

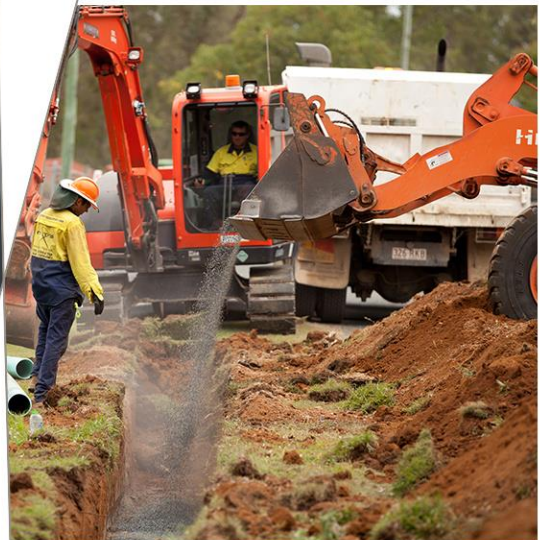
Summary Report

Review of Sydney Water Developer Direct Prices

3608-23

Prepared for
IPART

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1 Introduction

1.1 Background

IPART is currently undertaking a review of the maximum prices Sydney Water can charge for its services for the period 2020-2024. One of Sydney Water's statutory functions is to issue compliance certificates under s 73 of the *Sydney Water Act 1994*. These state that new developments have satisfied all their requirements relating to the availability of water, wastewater, recycled water or stormwater services.

Sydney Water provided minor construction services up until about 2001, after which it created the Water Servicing Coordinator (WSC) market to allow the private sector to undertake development related construction work. A private sector WSC would be engaged by the developer of a new property to assess the development, apply to Sydney Water for the s73 certificate (application services) and coordinate between clients and constructors for any required construction works (construction services).

Sydney Water has always retained its statutory function under s 73, but in 2017, based on customer feedback, Sydney Water also re-entered a small section of the WSC market through the formation of Sydney Water Developer Direct (SWDD). SWDD competes with WSCs on developments where only minor work is required – complying s73 works – by providing both the WSC role and offering the construction service.

IPART has received a number of submissions from WSCs claiming that WSCs face different information and compliance constraints to SWDD, suggesting that SWDD is able to set prices lower than WSCs.

As a result of this, IPART engaged Cardno to undertake a review of SWDD prices.

1.2 Objective

The objective of this project was to review SWDD prices and ascertain whether there is a competitive neutrality issue. In particular, the review was to conclude whether there is any evidence that Sydney Water is:

- > using its vertical integration to undercut application services offered by WSCs, or
- > cross-subsidising its application and construction services.

IPART currently regulates parts of SWDD's application services – whose costs for this are also passed through to WSCs – but not construction services. Both services need to be reviewed together due to the potential for cross-subsidies.

1.3 Scope

The scope of works for this project was to conduct an in-depth review of SWDD services, evaluate the reasonableness of prices, and address:

- > the cost build-up of SWDD's application services (to ensure each component of the services are priced reasonably).
- > whether Sydney Water has appropriately ring-fenced all SWDD services.
- > whether it is reasonable that SWDD contractors and WSCs face different information and compliance requirements, and whether SWDD derives an advantage through these different requirements
- > the extent of market competition in both application and construction services.
- > what (if any) regulation/monitoring of SWDD services is appropriate.

1.4 Approach

To complete the required scope of works, the key activities in the review methodology included a half-day workshop with Sydney Water which was held on 11 February 2020 and complementary desktop activities. Further review activities included analysis of financial information provided by Sydney Water, further information requests and assessment of this information.

2 Sydney Water Developer Direct

2.1 Overview

Sydney Water provides a service for low impact/minor works development customers, known as Sydney Water Developer Direct (SWDD).

Sydney Water approval is required when a developer customer wants to connect a property to Sydney Water's infrastructure. For certain developments, this approval is in the form of a "Section 73 Certificate". Developer customers apply for a Section 73 Certificate online through Sydney Water's web-based workflow system, eDeveloper.

