

4 CAPITAL EXPENDITURE

Capital expenditure or capex refers to the amount invested by TasWater in assets to provide regulated services. In determining maximum prices, the Regulator only includes capex used to provide regulated services. Capital expenditure on assets used to provide unregulated services, such as the supply of water for irrigation, is excluded.

The Regulator assesses TasWater's proposed capex using the prudence and efficiency tests and also assesses whether the overall level of proposed capex is feasible over the regulatory period.

The Draft Report invited submissions on the Regulator's draft decisions on TasWater's capital expenditure. The only submissions that contained comments were from TasWater and the Local Government Association of Tasmania.

4.1 The Regulator's decisions

The Regulator has made the following decisions:

1. Approve a capex allowance \$45.4 million lower than TasWater proposed, at a total of \$861.9 million for the fourth regulatory period, which is 95 per cent of TasWater's proposed capex, as set out in Table 4.1.
2. Accept that the expected costs associated with TasWater's CDO for the fourth regulatory period are prudent and efficient.
3. Accept that TasWater's proposed expenditure on the Pioneer water supply project is prudent and efficient.
4. Require TasWater to continue to provide the Regulator with six monthly progress reports on its capital program.
5. Require TasWater to implement the improvements in relation to asset management, capital planning and prioritisation and capex governance frameworks identified by CCGUS during the fourth regulatory period.
6. Require TasWater to provide the Regulator with six-monthly reports within one month of the end of the six-month period on its progress towards implementing the above improvements commencing from the six month period ending on 31 December 2022.
7. With respect to gain-share and pain-share adjustments with the CDO, require TasWater to include only those costs that it actually incurs when capitalising CDO-related expenditure and including that expenditure in its RAB.

4.2 Differences between the Regulator's decisions in the Draft and Final Report

There were no differences in the Regulator's decisions, as they affect the Price Determination, between the Draft Report and the Final Report.

4.3 Summary

Table 4.1 shows the outcomes from the decisions made by the Regulator in this Report with respect to TasWater's capex for the fourth regulatory period.

Table 4.1 TasWater's capex allowance for the fourth regulatory period (\$million, nominal)

	2022-23	2023-24	2024-25	2025-26	Total
TasWater's proposed capex	226.0	233.3	227.0	220.9	907.3
Regulator's adjustment	11.3	11.7	11.4	11.0	45.4
Capex allowance	214.7	221.6	215.7	209.9	861.9

TasWater's proposed capex allowance is significantly higher than approved by the Regulator under the previous determination by around \$70 million a year, or the equivalent of \$280 million over the fourth regulatory period.

4.3.1 Prudence, efficiency and the Regulator's capex allowances

Proposed capex is assessed as prudent if:

- it could be reasonably expected or required by an operator exercising good industry practice; and/or
- is consistent with delivering the required service levels, outputs and obligations over the relevant regulatory period.

Proposed capex is assessed as efficient if it is considered to be the minimum level of expenditure that is required to deliver a desired outcome or result consistent with an operator exercising good industry practice. That is, capex is efficient if it represents the most cost effective way of providing the relevant services.

The Regulator expects TasWater to develop and manage a prudent and efficient capex program that allows it to provide regulated services to its customers, while improving its compliance with its health, environmental and dam safety obligations.

The Regulator does not impose a limit on TasWater's capex. Rather, based on its assessment of TasWater's proposed capex applying the prudence and efficiency tests, the Regulator approves a capex allowance. This includes recognising commitments TasWater has made to the industry regulators (see Appendix C of this Report). It is, however, up to TasWater to decide how much it spends and which projects it invests in.

TasWater may spend more than the amount that the Regulator allows, or invest in projects that have not been included in the relevant capital allowance. Provided that expenditure is found in future price determination investigations to be prudent and efficient, the amount expended is included in TasWater's RAB in future years and TasWater can then receive a return on that expenditure and a depreciation allowance on the assets.

4.4 Assessment of TasWater's capex

In the Draft Report, in determining whether TasWater's proposed capex program for the fourth regulatory period is prudent and efficient, the Regulator considered the reasons and evidence TasWater provided in support of its capex priorities, and whether TasWater's proposed timeframes for delivery of its capex program are reasonable considering its past capex delivery. The Regulator also considered

how TasWater has prioritised capex projects after taking into account the requirements of other industry regulators and whether TasWater’s asset planning and asset management reflect best practice.

