

28 November 2024

Water Team
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Essential Services Commission
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Dear Water Team

CENTRAL HIGHLANDS WATER RESPONSE TO REVIEW OF NEW CUSTOMER CONTRIBUTIONS (NCCs) CONSULTATION PAPER

1. Summary of Central Highlands Water (CHW; our) response

We welcome the opportunity to provide a response to the Commission's consultation paper 'Review of New Customer Contributions.' This letter sets out CHW's response to each of the six consultation questions outlined in the consultation paper.

CHW's NCC framework and approach has been developed to meet the challenges and opportunities provided by growth in our region. Most recently we have successfully implemented changes to our underlying costing calculation through the adoption of an average incremental cost (AIC) approach that is intended to strengthen the ability of our NCCs to provide developers with clear cost reflective signals that promote efficient development decisions and simplify our framework and support our customers by improving the "understandability" of NCC pricing (CHW AIC approach is discussed in section 2.5).

We are supportive of locational based NCCs and have introduced separate water and sewerage NCCs for new and existing (including infill) growth areas. We are also supportive of increasing our utilisation of negotiated NCCs to allow us the flexibility to manage low growth, or small systems, while continuing to maintain compliance with our obligations to service customers across all our systems (sections 2.2 and 2.3 discuss the potential broader use of negotiated NCCs).

We have identified in this response several opportunities that we consider may be worth pursuing and that we believe will add value to the ESC's NCC framework. These opportunities primarily relate to achieving a greater level of clarity in the current framework around issues of:

- Greater specification of minimum evidentiary requirements for the support of NCC proposals. This includes guidance on how the 'no surprises' approach is intended to function and how the data provided in this process is to be treated.
- Developing an adequate stand alone and avoidable cost test that meets the ESC's expectations and can be incorporated into our negotiation framework.
- Developing cost allocation approaches that satisfy the regulatory requirements of the ESC. In particular, approaches that account for expenditures that are shared between new and existing customers and expenditures that have multiple drivers (such as growth and compliance).
- Specifying principles for the allocation of shared gifted asset costs between multiple developers.
- Clarity around the inclusion and quantification of sunk assets. This clarity may extend to materiality thresholds, asset type and age. We would appreciate guidance from the ESC in relation to the treatment of sunk assets for AIC based NCCs.

The basis for each of these observations is outlined in our following response to the six key questions raised by the consultation paper.

This response addresses each of these questions within the context of our experience developing our NCC proposal for Pricing Review 2023 (PR23), our experience in the implementation of our proposal and the challenges and opportunities we believe NCC will face going forward. We have addressed each of these questions separately.

2. What are your perspectives on the matters identified by the commission at the 2023 water price review?

The NCC consultation paper identifies several practices across water businesses' NCC proposals that the ESC considered did not reflect its guidance or the objectives it has established for NCCs. The following response to each of these issues reflects our experience in the PR23 price review.

2.1 Unjustified cost attribution

The consultation paper notes that some water businesses provided good justification for their NCCs proposals in PR23. However, many put forward proposals that could be improved to better support the objectives of the NCC framework.

Our PR23 NCCs represent a significant change to our approach to costing NCCs and while we endeavoured to provide a strong evidentiary basis for the changes, we are conscious that we may not have fully met the ESC's expectations.

We have begun a process of internally reviewing our demand and cost data, to inform our NCC pricing decisions going forward. We are confident that our systems and process will support the ongoing implementation and management of our NCCs and our future pricing submissions.

We believe the NCC review provides an opportunity to establish clear guidance on the regulatory accounting framework that supports NCCs. There would be value in having greater definitional clarity for growth related costs. In particular, specification of what constitutes a growth-related expenditure and how these expenditures should be shared between existing and new customers where they are providing capacity to both, or alternatively are servicing other primary drivers such as compliance obligations in small and aged systems.

2.2 Preference for standard pricing

The consultation paper notes that the NCC framework is intended to promote a flexible negotiate and arbitrate connection regime and raises the question of whether an observed preference for Standard NCC's is consistent with this intent.

While CHW has historically administered NCCs primarily through standardised charges, we believe there is value going forward in using individually negotiated charges for developments that are subject to high degrees of uncertainty or risk and/or have a unique cost profile.

Within the context of our development areas, we see a natural split between the application of standard charges for our bigger systems (such as Ballarat) where costs are more homogenous in nature and demand for connection is relatively predictable and our smaller systems where the flexibility of a negotiated approach would allow us to tailor NCCs to developments.

Recognition of the value of using NCCs to signal development costs and promote efficient timing and location decisions by developers is a key driver for our PR23 NCCs.

While we have adopted capped standardized charges in order to transition our major systems towards full cost reflective NCCs, we also maintain a negotiation protocol. We are conscious of the potential impacts to new customers of moving to a fully cost reflective location based NCC across all our systems and recognise that negotiated NCCs are a potentially effective tool for managing transitional shocks.

Our intention is to further develop our negotiation protocol in response to the outcomes of this NCC review to support such an approach going forward.

