

EXECUTIVE SUMMARY

This Final Report presents the outcomes from the Regulator's price determination investigation into TasWater's proposed prices and services for the fourth regulatory period.

The Regulator has determined maximum prices, based on an assessment of TasWater's efficient costs, which are equivalent of annual price increases of 3.71 per cent for each year of the fourth regulatory period. The price increases are due to TasWater's very large capital expenditure programme and its associated operating costs, and recent increases in the cost of debt and inflation.

The increase is much less, however, than TasWater's estimate of a 6.5 per cent annual increase to achieve full cost recovery by 2025-26. This is because the Regulator has reduced the allowed costs in several areas, including the return on TasWater's capital.

On 1 May 2018, TasWater signed a Memorandum of Understanding with the Tasmanian Government and the TasWater's Owners' Representatives Group which included TasWater's commitment to limit any annual price increases to 3.5 per cent to 2024-25. Consistent with the MOU, TasWater has proposed price increases of 3.5 per cent, including for the additional year of 2025-26.

As TasWater's 3.5 per cent increase is below the Regulator's price increase, the Regulator expects TasWater to increase its prices by 3.5 per cent in 2022-23 and the following three years. TasWater is required to submit by 7 June 2022 an updated price and service plan that reflects the decisions set out in the Regulator's Final Report and Determination. The Regulator will approve TasWater's Plan in late June 2022.

Background

Under the *Water and Sewerage Industry Act 2008* (Industry Act), the Regulator is responsible for the regulation of TasWater's water and sewerage services. The Regulator's price regulation activities are based on the legislated pricing principles set out in the Industry Act.

Under the Industry Act, TasWater is required to submit a proposed Price and Service Plan (PSP) for the forthcoming regulatory period, from 1 July 2022 to 30 June 2026. The Regulator will approve the final Price and Service Plan once it is satisfied it meets all the requirements of this Final Report and the Regulator's Price Determination.

The legislative and regulatory requirements for this investigation, and information about other industry regulators is provided in Appendices B and C of this Report.

The Regulator's purpose in conducting this investigation is to determine the appropriate prices and service levels for regulated water and sewerage services that will apply to TasWater during the fourth regulatory period. Appendix C of this Report sets out the context for this investigation.

TasWater owns, controls and operates water supply and sewerage systems in Tasmania. It manages all aspects of the water supply chain from dams and reservoirs to customer property connections and from customer sewer connections to wastewater treatment and disposal. As the primary provider of water and sewerage services in Tasmania, TasWater is subject to various public health, environmental and customer service regulatory requirements.

The Regulator determines maximum prices for TasWater’s services that will provide TasWater with sufficient revenue to:

- maintain financial sustainability; and
- fund its proposed capital expenditure (capex) program, including its initiatives to improve its compliance with required health, environmental and dam safety standards without imposing unacceptable price increases on customers.

In its preparing this Report and the Price Determination, the Regulator has considered submissions in response to the Regulator’s Draft Report from TasWater and other stakeholders. A summary of the issues raised in the submissions is attached to this Report as Appendix A. The submissions are also available on the Regulator’s website.

Prices

The Regulator’s decisions on TasWater’s approved costs, as set out below, would result in maximum annual uniform price increases of 3.71 per cent over the fourth regulatory period.

In its Draft Report, the Regulator calculated that annual price increases of 3.07 per cent over the fourth regulatory period would be required for TasWater to recover its efficient costs. The increased maximum prices approved by the Regulator in this report are mainly due to changes in some financial indicators such as interest rates and inflation forecasts.

The following tables present the actual prices for 2021-22 and the maximum annual prices for the major regulated services.

TasWater’s maximum fixed water charge per 20mm connection for full service customers (\$)*

2021-22	2022-23	2023-24	2024-25	2025-26
354.96	368.13	381.78	395.94	410.63

*The fixed water charge for each connection size is calculated by multiplying the fixed water charge for a 20mm water connection by the relevant multiplier as shown in Table 8.1 in Chapter 8.

TasWater’s maximum variable water charge per kilolitre of water for full service (ie water of drinking water quality) (\$)

2021-22	2022-23	2023-24	2024-25	2025-26
1.10	1.14	1.18	1.23	1.27

TasWater’s maximum fixed sewerage charge for full service customers per ET (\$)*

2021-22	2022-23	2023-24	2024-25	2025-26
681.20	706.46	732.66	759.84	788.02

*The target fixed sewerage charge for each connection is calculated by multiplying the target fixed sewerage for one ET by the applicable number of ETs. Multipliers and ETs are discussed in Chapter 8.