Developer customers engage a Water Servicing Coordinator (WSC) to act on their behalf through this process, including applying for a Section 73 Certificate through eDeveloper and to manage the process of meeting Sydney Water's requirements for connection to its infrastructure.

Since 1 March 2017, Sydney Water has allowed developer customers in selected Local Government Areas to apply directly to Sydney Water via the SWDD service, removing the requirement to engage a WSC for low impact/minor works developments. The initial SWDD offering provides "Novice" developer customers with many of the services currently supplied by WSCs, including application fee services and construction services.

Once the developer has paid the SWDD application fee, SWDD provides the following application fee services:

- > Assessment of building plans and development applications
- > End-to-end case management of the application for a Section 73 Certificate
- > Preparation of servicing proposals for the connection between development lots and Sydney Water's water supply pipes and sewerage mains
- > Issuing a Notice of Requirements Letter to the developer setting out the Section 73 Certificate Requirements
- > Determination of development works necessary to connect development lots to Sydney Water's water supply pipes and sewerage mains
- > Issuing of Section 73 Certificate and full building plan approval.

In addition to the application services, SWDD also offers customers the associated construction services to connect the developed lots to Sydney Water's infrastructure. SWDD provides these services by the developer customer entering into a Minor Works Deed with SWDD and using external competitively-tendered contractors to provide the services to the developer under the Deed. The construction services that SWDD provides to customers include:

- > Installing the connection between the development lots and Sydney Water's main sewer (Property Connection Sewer) and sealing the points of connection
- > Extending Sydney Water's main sewer (only where the extension required is less than 25 metres)
- > Concrete encasing of existing Sydney Water's sewer pipes (including any replacement of existing pipes of up to 25 metres required before encasement)
- > Installing a locked and tagged water service (i.e., installing the private water pipe between the water main and the water meter)
- > Installing new water service pipes from Sydney Water's water main to provide water (known as a 'main to meter service')
- > Piering inspections (as part of in-scope Building Plan Approvals).

2.2 Sydney Water Developer Direct business model

Sydney Water has established the business model for SWDD such that it will only accept applications for Section 73 certificates for developments for which only minor works are required. Minor works are works that do not impact on or require alterations to Sydney Water's mains infrastructure. For major works (i.e. works that do impact on or require alterations to Sydney Water's mains infrastructure) the developer needs to use a

WSC to manage these connections. Where an applicant is found not to meet the minor works requirement, Sydney Water advises the applicant to contact a WSC as SWDD is not able to undertake the application.

Research carried out on Sydney Water's behalf has shown that the minor works market that SWDD operates in is relatively small compared to the overall market. In addition, the WSCs are able to also focus on the larger proportion of development application work that SWDD does not service. As a result, Sydney Water considers that the market power of SWDD in the available WSC market could not be seen as harmful to competition.

In 2018, Sydney Water engaged with the WSC market and tendered on new arrangements for WSC services. These new arrangements have applied since 1 January 2019. Key changes and provisions under the new arrangements include:

- > Coordinator roles and designer roles have been integrated such that WSCs are also required to be designers, considered by Sydney Water to be a formalisation of the existing market standards. In addition, this has allowed for an expansion of the market by Sydney Water and the WSC market actively encouraging Designers to enter the WSC market for possibly greater customer choice and service.
- > Introduction of "Accreditation Categories" to cover different services (water, wastewater, recycled water etc.), different sizes of infrastructure and different roles (designer / verifier). Sydney Water has established a "Minimum Level" of accreditation as a mandatory requirement to be recognised as a WSC under the new contracting arrangement. As SWDD was already established at this time, Sydney Water did not require it to meet the Minimum Level.
- > Establishing an Engineering Competency Standard which sets out "*...the academic level, experience and professional qualifications required for creating and verifying different categories of engineering design work for Sydney Water's works. The ECS provides assurance that when assets are designed they achieve planned outcomes and are fit for purpose.*" For minor works, Sydney Water has deemed that there are no requirements under the Engineering Competency Standard. SWDD only undertakes minor works and, therefore, does not need to meet the requirements of the Engineering Competency Standard.
- > WSCs being required to have in place Professional Indemnity insurance with cover of \$10 million and a quality management system which had been independently certified as meeting the requirements of AS/NZS ISO 9001:2000 or equivalent.
- > Under the standard contract between Sydney Water and the WSCs, WSCs are required to:
 - Maintain a separate and specific bank account for monies collected on behalf of Sydney Water, unless otherwise agreed to in writing by Sydney Water (Clause 9.1)
 - Potentially lodge a security of \$50,000 with Sydney Water (Clause 10)
 - Use its best endeavours to include Sydney Water as specifically insured for motor vehicle and public liability insurance (Clause 12.6)