Proposed capex was assessed as to whether the expenditure is supported by a business case or other relevant information that demonstrates the proposed expenditure is both prudent and efficient, and consistent with TasWater’s longer-term plans.

This required the Regulator to examine aspects of TasWater’s capex program for the third regulatory period, focussing on:

- whether there was a need for TasWater to spend the amounts it did (was its capex prudent?);
- whether TasWater followed the most cost effective approach to achieving its desired outcomes (was its capex efficient?); and
- whether TasWater was able to deliver its capex program consistent with expected timeframes.

4.5 Engagement of external consultants

The Regulator engaged CCGUS to independently analyse and provide an opinion on TasWater’s actual and budgeted capex for the third regulatory period and its proposed capex for the fourth regulatory period. CCGUS also reviewed TasWater’s asset management, capital planning and prioritisation, and capital expenditure governance frameworks. This chapter references CCGUS’ key findings. CCGUS’ Final Report is available on the Regulator’s website at: [2022 Water and Sewerage Price Determination Investigation](#).

4.6 Regulator’s draft assessment of TasWater’s asset management, capital planning and prioritisation and capex governance frameworks

The Regulator noted CCGUS’ findings in relation to TasWater’s asset management, capital planning and prioritisation, and capital expenditure governance frameworks. The overall objective of this aspect of the review was to evaluate TasWater’s strategic planning and governance framework and to inform the Regulator’s assessment of the prudence and efficiency of actual and proposed capex. As part of its review of the selected projects, CCGUS also assessed whether there were any systemic issues with TasWater’s frameworks.

The Regulator also supported CCGUS’ recommendations in its draft report²² and, in particular, the importance of streamlining and refining the existing frameworks in alignment with the CDO’s processes to enable clear and transparent planning and decision making.

In the Draft Report, the Regulator expected TasWater to implement CCGUS’ recommended improvements in relation to its asset management, capital planning and prioritisation, and capital expenditure governance frameworks by the time the next price determination investigation is conducted.

To ensure that these improvements are progressed by TasWater in a timely manner, in the Draft Report the Regulator set out its intention to require TasWater to provide regular progress reports during the fourth regulatory period.

²² CCGUS’ Draft Report, page 62-63. These recommendations are also in the CCGUS Final Report.

4.6.1 Other asset planning issues

The Regulator recognises the legacy issues caused by the previous individual council ownership of water and sewerage assets which has resulted in assets being duplicated in adjoining municipalities. TasWater still has a large number of assets, including separate water supply systems, spread over a wide area though its focus has increasingly been on regional planning when developing its capital program (for example, the North West Water Supply Strategy).

However, in the Draft Report the Regulator raised concerns about the lack of inter-connectivity between TasWater's water supply networks. The issue is that if there is an outage at a major water treatment plant, or there is a shortage of sourced water in any one system, there may be no alternative source of supply for customers in that area and water restrictions may be imposed.

The Regulator considered that TasWater should seek to reduce the incidence of water restrictions, which includes assessing opportunities for increasing connectivity between water supply networks. In the Draft Report, the Regulator also sought details from TasWater of the outcomes from any assessments that TasWater had conducted.

4.6.1.1 Submissions on Draft Report

In its response, TasWater stated that inter-connectivity is one option investigated when considering upgrades or renewals of water systems as part of its capital planning processes. TasWater also stated that that interconnection on its own does not reduce the likelihood of water restrictions, and that supply side constraints must be addressed to improve water security ie interconnectivity between water supply systems may not improve water security / reduce water restrictions if the second interconnected system does not have sufficient water to supply the first interconnected system. TasWater provided the Regulator with a copy of its water surety strategy but did not provide details of any assessments TasWater had carried out where inter-connectivity had been investigated.

4.6.1.2 Regulator's conclusion

The Regulator notes TasWater's response and does not intend taking any further action on this issue.

