

Department of Treasury and Finance

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Dear Mr Dimasi

Submission to Water and Sewerage Industry Draft Price and Service Plan Guideline Issues Paper

I refer to the request for comments on TasWater's proposed changes to the regulatory framework for the water and sewerage industry, as set out in the Draft Price and Service Plan Guideline Issues Paper.

The Department of Treasury and Finance considers that the Economic Regulator's method of determining water and sewerage prices under the current regulatory framework provides an appropriate balance of incentives and accountability to ensure that services are delivered as efficiently as possible. TasWater's proposals, which have not been tested with customers, raise a number of concerns associated with risk allocation, price stability and customer choice. I offer the following comments to assist in your consideration of these proposals.

Duration of the regulatory period

Extending the regulatory period to five years would, over time, result in some regulatory cost savings to TasWater and, ultimately, customers. However, this proposal is entwined with TasWater's other proposals to introduce annual price adjustments. As such, the proposals should not be considered in isolation. For instance, the claim that a longer regulatory period provides more price certainty for customers is not necessarily true if a process for annual price adjustments is also adopted.

It is acknowledged that five-year regulatory periods are not uncommon, but they typically apply to regulated entities in mature states of operation. As noted in the Issues Paper, TasWater is proposing significant tariff reform over the forthcoming regulatory period. In addition, TasWater remains in a long-term transition to achieving full regulatory compliance. Both these factors create considerable uncertainty that would be more difficult for TasWater and the Regulator (on behalf of customers) to manage with a longer regulatory period without additional regulatory reporting and oversight, which would only add to regulatory and compliance costs.

Annual price indexation and move to a ‘real’ pricing framework

This issue primarily relates to risk allocation. In this case, inflationary risk.

It is considered that the regulatory principle that should be adopted is that risks are allocated to the party most capable of managing them. This proposal is aimed at shifting current inflationary risks from a monopoly essential service provider to customers through annual price adjustments. Customers, particularly those already facing economic hardship, are not well-positioned to absorb and manage these risks. Frequent price changes could create financial instability for households and businesses, making it difficult for them to budget and plan effectively.

The current multi-year pricing model offers a degree of stability and predictability that benefits everyone. Customers know what to expect, which helps them manage their finances more reliably. Introducing annual resets would likely lead to greater uncertainty and potential hardship, especially for the most vulnerable in our society. Even with support mechanisms in place, the frequent fluctuations in pricing could still pose significant challenges for these groups.

TasWater’s concerns about this issue are likely to have been heightened by its experience of the past couple of years where inflation increased markedly. That was a period of extraordinary price change that is unlikely to be repeated often. In addition, some degree of inflationary risk is a standard part of commercial operations and is borne by all businesses.

While Treasury does not consider that any action is required on this matter, if the Regulator wanted to address this issue, it is proposed that a mechanism to share inflationary risk would be better than one that simply transferred it from TasWater to its customers. For instance, there could be an annual adjustment process, but that prices would only be adjusted when the annual CPI increase was outside a pre-defined band above and below inflation forecasts. This would provide price stability and ensure that TasWater is managing inflation risk most of the time, as it is best placed to do so, but that prices could be adjusted to account for extraordinary price changes.

Treasury considers that any significant change in the risk allocation between TasWater and its customers should be accompanied by a review of the risk parameters within the WACC calculation.

Annual recalculation of the cost of debt

The pricing structure is designed to ensure that the utility can generate sufficient revenue to cover its costs; maintain financial stability; and fund necessary investments in infrastructure. It is acknowledged that the current mechanism to calculate the cost of debt is not perfect. However, as stated in the Issues Paper, there is no definitive method to accurately reflect an efficient debt portfolio.

While the proposal may deliver benefits to customers in some instances (where interest rates are falling), it is very similar to the previous proposal in that it involves a risk transfer away from TasWater to customers and will reduce price certainty. Again, TasWater’s concerns on this issue are likely to have been influenced by its recent experience with rapidly increasing interest rates, which is unlikely to be repeated often.