2.3 Ring-fencing of the Sydney Water Developer Direct business

Measures that Sydney Water has taken to ring fence the SWDD business and not sought to favour its own interests through marketing of the services provided by SWDD include:

- > Establishing a work flow that is consistent for both SWDD and WSCs
- > Establishing separate cost centres and accounts
- > Allocating and including appropriate corporate overheads to the SWDD business
- > Listing the WSCs alphabetically on Sydney Water's externally facing website that lists all the WSCs that developer customers can choose to provide the application services. As a result, SWDD is near the bottom of the list.
- > Sydney Water providing its application services customers with the option of switching to a different WSC for construction services.

The process steps for SWDD and the WSCs providing application services are largely the same and we did not observe any areas that favour SWDD over the WSCs.

2.4 Financial management of Sydney Water Developer Direct

2.4.1 Costs

SWDD approaches its finances and ensures a commercial return by first determining its costs, and using these to develop the price for its services based a building block approach. A margin is then added to allow for a margin that Sydney Water considers appropriate for a theoretical benchmark “reasonably efficient operator”. A key assumption made by SWDD in determining the application fee price is the volume of applications processed and the construction activities delivered. In this way, SWDD approaches pricing as a rate of return on its cost base. It then monitors revenue and costs to determine the profit it is making.

The costs of the SWDD business are the sum of:

- > Direct salary costs
- > Salary on-costs (to cover annual leave, long service leave, superannuation and payroll tax)
- > Corporate overheads (allocated in accordance with its cost allocation manual and the analysis provided to IPART as part of the 2016 Determination process)
- > Capital charge for software (for the software used by SWDD to assist in receiving and processing Developer Direct applications. This has been assigned a ten year useful life).

Salary costs (loaded with on-costs) are adjusted to account for the time spent by the SWDD staff working outside of direct SWDD activities before corporate overheads are added. Sydney Water has allocated a percentage of their working week on SWDD case management plus pro rata allocations for holiday and sick leave. The remainder of the working hours for non-SWDD activities include the similar pro rata holiday and sick leave allowance, plus time for internal meetings, professional development and Sydney Water development work outside of the SWDD team. Some SWDD team members are also involved in providing training and other non-SWDD development activities within Sydney Water.

As SWDD have only recently moved staff to timesheets, this derivation is based on a one-off assessment of the time spent by staff on various activities. The introduction of timesheeting is expected to provide Sydney Water with more accurate data to use to gain a better understanding of the split of work in future cost forecasting.

2.4.2 Revenue

SWDD’s revenue consists of customer applications fees and the minor works construction cost component paid by customers who engage SWDD to manage this process.

The minor works construction charges vary on a case-by-case basis. Competitive quotes are obtained by SWDD through its panel of contractors to fit the technical requirements of the job and at the least cost. The quotes are passed directly onto customers and the customers are free to choose any contractor or can decide to use a WSC to take over the construction phase of the required minor works.

SWDD adds a margin to the s 73 application fee on a competitive-neutrality basis to allow WSCs to compete, and to allow for variance in early forecasts. SWDD adds a separate margin to the construction fee. Work-As-Constructed and Project Coordination fees on all construction works are included as separate fees, together with any other applicable fees.

SWDD monitors and reports its revenue and expenses through the SWDD Financial Monthly Report spreadsheet. A worksheet is set up annual to cover the forthcoming year and record the regulated and unregulated components of SWDD’s income and costs. Based on this information, total income and costs are calculated to derive the monthly and accumulated margin/profit. The spreadsheet also records the number of applications received each month and the number of applications that was forecast to be received in each month when the application fixed fee for the year as calculated.