4.7 Capital Delivery Office

TasWater's Capital Delivery Office commenced operating in July 2019. At the start of the Regulator's investigation, the CDO had therefore been in operation for approximately two years. The arrangement was formalised with TasWater's alliance partners UGL Engineering and CPB Contractors and their sub-alliance partner WSP through a Program Alliance Agreement (PAA) that was scheduled to expire on 30 June 2023. In February 2022, TasWater exercised its option to extend the agreement, with the agreement now expiring on 30 June 2025.

Initially the CDO was responsible for managing all capital infrastructure projects but this was subsequently changed such that the CDO manages the larger, more complex projects. On this basis, the CDO will be responsible for \$710 million of the proposed capital expenditure for the fourth regulatory period of \$901 million²³, with TasWater managing smaller less complex projects not requiring the same level of expertise and governance.²⁴

²³ CCGUS' Draft Report, page 62. These recommendations are also in the CCGUS Final Report.

²⁴ TasWater's proposed PSP, page 13.

The CDO is involved in program management, planning and investigation, project development and project delivery²⁵ but does not generally carry out any construction activities even though it has the capacity to do so under the PAA in very limited circumstances.²⁶

In its proposed PSP and in information supplied to the Regulator during the investigation, TasWater stated that:

The CDO model for capital delivery using alliance partners ... was set up to confidently deliver TasWater's accelerated capital program in the most reliable, efficient and value-adding manner available after extensive research and an evaluation process of possible delivery models. This included a reference exercise evaluating the learnings from other major Australian water utilities using an alliance-style delivery model. While many of the delivery models adopted by other water utilities in Australia are not labelled as alliances, such a delivery model is common throughout Australia's water industry.²⁷

4.7.1 CCGUS' review

The Regulator required CCGUS to examine the operation of TasWater's CDO and in particular to review and report on the CDO's performance for the 2019-20 and 2020-21 financial years and assess the CDO's progress towards achieving the objectives identified in the Business Case approved by TasWater's Board that led to the establishment of the CDO.

In its Draft Report, CCGUS made the following findings in relation to the CDO:

- the hourly charge rates by person and position are reasonable and the margins identified in the PAA are reasonable and in line with current industry practice;
- "...the CDO delivery of Strategic Business Cases (SBC), Detailed Business Cases (DBC) and Total Outturn Cost (TOC) documentation is very comprehensive, and where completed, provides considerable assurance to the Gateway decision makers that the best outcome for customers has likely been identified and where delivered effectively through the procurement and delivery management, should provide cost efficiency."
- "At present, the Review Team is unable to draw a conclusion on whether or not the CDO implementation has improved TasWater's capex delivery efficiency during a surge in capex, however the indications are that it is having a positive effect."²⁸

4.7.2 Regulator's assessment

As set out in the Draft Report, according to information provided to the Regulator by TasWater, the costs associated with the CDO's operations are expected to total \$36.8 million between 1 July 2019 and 30 June 2024 with the annual Program Management Budget under the Agreement of approximately \$9 million comprising:

- direct costs for alliance partners and TasWater staff;
- a risk allowance; and
- an Alliance Contractor fee.

²⁵ TasWater's proposed PSP, page 106.

²⁶ TasWater, Submission to Regulator's Draft Report, page 24.

²⁷ TasWater's proposed PSP, page 128.

²⁸ CCGUS' Draft Report, page 8. These recommendations are also in the CCGUS Final Report.

Based on CCGUS' findings and its own analysis, the Regulator considered the costs associated with the CDO were not unreasonable given the positive impact the CDO appears to be having on the delivery of TasWater's capital program. In the Draft Report, the Regulator also stated that it intended conducting an ex-post review in 2025-26 as part of the next pricing investigation, to assess over a longer period of time, the CDO's performance.

The PAA also allows for fee modifiers such as gain-share and pain-share adjustments:

"... alliance contracting is underpinned by a risk and reward compensation regime. This means that parties equitably share in the financial "gain" of a project's success or the financial "pain" of a project's underachievement. All parties to the contract therefore have a shared interest in the overall success of the project."²⁹

TasWater has advised that, under the PAA, TasWater and its Alliance Partners share one half of the gain if a project is delivered under budget, ie the Alliance Partners receive the original fee plus one half of the underspent amount up to the maximum of the original fee. However, if a project costs more than budgeted, the Alliance Partners' fund one half of the overspent amount up to the amount of the original fee, with TasWater funding the remaining overspent amount.