2.3 Inadequate negotiation framework

The consultation paper notes that the PREMO 2023 water price review found water businesses provided varying degrees of information to developers and that there were potential inconsistencies with the ESC's 2013 explanatory note.

Given the potential to expand the use of negotiated NCCs, we are committed to undertaking an interim review of our negotiation protocol over the course of this pricing period in preparation for the next price review. This review will address the outcomes of the ESC's current NCC review and any feedback we receive from customers over the course of the current regulatory period.

We believe that it is important that the protocol provides for negotiated outcomes that comply with the NCC principles and that the developers we negotiate with have ready access to a level of information regarding the costing of the development that allows them to participate effectively in the negotiation. We also believe that there should be consistency across both the standard NCC and negotiated NCCs in relation to the underlying accounting treatment of costs.

Our current NCC Negotiation Framework has been developed to address the needs of our developers. We note that to date we have not had any feedback from developers on risks or opportunities relating to the Negotiation Framework. However, given the potential for greater utilisation of negotiation we are committed to fully disclosing the costs associated with servicing developments during the negotiation process.

2.4 Engagement issues

The consultation paper invites feedback on engagement issues associated with the PREMO 2023 price review. Effective engagement is a key aspect of the PREMO regulatory framework. We sought to ensure that this occurred during PR23, which

included consideration of NCC by residential customers as part of our deliberative assembly discussion on growth and development. In addition, our engagement with developers resulted in the transitional price path that we have implemented for NCCs.

CHW is a business that prides itself on engagement with our customer base. The PR23 draft decision accepted our 'Advanced' self-rating for Engagement on the basis that we had designed and delivered a sound engagement program with strong customer and stakeholder influence on the proposals of our submission.

We note that issues were raised with the ESC in response to the draft decision that our NCC consultation was overly focussed on commercial developers at the expense of residents seeking to add dwellings to their property or to take up vacant land in regional towns. We have considered this feedback in the context of CHW's overall engagement, which did include some consideration of new customer contributions by residential customers as part of its deliberative assembly discussion on growth and development.

We are broadly supportive of the PREMO engagement framework and highly value the impact it has had on our ability to align our services with customer value. We are planning on addressing those issues raised through the PREMO 2023 price review with our customers and developers in the engagement leading up to the next water price review.

We note the concerns raised in the consultation paper and would see value in the ESC outlining its minimum expectations in relation to engagement with both developers and our broader customer base.

2.5 Application of an average increment cost approach

The consultation paper makes the observation that a number of businesses (including CHW) have adopted the average incremental cost (AIC) approach to calculating the cost basis for NCCs. The paper does not pose any specific questions regarding AIC but does provide businesses with an opportunity to comment on alternative approaches to the Net Cashflow Approach developed in 2013.

In PR23, CHW successfully implemented reforms to its NCC framework based on the adoption of an average incremental cost estimation approach for standard NCCs. The CHW's board approved this reform and continues to be supportive of the AIC approach as a key component of our general approach to addressing cross subsidies.

We note that AIC as with the Net Cashflow Approach has the potential to address concerns around fairness, locational signals, and timing. We believe AIC provides us with a stronger foundation for achieving more efficient NCCs, that is NCCs that can reflect the costs and risk profiles of development. Effective NCCs are a key element of our approach to managing our growth and ensuring that we can continue to deliver value to both our existing and new customers. They provide clear signals to our developers of the costs associated with their development.

We also believe one of the material benefits of an AIC approach is its relative simplicity and understandability. The intuitive nature of AIC is central to our ability to provide clear cost signals and to deliver effective and informed negotiated NCCs.

We note that the consultation paper raises the application of AIC as a key implementation issue that needs to be addressed. To date our application of AIC has been consistent with our expectations and our PR23 submission. Developers and customers have not raised with us any material concerns regarding AIC post the PR23 Determination. CHW is happy to work with the ESC to address any specific implementation issues that come to light over the course of this NCC review. We are happy to provide further responses to the ESC regarding implementation, if it sees value in raising targeted questions addressing specific concerns regarding AIC.

We also intend on taking advantage of any shared learnings from other AIC businesses that may arise through the course of this NCC review that will add value to our developers and customers in our pricing submission for the 2028 Water Price Review.

2.6 *Uncertainty around gifted assets*

The consultation paper seeks feedback on the ability of the current framework to address issues of uncertainty around gifted assets.

To date we have not received material feedback that indicates that the current approach is not meeting the objectives of the ESC's NCC framework. However, we would see value in the ESC providing a clearer articulation of principles for allocating the costs associated with gifted assets that are shared between multiple developers. It is important that these principles continue to provide us with the flexibility we need to allow for tailored asset solutions that service both individual developments and the broader development zones they sit in.

2.7 *Timing of development and development service plans (DSPs)*

The consultation paper seeks feedback on the use of development service plans. CHW maintains DSPs across our major systems which are regularly updated following consultation with stakeholders. To date we have not experienced any NCC related issues with the current framework and our DSPs.