2.5 Cost build-up of Sydney Water Developer Direct application services

SWDD charges its customers a fixed fee for the application services it provides.

In addition to SWDD’s business costs components outlined in Section 2.4, the background considerations in its approach to developing its fee also include:

- > SWDD’s s73 complying application fee, Building Plan Application and Property Sewerage Diagram fees are supplied by Sydney Water’s Customer Programs/Customer Services annually

- > The s73 complying application fee, Building Plan Application and Property Sewerage Diagram are regulated fees and do not attract GST
- > SWDD includes the fee for the Property Sewerage Diagram Fee as this diagram is no longer available free to WSCs. The diagram is required to be checked to ensure no trespassing private sewer.

SWDD calculates the fixed application fee based on a forecast of the average number of applications it expects to receive each month. This forecast, which is completed each year when the fee is calculated for the forthcoming year is critical to in the calculation as the calculated fix fee per application increases as the number of anticipated applications per month decreases.

3 Key findings

Our review assessed the SWDD business model and WSC compliance requirements, the SWDD process and ring-fencing of the SWDD business from the wider Sydney Water business, financial management of SWDD and the cost build-up of SWDD application services.

The main conclusions drawn from our discussions with Sydney Water at the half-day project workshop, our assessment of the documentation provided to us by Sydney Water and IPART and the analysis of data that we completed are as follows:

1. We consider that SWDD has been advantaged over WSCs by facing a lesser competency requirement to undertake application and design services and by being able to adopt a business model that cannot be readily pursued by other WSCs. Sydney Water confirmed that there are no means by which a WSC could qualify for the panel without meeting the Engineering Competency Standard and only deliver minor works (i.e. as SWDD does) based on the accreditation requirements under the WSC tender application process. Sydney Water identified this as the basic scope that customers needed from the new model combining the 'Designer' and 'WSC' capabilities.

We note that Sydney Water has refuted this finding as it considers that the WSCs can and do adopt a business model where they can outsource the Engineering Competency Standard (ECS) requirements on an 'as needs' basis. By way of having sub-contracting arrangements available on a case-by-case basis, Sydney Water considers that the WSCs do not need to invest in employing staff to meet ECS requirements. As a result, Sydney Water considers that there is no barrier in place prohibiting a WSC from only doing minor construction type works and never accessing their Design supply chain for more complex works.

Although we consider that there is not a level playing field between SWDD and the WSCs in relation to the ECS requirements, we caution, however, that we cannot make firm conclusions as to whether these advantages are material as we do not have information on the volume and returns expected from each market segment. Generally, a WSC should expect higher returns for undertaking more complex designs and for the more advanced Accreditation Categories as there should be fewer competitors. SWDD is competing within a market segment that is the least complex and, therefore, should be more commoditised and offer lower returns.

2. There are contractual requirements that WSCs face which we have not seen evidence that SWDD faces. These are likely to add to the cost of WSCs conducting their activities compared with SWDD. These additional requirements include:
 - a. WSCs are required to obtain Professional Indemnity insurance coverage that specifically recognises WSC activities
 - b. WSCs are required to have in place a quality management system that covers "all activities under the contract"
 - c. WSCs are required to maintain a separate and specific bank account for monies collected on behalf of Sydney Water, unless otherwise agreed to in writing by Sydney Water
 - d. WSCs are potentially required to lodge a security of \$50,000 with Sydney Water
 - e. WSCs are required to use their best endeavours to include Sydney Water as specifically insured for motor vehicle and public liability insurance on their own insurance

Sydney Water has noted that the separate bank account requirement is not binding and WSCs can request to opt out of the requirement, that for the lodgement of a security, it is possible under good financial management for WSCs to organise bank-based guarantees, and that the motor vehicle and public liability insurance is required on a best effort basis only.