With respect to these fee modifiers, the Regulator intended requiring TasWater to include only those costs that it actually incurs when capitalising CDO-related expenditure and including that expenditure in its RAB.

TasWater also advised the Regulator that the CDO's costs are not capitalised until the relevant project is completed and commissioned. The Regulator considered this treatment to be appropriate.

Noting that the CDO has been operating for less than three years and CCGUS' findings, the Regulator's draft assessment for the fourth regulatory period, as set out in the Draft Report, was that the costs associated with TasWater's CDO are prudent and efficient.

4.8 Actual capex for the third regulatory period

As explained in the Draft Report, TasWater's PSP for the third regulatory period indicated forecast capex of \$475.6 million (\$2021-22) for the third regulatory period to 30 June 2021. TasWater's actual capex for this period was \$446.4 million (\$2021-22), lower than the Regulator's allowances by approximately \$29.1 million, or 6 per cent.

TasWater developed its capex program for the third regulatory period using a prioritisation process aligned with its Long Term Strategic Plan (2018-2037). The process sought to identify the most efficient combination of projects to deliver upon customer promises and outcomes, reflecting the relative priorities of each.

TasWater also reported an additional category labelled 'various' which was not considered during the 2018 price investigation and totals \$10.0 million over the third regulatory period. TasWater advised that these costs relate to the CDO's program management overheads, which have been distributed across all projects and therefore relate to a number of the cost drivers. This expenditure was assessed by CCGUS as prudent and efficient.

TasWater's proposed PSP for the fourth regulatory period attributed the reduction in spending during the third regulatory period to delays in major compliance projects (Bryn Estyn WTP Major Upgrade, Pardoe Sewer Improvement Project and the Forth WTP Upgrade).

²⁹ Walsh, P., www.constructionblog.practicallaw.com/painshare-and-gainshare-provisions-in-alliancing-contracts-the-benefits-of-pulling-together/, 30 November 2015.

To compensate for this reduction, expenditure on major renewal projects (assets that have exceeded end of life) were brought forward (\$88.8 million higher than allowed for by the Regulator for the third regulatory period), and additional funds were expended on growth projects (\$37.9 million higher) and service improvement projects (\$21.1 million higher). CCGUS' review of this aspect of TasWater's capex for the third regulatory period found the reprioritisation of expenditure to be prudent.³⁰

TasWater also provided figures to the Regulator demonstrating how the major cost drivers of its capex program changed during the third regulatory period and how its actual capex related to its various service delivery areas, as shown in Table 4.2.

Appendix 11 of TasWater's proposed PSP provides a full list of capex projects for the third regulatory period.

Table 4.2 Comparison of TasWater's actual capex and the Regulator's approved capex by cost driver for the third regulatory period (\$million) (\$2021-22)

Cost Driver	Regulator approved capex	Actual capex	Change
Growth	1.1	39.0	37.9
Asset renewal	67.5	156.3	88.8
Regulatory compliance	349.6	162.7	-186.9
Service improvement	57.4	78.5	21.1
Various	10.0	10.0
Total	475.6	446.5	-29.1

Source: CCGUS' Draft Report, Figure 3-2, page 84.

4.8.1 CCGUS' findings - third regulatory period capex

CCGUS completed an ex post assessment of the following three projects:

- Pardoe Sewer Improvement Plan;
- Bryn Estyn WTP Major Upgrade; and
- North West Water Supply Strategy (formerly the Forth WTP Upgrade).

These projects were not completed during the third regulatory period due to delays, and are now either due for completion or will commence in the fourth regulatory period. CCGUS found that the Bryn Estyn and the North West Water Supply Strategy projects were prudent and efficient. TasWater did not proceed with the Pardoe SIP as it concluded that prudence and efficiency could not be proven at the time.³¹ Descriptions of each of these projects and programs and the detailed findings are provided in Section 3.6.2 of CCGUS' Draft Report. CCGUS' prudence and efficiency findings are summarised in Table 4.3 below.