As at 1 July 2021, there were approximately 3 100 customers paying less than standard water and sewerage prices. The Regulator has decided to accept TasWater’s proposal to move these customers to standard prices by the second year of the fourth regulatory period ie by 2023-24.

Revenue requirement

The Regulator has used a building block approach in calculating TasWater’s revenue requirement, or Notional Allowable Revenue. The purpose of the Notional Allowable Revenue is to determine the maximum prices that TasWater may charge for regulated water and sewerage services for each year of the fourth regulatory period.

Under the building block approach, the efficient costs of the activities needed to provide water and sewerage services to customers are added together to determine TasWater’s revenue requirement.

The cost components, or building blocks, are:

- operating expenditure (opex) (Chapter 5 of this Report);
- return of capital (regulatory depreciation) (Chapter 6);
- tax allowance (Chapter 2);
- inflation offset (Chapter 2); and
- return on capital (Chapter 7).

The key inputs used in calculating the building blocks are:

- capital expenditure (capex) (Chapter 4);
- the values of the Regulatory Asset Base (RAB) (Chapter 2); and
- the Weighted Average Cost of Capital (WACC) (Chapter 7).

The maximum prices for regulated water and sewerage services in Tasmania are then determined such that TasWater’s total revenue from providing these services, using the annual demand forecasts, is equal to the Notional Allowable Revenue. The Regulator does not set any limit on TasWater’s actual revenue; the only limits apply to TasWater’s prices.

The Notional Allowable Revenue estimates prepared by TasWater and determined by the Regulator are set out below, expressed in current dollars.

TasWater’s NAR from its proposed PSP (\$000s)

Building block component	2022-23	2023-24	2024-25	2025-26
Return on capital - existing	92 746	92 050	91 347	90 870
Return on capital - new	82 655	94 272	105 100	114 679
Depreciation	102 761	108 828	115 237	124 821
Inflationary gain	-54 792	-67 432	-80 983	-94 952
Opex	200 066	206 065	213 533	220 722
Tax	0	0	0	0
Total	423 436	433 783	444 234	456 140

TasWater's NAR as approved by the Regulator (\$000s)

Building block component	2022-23	2023-24	2024-25	2025-26
Return on capital - existing	89 734	90 653	91 399	92 121
Return on capital - new	82 419	91 220	100 712	110 565
Depreciation	104 208	108 836	115 765	126 998
Inflationary gain	-126 702	-133 297	-139 337	-146 494
Opex	205 054	211 669	219 132	226 815
Tax	0	0	0	0
Total	354 713	369 082	387 670	410 005

Summary of the impact of the Regulator's decisions on TasWater's NAR (\$000s)

	2022-23	2023-24	2024-25	2025-26	Total
Return on capital - existing	-3 012	-1 397	52	1 251	-3 107
Return on capital - new	-236	-3 052	-4 388	-4 114	-11 790
Depreciation	1 447	8	528	2 177	4 160
Inflationary gain	-71 910	-65 865	-58 354	-51 542	-247 671
Opex	4 988	5 604	5 599	6 093	22 284
Total	-68 723	-64 701	-56 564	-46 135	-236 124

The difference between TasWater's and the Regulator's NAR estimates is principally due to different estimates of the return on capital and different estimates of inflationary gain (highlighted in red).

In estimating the return on capital, if nominal values are used for interest rates and the rate of return on equity, as in this pricing investigation, it is necessary to deduct the impact of inflation from the value of capital for each year. Otherwise, TasWater would receive excessive returns as the impact of inflation on returns would be allowed for twice, once in interest rates and the rate of return on equity and also through the inflated capital values to which these rates are applied. This deduction from the nominal capital value is called 'inflationary gain'.¹ The higher the inflation rate applied for future years, the greater the inflationary gain.

The Regulator's inflation assumptions are based on very recent RBA forecasts and are significantly higher than TasWater's forecast inflation rates. TasWater prepared its Price and Service Plan around one year earlier, when economic conditions, including interest rates, and the forecasts of key economic indicators such as inflation, were significantly lower.