3. The allocation of SWDD staff time to SWDD costs is likely to be materially understated due to the exclusion of time for professional development, meetings and annual leave. Our analysis suggests that this allocation should increase from 79% of staff costs to 91%. Sydney Water has noted that a 91% labour allocation should not be retrospectively applied to a backward looking analysis to make any inferences about price based competitive neutrality, as this information was not available to SWDD at the time, so would have been impossible to more accurately include in forecasts at the time.

4. We found that there is no formal agreement between Sydney Water and SWDD for the provision of the specific software that SWDD uses. This appears contrary to good practice for ring-fencing. Sydney Water has agreed with this finding in principle but considers that this has already been applied.
5. The construction revenue received by SWDD accounts for just over half of all revenue. Where this revenue is excluded and the application service treated as a stand-alone activity, revenue and margin are materially impacted.
6. SWDD appears to have not included software costs in its monitoring of its ongoing finances. Where these costs are included, the profitability of SWDD activities is materially impacted over the period from inception to date.
7. If SWDD was to increase the amount of staff time allocated to SWDD activities to the 91% arising from our analysis, this would (by itself) materially impact the profitability of the business. If applied alongside including the software charge, the materiality of these impacts would be greater.
8. SWDD determines its prices based on assumed volumes of activity. Where these volumes have not been achieved consistently in the 19/20 financial year, there is no evidence that SWDD is responding to maintain or recover a desired rate of commercial return.

With regard to the findings we have summarised above in 6, 7 and 8, Sydney Water states that in accordance with the NSW Government's 'Policy Statement on the Application of Competitive Neutrality', government businesses are allowed the same flexibility as their private sector counterparts in engaging in pricing strategies and loss-leading activities. As such, it is a legitimate and recognised business strategy to continue operating with periods of negative profit under the State policy.

Although Sydney Water has stated that it is not SWDD's strategy to have loss-leading pricing, it has noted that periods of learning and development or forecasting errors does not constitute *prima facie* evidence of any non-compliance with competitive neutrality.

Sydney Water notes that the NSW Government's policy makes it explicit that a long-term review of margins and profitability is required to assess a non-compliance with competitive neutrality. As such, Sydney Water has noted that it seeks to correct forward-looking business pricing through the annual price review it has for its contractor schedules and application fee costs, as well as its decision to set the margins at what they are according to a priori margin squeeze test. A long-term review of margins and profitability has not been undertaken in this review, we have only considered financial performance over the period of time since SWDD commenced.

4 Recommendations

We make the following recommendations to improve the transparency of the competitive neutrality of SWDD and to remedy some of the areas where we consider that SWDD may currently have an advantage over WSCs:

1. We recommend that Sydney Water reviews the Engineering Competency Requirements that have been applied to WSCs but not to SWDD. If Sydney Water considers that there is an inconsistent requirement preventing WSCs from adopting a business model that WSCs cannot then it should implement appropriate remedies for this.
2. We recommend that SWDD reviews its quality management system and provides evidence that they satisfy the same criteria that were applied to prospective WSCs through the tender process.
3. We recommend that Sydney Water provides evidence to IPART that SWDD is meeting the contractual requirements places on WSCs such that WSCs are not be disadvantaged by the costs of meeting these requirements. Specific areas of concern include:
 - Maintaining a separate and specific bank account for monies collected on behalf of Sydney Water, unless otherwise agreed to in writing by Sydney Water (Clause 9.1)
 - Potential requirement to lodge a security of \$50,000 with Sydney Water (Clause 10)
 - Use best endeavours to including Sydney Water as specifically insured for motor vehicle and public liability insurance (Clause 12.6)
4. We recommend that SWDD revisits its assumptions for the allocation of staff time to SWDD activities.
5. Where SWDD considers that a change to its assumption regarding the allocation of staff time to SWDD, its pricing and financial monitoring should be revisited.
6. We recommend that Sydney Water consider a default allocation of 100% of SWDD team time to SWDD costs and only make adjustments where there is clear evidence to support this.
7. We recommend that Sydney Water and SWDD formalise a level of service agreement between for the provision of the SWDD software.
8. We recommend that SWDD revisits its monthly reporting and calculation of costs and profit to confirm whether the software charge has been adequately incorporated or otherwise. If it hasn't, SWDD should update its monitoring to include these costs.