Expenditure originally committed to the above projects was re-prioritised during the third regulatory period, which allowed TasWater to generally meet its service performance targets, and to avoid future renewals expenditure.

CCGUS accepted that total actual capex in the third regulatory period was prudent and efficient as:

³⁰ CCGUS' Draft Report, pages 88-89. This finding is also in the CCGUS Final Report.

³¹ TasWater, Submission on Regulator's Draft Report, page 24.

- actual expenditure was lower than the allowance set in the 2018 determination;
- service performance targets have generally been met, and in some cases, exceeded; and
- the deferral of compliance expenditure was prudent, as was TasWater’s reprioritisation of renewals works.

4.8.2 Regulator’s draft assessment - third regulatory period capex

In the Draft Report, the Regulator, having reviewed CCGUS’ findings, stated that it intended accepting them, noting that while there was a capex underspend, the reprioritised expenditure for the third regulatory period was found to be prudent and efficient.

In relation to the reprioritisation of expenditure during the period, the Regulator recognised the fluid nature of capital projects and of water utilities’ (including TasWater’s) capital programs and the need to reprioritise due to internal and external factors, notwithstanding that reprioritisation of expenditure must meet the prudence and efficiency tests.

The Regulator noted that in calculating the RAB values, TasWater had used actual capex for the third regulatory period, and therefore no reduction in the RAB is required for the fourth regulatory period to clawback the underspend and ensure TasWater only receives a return on capex it has actually incurred.

4.9 Review of proposed capex for the fourth regulatory period

4.9.1 CCGUS’ findings on prudence and efficiency

As detailed in its Draft Report, CCGUS reviewed 15 of TasWater’s major capital projects/programs for the fourth regulatory period. For each of these sample projects, CCGUS relied on the information set out in TasWater’s proposed PSP and information supplied by TasWater in response to information requests to demonstrate the application of its decision-making processes.

Where CCGUS was unable to determine an efficient level of expenditure for a project, this expenditure has been categorised as “at risk”, and is included in CCGUS’ “expenditure ceiling” which takes into account CCGUS’ recommended adjustments to TasWater’s proposed capex.

Descriptions of each of these projects and programs and the detailed findings are provided in Section 3.6.2 of CCGUS’ Draft Report. These are unchanged in the CCGUS Final Report. CCGUS’ findings on prudence and efficiency are summarised in Table 4.3 below.

CCGUS’ detailed project reviews concluded that \$24.0 million of expenditure should not be included in TasWater’s RAB as a result of the application of the prudence and efficiency tests. Further, \$139.5 million was considered to be “at risk” pending the provision of additional information. CCGUS further recommended that the \$139.5 million be included in capital expenditure estimates for the fourth regulatory period, but be subject to an ex-post review where expenditure not deemed to be prudent and efficient would be removed from the RAB as part of the price investigation for the fifth regulatory period.³²

³² CCGUS’ Draft Report, Tables 3-71 and 3-72, page 205.

Table 4.3 Summary of CCGUS' findings on prudence and efficiency for sampled capex projects

Project / Program	Prudent?	Efficient?
Water		
North West Water Supply (NWWS) Strategy (previously Forth WTP Upgrade)	✓	✓
Bryn Estyn WTP Major Upgrade	✓	✓
Launceston Water Supply Surety	✓	x ¹
Water Mains Renewal Program	✓	✓
Metering Program	✓	✓
Sewerage		
Launceston Sewer Improvement Plan (LSIP)	✓	x ¹
Macquarie Point Sewer Treatment Plant Relocation	✓	x ¹
Hobart Sewer Improvement Plan	✓	x ¹
Sewer Treatment Plant Renewals Program (including mains)	✓	✓
Pardoe Sewer Improvement Plan	✓	x ¹
Dual function		
Non-network IT	✓	✓
IT business initiatives	x	x
Non-network other - Fleet	✓	x ¹
SCADA Program	✓	✓

Note: 1. CCGUS recommended that *some* expenditure not be included as efficient for these projects/programs.

