios.

Administrative cost – The benefits associated with the NCC framework should outweigh the costs associated with implementation and ongoing management of NCCs.



The AIC proposals

The regional businesses proposed to maintain the framework's historical approach to financing out-of-sequence developments through the pre-existing incremental financing mechanism.

The proposals also maintained the pre-existing approaches to reimbursement schemes (to address pioneer developer issues) and the negotiated NCC framework (for unique developments). However, the businesses proposed to adopt the AIC method for standard (scheduled) NCCs.

The AIC NCCs are based on 20 years of forward cost and growth forecasts. The NCCs were determined over a 10-year price path with review every five years to account for changes in forecast growth and any changes in the sequencing of actual capital expenditure.

Several businesses proposed NCCs that differentiate between the highest growth systems based on connection forecasts, growth expenditure and demand risk, with their remaining systems being managed through a common NCC.

To avoid discouraging development through the application of relatively large NCCs, several businesses levied a cap on individual system NCCs.

Calculating AIC NCCs

The AIC approach estimates NCCs by separately identifying capacity related expenditure and averaging the expenditure over growth related output. The AIC approach can be broadly summarised under the following steps:

1. Consider the resource position over a suitably long time period (20 to 25 years, or longer depending on the robustness of data and degree of uncertainty associated with forecasts). This step involves determining the availability of existing capacity for water and wastewater treatment.
2. Forecast unconstrained demand (demand based on present demand policies) over the same period. Including both demand from existing customers and from new customers. This step will require the ability to accurately forecast growth over the period.
3. Identify a schedule of capital projects that can be implemented to meet capacity requirements over the period — the capital program must only include expenditure relating to increased capacity and should not include expenditure relating to changes in quality of service or compliance with new obligations (unless those associated expenditures are clearly driven by growth).
4. Optimise the capital program to generate the least cost solution to addressing supply/demand imbalances
5. Estimate the AIC as the present value of the expected costs of the optimal strategy divided by the present value of the changes in the underlying customer connections (assuming the supply demand balance is maintained).

Contacting URA

URA's support for the VicWater NCC review was led by Tim White and Mark Fitzgibbon. Both Tim and Mark are senior regulatory economists and have been involved in the development and operation of developer charge frameworks across several jurisdictions and a number of water businesses.

Please don't hesitate in reaching out to either Tim or Mark if you have any queries about good practice approaches to calculating NCCs and developer charges, regulatory treatments and approaches to NCCs and developer charges or to the broader application framework for NCCs and developer charges.



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