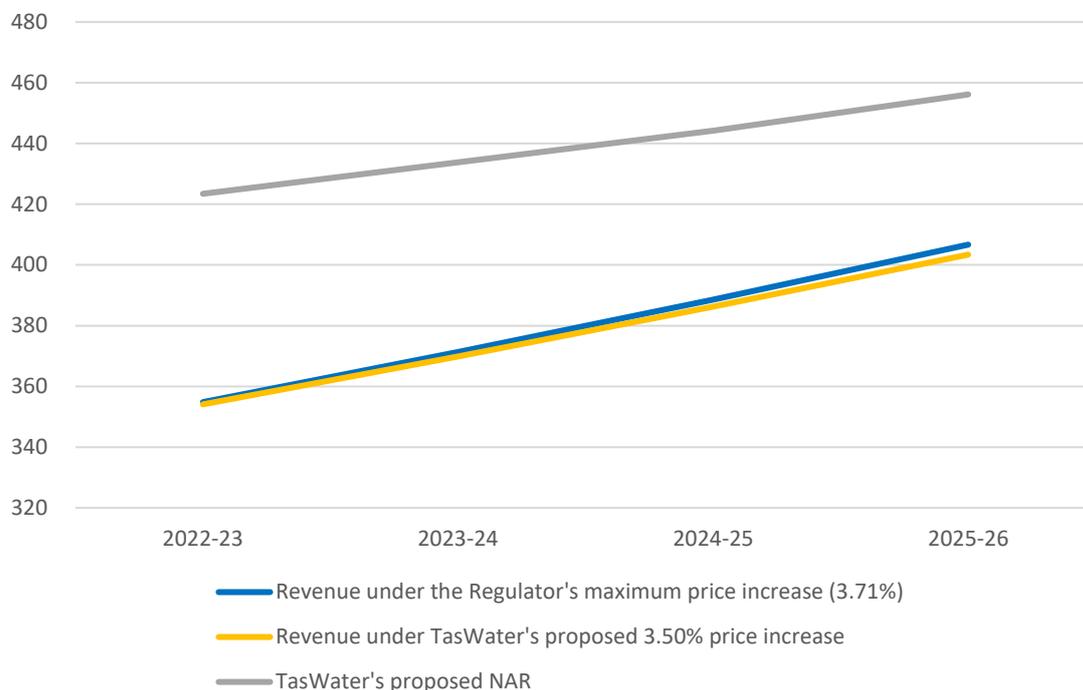
TasWater has advised that some elements of its proposed Price and Service Plan, including its inflation rate forecasts, would have been different if recent trends in inflation had been foreseeable at the time its proposed Price and Service Plan was prepared.

¹ If real or inflation-adjusted rates are used for the return on equity and debt, there is no deduction for the impact of inflation on capital values.

The chart below shows TasWater's annual revenue based on:

- TasWater's estimate of the price increase required to recover its NAR in 2025-26;
- TasWater's proposed 3.50 per cent price increase; and
- the Regulator's 3.71 per cent maximum price increase.

TasWater's revenue projections and notional revenue for the fourth regulatory period (\$ million)



Capital and operating expenditure

The Regulator engaged external consultants, a consortium comprising Carisbrooke Consulting Group, Utilities Regulation Advisory and Strategic Infrastructure Planning and Advice (CCGUS), to review TasWater's capex and opex. Copies of CCGUS' Draft Report and Final Report are available on the Regulator's website: www.economicregulator.tas.gov.au.

Higher rates of inflation account for most of the increase in TasWater's opex allowances from those in the Draft Report, from a total of \$793.4 million over the four years in the Draft Report to \$862.7 million.

The Regulator has included a 1.5 per cent annual productivity factor in determining TasWater's opex allowances, as included in the Draft Report. This is greater than the annual productivity factor proposed by TasWater of 1.1 per cent in its submission to the Draft Report.

TasWater proposed a total of \$907.3 million for capex relating to regulated water and sewerage services over the fourth regulatory period, a substantial increase, on an annual basis, from capex in recent years. In light of this large proposed increase and noting that that major projects can be delayed for reasons outside TasWater's control, the Regulator has accepted 95 per cent of TasWater's proposed capex allowance for each year of the fourth regulatory period.

The impact of the Regulator's decisions with respect to TasWater's opex and capex are set out in the following table.

Regulator's opex and capex for TasWater for the fourth regulatory period (\$million)

	TasWater proposal	Regulator's decision	Reduction
Capex	907.3	861.9	-45.4
Opex	840.5	862.7	+22.3

Chapters 4 and 5 of this Report set out the Regulator's analysis and decisions on TasWater's proposed capex and opex respectively.

Regulatory depreciation

The Regulator's decision is to continue to apply a value-weighted average approach to the calculation of regulatory depreciation for existing assets, which were those assets transferred to the regional water and sewerage corporations before 1 July 2011, and a line by line approach for all other assets (new assets).

The Regulator has also made the decision to reduce TasWater's proposed regulatory depreciation to account for variations between TasWater's Financial Model and its Asset Register and the flow on effects of the Regulator's decision on TasWater's proposed capex.