4.9.2 CCGUS' findings on deliverability

In relation to the deliverability of TasWater's proposed capex program (and noting the substantial additional third party financed capex estimated at \$296 million for the fourth regulatory period), as set out in its Draft Report, CCGUS found that:

- TasWater and the CDO are very aware of the potential constraints which may arise within Tasmania with respect to contractor availability. Ultimately it is only possible for TasWater to seek to reduce the risk of delivery constraints arising from supply side issues.
- It will be more evident whether there is a concern for capex delivery around the mid-point of the fourth regulatory period, at which time CCGUS recommended continuation of regular reporting by TasWater to the Regulator on its capex performance, as has been the recent approach.³³

CCGUS identified that while TasWater's recently improved capital planning and delivery systems and processes give some confidence in its ability to deliver a significantly larger proposed capital program, some concerns remain regarding available capacity within the local construction contractor market.³⁴

³³ CCGUS' Draft Report, pages 66-67. This recommendation is also in the CCGUS Final Report.

³⁴ Ibid, page 66.

CCGUS also concluded that TasWater’s flexible procurement processes and regionalisation of projects, alongside hands-on and proactive project management techniques used by the CDO, support the expansion of the local contractor market from both a capability and capacity point of view, maximising the chances of efficient delivery of a large capital program.³⁵

4.10 Regulator’s assessment - fourth regulatory period

4.10.1 Prudency and efficiency findings

In the Draft Report, in relation to “at risk” expenditure, the Regulator noted that the two largest projects, the Hobart Sewer Improvement Plan and the Launceston Sewer Improvement Plan, are in the early stages of the capital planning process. As a result, strategic business cases and detailed business cases are yet to be developed, and therefore, detailed information about those projects could not have been available for CCGUS’ review.

In its Draft Report, the Regulator did not consider that information deficiencies should be used as the basis for reducing TasWater’s proposed capex, particularly where projects are in the early stages and information is not yet available.

Over the course of the fourth regulatory period, much of this information is expected to become available and these projects will have progressed. When the next price investigation is conducted, the Regulator assessed that it will be well placed to assess, ex-post, whether this capex has been prudent and / or efficient.

4.10.2 Deliverability

In its Draft Report, the Regulator made a draft decision to reduce TasWater’s total proposed capex allowance by 5 per cent (\$45.4 million over the fourth regulatory period) rather than reduce expenditure on specific projects. The Regulator made this draft decision due to concerns about TasWater’s capacity to deliver its proposed capital program, which was significantly larger than in the past. TasWater also has a record of not meeting proposed capex levels in earlier regulatory periods.

The Regulator acknowledged and accepted CCGUS’ findings with respect to the potential for the CDO to assist with the delivery of major projects. However, the Regulator notes that many delays to major projects have been due to factors that are largely or wholly outside TasWater’s control. The Regulator considered that, over the fourth regulatory period, there is a strong likelihood that some planned capex will not proceed as planned due to factors that are, at least in part, outside TasWater’s control.

The Regulator’s Draft Report stated that it intended continuing to require six monthly progress reports from TasWater on its capital program in accordance with current practice.

4.10.3 Pioneer water supply

In early 2020, the Regulator advised the Director of Public Health that it intended to review the prudency and efficiency of TasWater’s proposal to address the issues with the water supply at the township of Pioneer in the State’s north east.

³⁵ CCGUS’ Draft Report, page 9.

The Regulator’s review of the detailed business case for this project found:

- the project is forecast to cost \$4.7 million (ie in excess of \$110 000 per connection); and
- TasWater is yet to reach agreement with Tasmanian Irrigation to access the water required to supply Pioneer via the proposed pipeline.

Given TasWater’s obligations as they relate to water supply at Pioneer, in the Draft Report the Regulator was satisfied that the preferred option of providing reticulated water supply appeared sound and, according to the analysis set out in the detailed business case, would deliver the best overall outcomes.

On this basis, in the Draft Report the Regulator considered that the proposed expenditure was prudent and efficient and intended to accept TasWater’s proposal. The Regulator noted that, as with many other projects, it is likely there will be an ex-post review of the expenditure as part of the next pricing investigation.

4.10.4 TasWater’s capex allowance for the fourth regulatory period

In the Draft Report, the Regulator noted that CCGUS recommended adjustments to proposed capex on individual projects and has treated other proposed capex as “at risk” subject to the provision of additional information.