TasWater has a broad set of tools available to manage cost of debt risk and, therefore, is best placed to manage these risks. The Regulator’s current method provides incentives for TasWater to develop efficient financing solutions and ensure that forecasts are accurate and well founded.

As a regulated monopoly essential service provider, TasWater faces less risk than unregulated entities in a competitive market. There does not appear to be a valid argument why TasWater should be permitted to further de-risk its operations in relation to this issue at the expense of customers.

As noted previously, any significant change in the risk allocation between TasWater and its customers should be accompanied by a review of the risk parameters within the WACC calculation.

Regulate prices for Category 3 and 4 industrial trade waste customers

Price regulation for these customers was specifically not adopted due to the recognition that the size and capabilities of these customers are such that, if they wish, they can install their own waste pre-treatment to convert their trade waste to sewer quality waste. Therefore, TasWater is not a monopoly supplier of trade waste sewerage services to these customers.

Also, as acknowledged in the Issues Paper, these customers are very diverse in nature and often require bespoke sewerage and trade waste solutions. This situation does not lend itself well to a regulated pricing solution.

These customers can also represent significant costs to serve due to the nature and volume of trade waste they can generate. The TasWater proposal seems to imply a more uniform charging arrangement. In this context, it would not be appropriate for cross-subsidisation to occur, in the interest of uniform pricing, where significant costs associated with large scale commercial ventures are met in part by other trade waste or sewerage customers.

Dealing with these large trade waste customers is challenging and there are many legacy issues to address in terms of non-compliant trade waste discharges to the sewerage network and under-recovery of costs. However, these need to be dealt with through standard commercial negotiations and enforcement of environmental regulations.

TasWater has not presented evidence of a market failure that would necessitate the imposition of regulation to a currently contestable market.

Considering whole-of-system outcomes

Treasury does not believe the current framework prevents TasWater from selecting a regulatory solutions based on external benefits, provided that the regulated and unregulated components are explicitly accounted for.

The test should be, if something is the most prudent and efficient means of meeting regulatory and customer demands in relation to the provision of water and sewerage services, then the Regulator should consider allowing it to be recovered through regulated prices. This assessment could involve broader considerations, e.g. constructing a water re-use scheme to avoid having to upgrade a sewerage treatment plant to meet environmental requirements.

TasWater provides an example of investing in upstream catchment practices to reduce nutrient inflow which could then be used to justify nutrient inflows from a sewerage treatment plant. If this solution meets the EPA requirements and is the most efficient option to address the identified sewerage-related issue, then Treasury is unaware of any restrictions within the current regulatory preventing the Regulator from considering such a proposal.

There is a broader concern with proposals that are not the most efficient and prudent options, but are justified on other factors, including customer willingness to pay. As the Issues Paper points out, this is a very difficult concept to accurately measure. Also, most proposals will only have localised impacts. With statewide pricing, the willingness of affected customers to pay is distorted by the fact that all customers will pay. As an example, assume the cheapest option for a network upgrade is to run pipes through reserve land and this has no regulatory barriers, but strong community opposition. This proposal could be used to justify an alternative more expensive route to address the concerns of the affected locals, but would be paid for by all Tasmanian customers. While it would be an easier outcome for TasWater, it would not be in the best interests of customers as a whole.

The current framework already allows for consideration of broader solutions to meeting customer and regulatory demands, but this assessment should continue to be focussed on what is prudent and efficient and in the best interest of customers.

Final comments

In conclusion, Treasury considers that the current regulatory framework provides sufficient ability for TasWater to manage its commercial and operational risks and that TasWater has not provided evidence that its proposals will provide net benefits to customers.

Should you have any queries or require any further information regarding this matter, please contact Dean Burgess on (03) 6145 5833 or email dean.burgess@treasury.tas.gov.au.

Yours sincerely



Gary Swain
Secretary

29 May 2024