It is important to note that there are material differences between the practical challenges faced by regional businesses such as CHW and metropolitan businesses. While we maintain DSPs for our major growth areas, there would be little value in extending these to our low growth systems. Unlike metropolitan businesses we do not service high density growth connecting to an integrated network and do not have the same advantages of economies of scale and scope in our planning. The costs associated with extending our DSPs to capture these systems would far outweigh any benefit achievable through NCC pricing.

Increasing the specificity and regularity of our DSP program would likely require additional funding which would need to be recovered from developers through ancillary charges or contributions. This change, and the support for the associated increased costs for implementation would need to be tested with our developers in future pricing submission development and engagement processes.

2.8 *Guidance for NCCs*

The consultation paper seeks views from stakeholders about the changes that may be needed to the ESC's guidance to support the objectives of the NCC framework. In general, we believe the current framework allows for an adequate level of guidance. However, there are several areas where there would be value in providing further guidance (see response section 3.).

We would also see value in the guidance recognising the inherent differences between regional and metropolitan businesses and challenges regional water business face in servicing growth. These differences relate to:

- Less opportunity in regional areas to pursue/promote infill development.
- Absence in a regional context of high-density development analogous to that occurring in Melbourne's city and satellite suburbs. This relative lack of density means we do not achieve the economies of scale that are associated with metropolitan planning frameworks.



- Material differences in the risk profile of development. The regional development boom that we have experienced over the 2020-2023 period is unprecedented. There is a high degree of uncertainty as to whether this boom will continue unabated, whether it will speed up or alternatively decelerate, noting 2023/24 saw a return to previous trend. This uncertainty places significant risk on CHW and our existing customer base. It is appropriate that we share this risk with developers such that we can promote efficient timing and locational decisions.

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

As stated in response section 2.8, in general, we believe the current framework allows for an adequate level of guidance. However, there are four specific areas where greater clarity would support us in the development of our pricing submissions.

1. Greater specification of minimum evidentiary requirements for the support of NCC proposals. We note that in addition to our PR23 submission, CHW also participated in the “no surprises” early engagement process. We are supportive of this process and see it as a valuable tool in being able to justify our costs with the ESC. There would be value in providing further guidance on how the ‘no surprises’ approach is intended to function and how the data provided in this process is to be treated. In relation to the pricing submission, there would be value in clarifying the level of information needed beyond the submission of the NCC model, to support the ESC in their review of our growth expenditure.
2. Clarity around what the ESC believes is an appropriate method for applying and evidencing the application of the avoidable and standalone cost test outlined in the NCC principles. We are conscious that these principles are intended to function within the context of price setting and need to be practically effective. It is important that the administrative costs of applying the tests do not impose undue burden. It is also important that they promote transparency and support our negotiation frameworks.
3. Clarity around the minimum regulatory expectations for the allocation method for identifying the share of growth expenditure attributable to new and existing customers. There would be value in providing examples of appropriate allocation methodologies.
4. Clarity around the inclusion and quantification of sunk assets. This clarity may extend to materiality thresholds, asset type and age. We note that the AIC

method is forward looking and does not include sunk assets within the context of the 10-year NCC price path we have committed to. We would appreciate guidance from the ESC in relation to the treatment of sunk assets for AIC based NCCs.

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

CHW successfully engaged with our developers and broader customer base in the development of our PR23 Submission. Our engagement, and the objectives and outcomes our customers value (both new and existing customers) are core drivers for our NCC approach.

We believe CHW is best placed to manage this engagement. We have a longstanding direct relationship with our customer base and are best placed to inform and engage with developers and our existing customers the challenges and opportunities associated with growth and how these should be addressed in our prices (including NCCs) and our work program.

We do not believe there would be benefit in the ESC having a direct role in engagement with connection applicants outside of continuing the existing regulatory oversight. We are also conscious of the potential for flow-on effects in our broader engagement on water and sewerage services given the often-shared nature of assets servicing growth and the impacts it has on our broader customer base.

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

CHW appreciates the opportunity provided by the ESC to draw attention to other issues or information that could impact on our NCC outcomes. We fully documented the drivers for our growth outcomes and our recent NCC changes in our PR23 Submission. These drivers remain unchanged.

We are confident that the current NCC framework (as implemented through PR23) provides us with sufficient flexibility to address the challenges and opportunities we identified in our PR23 Submission and any that have arisen since the determination.

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

While we appreciate that the ESC adopted the terminology of New Customer Contributions with the purpose of explicitly linking the underlying developer charge to

the new customers who will ultimately connect and consume water and wastewater services, we have no position on whether such charges should be renamed as developer charges.

We note that developers in our area commonly refer to NCCs as developer charges. However, to date the use of the “new customer contributions” has not negatively impacted on our engagement of developers or our broader customer base.

7. Any other relevant matters the ESC should consider?

At present, we have not identified any further relevant matters. However, we are committed to actively engaging in the review process and will respond to any issues that may emerge during the review.

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