The Regulator will conduct an inquiry during the fourth regulatory period to address concerns about TasWater's approach to regulatory depreciation. The inquiry will, amongst other things, review the platform TasWater uses for its Asset Register and the assumptions that are used for the economically useful lives of TasWater's new assets, as explained in Chapter 6 of this Report.

Regulatory depreciation for TasWater for the fourth regulatory period (\$million)

	TasWater's proposal	Regulator's final decision	Changes
Existing Assets	205.3	213.4	+8.1
New Assets	246.4	242.4	-4.0
Total	451.7	455.8	+4.1

Return on Capital

The Regulator's decision is to apply a lower Weighted Average Cost of Capital (WACC) for new assets and a higher WACC for existing assets than TasWater proposed. As discussed above, the Regulator also set a much higher value for inflationary gain.

The following table compares TasWater's proposed WACCs to the WACCs determined by the Regulator.

Comparison of TasWater's proposed and the Regulator's WACCs

	TasWater's proposal	Regulator's decision
WACC _{EXISTING}	4.17%	3.79%
WACC _{NEW}	5.41%	5.28%

Applying the Regulator's proposed WACCs to its calculation of TasWater's RAB results in the Regulator's allowance for the return on capital of \$748.8 million for the fourth regulatory period. This is \$14.9 million lower than the return proposed by TasWater of \$763.7 million. The Regulator's

allowance for the return on capital equates to an annual average of \$187 million, compared to the annual average of \$149 million approved for the third regulatory period. These values do not include the impact of inflationary gain.

The cost of debt and the estimate of the risk-free interest rate have increased since the Regulator prepared its Draft Report, resulting in increases in the WACCs determined by the Regulator. Specifically, the WACC_{EXISTING} has increased from 3.63 per cent to 3.79 per cent and the WACC_{NEW} has increased from 4.75 per cent to 5.28 per cent.

Chapter 7 discusses the Regulator's decision on the WACC components in more detail.

Sewerage and trade waste pricing

The Regulator will conduct two pricing inquiries during the fourth regulatory period, one into TasWater's approach to sewerage charging and the second into trade waste charging. This is in response to submissions from stakeholders to this investigation and also arising from the Regulator's concerns that TasWater's current approach to pricing in these areas may not be sufficiently cost-reflective and equitable. It is expected that the results of the inquiries will inform the Regulator's assessment of TasWater's proposed approaches to charging for these services for the fifth regulatory period.

Regulatory compliance

TasWater is subject to regulation by three Tasmanian industry regulators, namely the Environment Protection Authority (EPA) for environmental management, the Director of Public Health for water quality and the Secretary of the Department of Natural Resources and Environment Tasmania (NRET) which is the Delegate for Dam Safety Regulation.

TasWater has liaised with these industry regulators in preparing its proposed PSP. The Regulator has also consulted with the industry regulators and is satisfied that TasWater's proposed PSP reflects their priorities and agreed compliance improvement outcomes.

Customer contract and policies

TasWater's proposed PSP for the fourth regulatory period included a draft customer contract and draft policies in relation to its proposed pricing for particular water and sewerage services, together with policies governing its interactions with customers.

Appendix D of this Report discusses the Regulator's assessment of TasWater's proposed customer contract and policies. The customer contract and policies approved by the Regulator are attached as Appendices E and F respectively of this Report.

Customer service

The Regulator sets customer service standards for TasWater. Each service standard has a minimum or target level of service for TasWater to achieve. In its proposed price and service plan, TasWater proposed changes to its service standards to reflect feedback from customers with regard to their preferences and service level expectations.

In its draft decision, the Regulator stated that it intended approving most of TasWater's proposed service standards as they were consistent with the regulatory requirements and were informed by the outcomes from TasWater's customer engagement. However, for some measures, the Regulator intended setting higher performance standards than TasWater proposed and required clarification from TasWater on how some of the standards are to be defined.

The only submission in response to the Regulator’s draft decision on service standards was from TasWater, which supported most of the Regulator’s draft decisions but did not agree with the Regulator’s draft decision to retain the service standard for unaccounted for water. TasWater also sought to retain its proposed service levels for water main breaks rather than the improved service levels in the Regulator’s Draft Report. After considering TasWater’s submission, the Regulator decided to set the service standards in these areas as in the Draft Report.

The Regulator’s decisions on customer service standards are set out in Chapter 10 of this Report and in Appendix G. TasWater’s Customer Service Code will be amended using fast-track provisions to reflect these decisions.