However, in its Draft Report the Regulator considered it was more appropriate to make a global adjustment to TasWater’s proposed regulated capex, rather than adjusting proposed expenditure on individual projects. This recognised the fluid nature of TasWater’s capital program as evidenced in previous regulatory periods where TasWater has reprioritised its expenditure in response to internal and external factors.

Due to the Regulator’s concerns about the size of TasWater’s capital program and the issues identified by CCGUS regarding the efficiency of some proposed capex, in its Draft Report the Regulator stated its intention to not accept five per cent of TasWater’s proposed regulated capex in each year of the fourth regulatory period.

The Regulator also expected that capex undertaken during the fourth regulatory period, particularly capex assessed as “at risk” by CCGUS, will be examined in depth under the prudence and efficiency criteria in the next price investigation. Conversely, if over the fourth regulatory period, TasWater reprioritises expenditure on other projects or programs not assessed as part of this price investigation, these will be assessed against the prudence and efficiency criteria by the Regulator in the next investigation.

4.10.4.1 Submissions on Draft Report

TasWater³⁶ and LGAT³⁷ raised concerns about the impact of the Regulator’s draft decision to reduce TasWater’s proposed capex.

TasWater’s submission on the Regulator’s Draft Report referred to the recent acceleration in its capital program delivery and the positive impact the CDO was having on delivery and to the negative impacts of reducing its capex allowance on achieving compliance outcomes and customer service outcomes. TasWater also claimed that it would have to delay some capital projects if its proposed allowance were reduced.

³⁶ TasWater’s submission on the Regulator’s Draft Report, pages 6-9.

³⁷ Local Government Association of Tasmania’s submission on the Regulator’s Draft Report, pages 2-3.

LGAT considered it unreasonable to reduce TasWater's capex and that a better approach would be to assess the prudence and efficiency of TasWater's capex as part of the next investigation in 2025-26.

4.10.4.2 Regulator's analysis

TasWater's proposed capex, including third party capex, is substantially greater than its capex to date at around \$1.2 billion over four years (around \$900 million in regulated capex and \$300 million in third party capex).

The Regulator does not agree with TasWater's statement asserting that its capacity to roll out its capex is limited by the Regulator's capex allowance. The allowance is determined only as an input into setting prices; it does not limit TasWater's actual capex. If found, ex-post, to be prudent and efficient, any additional capex above the allowed level will be included in TasWater's asset base after the fourth regulatory period. The maximum prices in future periods would include a return on that capex, as well as depreciation.

If, over the fourth regulatory period, TasWater does actually deliver the level of capex it proposes, maximum prices over that period would, in retrospect, have been too low. This is because they would not have accounted for a return on the excluded capex or the depreciation costs relating to that capex. However, with price increases capped at 3.50 per cent, prices for the fourth regulatory period will not be set at a level that allows TasWater to recover all its efficient costs.

It follows that if TasWater's price increases are constrained by the price increase cap, a decision to not include \$45 million of capex will also not affect the capacity of TasWater to borrow sufficient funds for that additional investment.

In past regulatory determinations, as the actual level of capex has been below the level approved by the Regulator, in retrospect the maximum prices in these determinations were above the level required for TasWater to recover its actual efficient costs. However, in practice, this has had no effect on actual prices as they have always been set by TasWater below the maximum prices approved by the Regulator.

TasWater further advised the Regulator on 4 April 2022 that year-to-date capex as at 28 February 2022 was \$152.2 million³⁸ and stated that:

Typically, over the past eight months as indicated, we have been within 5% of our forecasts.

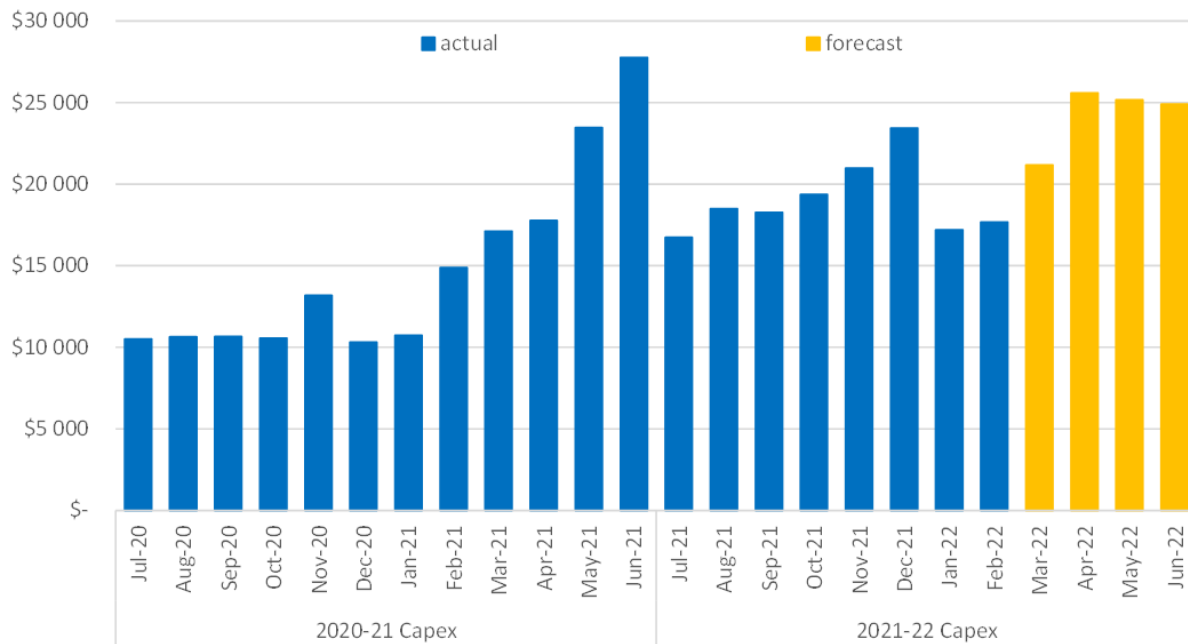
Overall, the FY2021/22 capital expenditure forecast is currently \$249.0M against a budget of \$229.9M. This forecast has slowly increased across the financial year as we had more confidence in our ability to deliver above our FY22 budget set in March 2021.

This figure is reported as our most likely expenditure for the year and includes the externally funded projects. With an increase in sophistication of our reporting systems and processes, we now also capture a best and worst-case scenario in our internal reporting. Positively, our worst-case scenario still achieves our budget target and our focus has been on managing our best-case scenario which is forecast slightly above \$250M.

The following chart sets out actual monthly capex (regulated and third party) from July 2020 to February 2022 and forecast monthly capex for March 2022 to June 2022.

³⁸ Of the year to date expenditure, 96 per cent relates to regulated capex (remaining 4 per cent to externally funded projects) and 75 per cent relates to projects as opposed to programs.

Figure 4.1 Actual monthly capex (regulated and third party) from July 2020 to February 2022 and forecast monthly capex from March 2022 to June 2022 (\$'000)



Source: TasWater response to request for information, 4 April 2022.

Based on TasWater's advice, capex is expected to reach, as a best case, \$250 million for 2021-22. However this is still \$50 million short of the average expenditure required of almost \$300 million for the fourth regulatory period. Furthermore, this estimate is based on above-average levels of capex for the remaining four months.

In response to LGAT's suggestion that the Regulator not reduce TasWater's proposed capex and assess prudence and efficiency of that expenditure ex-post during the next investigation, the Regulator notes that this assessment would occur in any case as part of the capex review during the next investigation.

4.10.4.3 Regulator's decision

The Regulator has decided to retain the Draft Report decision to accept 95 per cent of TasWater's proposed annual capex.

Having considered the issues TasWater and LGAT raised about the Regulator's draft decision to reduce TasWater's proposed capex, the Regulator is still concerned about the relative size of TasWater's proposed capital program compared to previous programs. The Regulator considers this reduction to be modest, given the size of TasWater's overall capital program.

This decision therefore reflects the Regulator's assessment that, based on past experience and despite recent developments, TasWater's may not be able to deliver all of its very ambitious capital program as forecast.

The Regulator also notes that the capital expenditure allowance does not limit the amount TasWater can spend on capital projects or dictate the specific projects TasWater can invest in during the fourth regulatory period.