



**Tasmanian Water and Sewerage Industry**  
**2018 Price Determination Investigation**

**Consultation Paper on the**  
**Price and Service Plan Guideline**

**May 2016**

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# 1 INTRODUCTION

Early in the 2017-18 financial year, the Tasmanian Economic Regulator (the Regulator) will commence a review of the maximum prices TasWater (as a regulated entity) can charge for its water and sewerage services from 1 July 2018.<sup>1</sup>

The price determination investigation will begin when TasWater submits its proposed price and service plan for regulated services.

The Regulator will assess TasWater's proposed price and service plan in accordance with the regulatory framework for price determinations governing regulated entities as set out in the *Water and Sewerage Industry Act 2008* (Industry Act). The Regulator will also take into account the views of other stakeholders including TasWater's customers, industry regulators and other interested parties before making a price determination.

The Regulator is required under the Industry Act to issue guidelines to TasWater for the preparation of the entity's proposed price and service plan. The price and service plan guideline<sup>2</sup> (the Guideline) may:

- specify the requirements for TasWater to comply with when submitting its proposed price and service plan to the Regulator for approval; and
- specify the process for the preparation and approval of the proposed price and service plan, including the extent of public consultation and timelines and the subsequent publication of prices for each regulated service.

The purpose of this paper is to consult with stakeholders on the matters to be covered in the Guideline for the 2018 water and sewerage price determination investigation. The Regulator will consider feedback prior to releasing a final Guideline in June 2016.

In preparing the Guideline, the Regulator will have regard to:

- its overarching objectives in performing its regulatory functions under the *Economic Regulator Act 2009*;
- issues relating to price regulation as set out under Division 5 of the Industry Act; and
- placing particular emphasis on the matters set out in section 15 of the Industry Act.

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<sup>1</sup> The Regulator's most recent price determination for TasWater (2015) is scheduled to cease on 30 June 2018.

<sup>2</sup> The Guideline developed for the third regulatory replaces the Guideline developed for the second regulatory period.

The first part of this paper provides background on the purpose of the Guideline including legislative requirements and changes to the industry and regulatory framework since the last price determination investigation was completed.

The second part of the paper outlines the Regulator’s key considerations in the development of the Guideline and invites submissions from interested parties on the contents of the draft Guideline.

This paper must be read in conjunction with the draft Guideline.

Terms used in this paper have the same meaning as the equivalent terms in the draft Guideline.

To assist interpretation, the draft Guideline contains a glossary of terms used in the draft Guideline and in this Consultation Paper.

## 1.1 Responding to the draft Guideline

The Regulator invites written comments on the draft Guideline. Submissions will be considered prior to the draft Guideline being finalised and must be received by the close of business on 3 June 2016.

We would prefer to receive written comments by email to [office@economicregulator.tas.gov.au](mailto:office@economicregulator.tas.gov.au).

Written submissions and enquiries may be made to:

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The Regulator’s normal practice is to publish all submissions on its website unless the author of the submission requests confidentiality in relation to the submission (or any part of the submission). Any parts of a submission that the author has requested remain confidential should be submitted as a separate attachment to those parts of a submission that the author considers suitable for publication.

The Regulator will not publish submissions which contain material that the Regulator believes is, or could be, derogatory or defamatory.

If you would like further information on the treatment of confidential submissions, please refer to the Regulator’s *Policy on the treatment of confidential submissions* document on our website ([www.economicregulator.tas.gov.au](http://www.economicregulator.tas.gov.au)).

## 2 BACKGROUND

Independent regulation of water and sewerage prices in Tasmania commenced on 1 July 2012 with the first regulatory period covering the period from 1 July 2012 to 30 June 2015. The second regulatory period extends from 1 July 2015 to 30 June 2018, with the third regulatory period to commence on 1 July 2018.

The regulatory framework for the Tasmanian water and sewerage industry provides the Regulator with the power to regulate pricing and service standards to promote efficient long-term investment in water and sewerage infrastructure.

The regulated entity responsible for the provision of regulated water and sewerage services in Tasmania is currently the Tasmanian Water and Sewerage Corporation Pty Ltd (TasWater).

The Regulator and TasWater's obligations in relation to the regulation of prices and service standards are provided for in:

- the *Water and Sewerage Industry Act 2008* (Industry Act);
- the *Water and Sewerage Industry (Pricing and Related Matters) Regulations 2011* (Pricing Regulations); and
- the *Water and Sewerage Industry (Customer Service Standards) Regulations 2009*.

### 2.1 Legislative requirements

#### 2.1.1 The Industry Act

The Regulator has a statutory responsibility under section 66 of the Industry Act to make a price determination that applies to TasWater in respect of regulated services.

In making a price determination the Regulator must, amongst other things, consider a price and service plan submitted by TasWater; prepared in accordance with a price and service plan Guideline issued by the Regulator.

Section 65 of the Industry Act outlines the requirements for a price and service plan while the Guideline sets out other matters the price and service plan is to address. The Guideline also specifies the process for the preparation and approval of a proposed price and service plan, including the extent of public consultation and timelines and the subsequent publication of prices for each regulated service.

The Industry Act also includes pricing principles to apply in relation to the price for regulated services. However, an amendment to the Industry Act in July 2011 explicitly recognised that not all the pricing principles in the Industry Act would be achievable

immediately without adverse effects on customers and/or the previous regulated entities.<sup>3</sup>

Consequently, the Regulator has discretion in terms of the extent to which TasWater is required to comply with the pricing principles during the transition period.<sup>4</sup>

### **2.1.2 Matters to which Regulator is to have regard**

In performing functions and exercising powers under the Industry Act, the Regulator must seek to achieve the objective of the Industry Act and must have regard to the following matters (per section 15 of the Industry Act):

- (a) relevant health, public safety and environmental obligations;
- (b) the promotion of efficient long-term investment in water infrastructure and sewerage infrastructure, so as to achieve the lowest sustainable costs of the provision of water services and sewerage services;
- (c) the promotion of efficient pricing for regulated services;
- (d) the impact of the rate of change of prices for customers;
- (e) the maintenance of appropriate service standards for the provision of water services and sewerage services;
- (f) the avoidance of regulatory duplication, so far as is practicable, through appropriate consultation with, and data collection from, other relevant persons;
- (g) any matters relating to the water and sewerage industry prescribed in the regulations;
- (h) any other matters that the Regulator considers relevant.

### **2.1.3 The Pricing Regulations**

The Pricing Regulations cover the following matters:

- defining the maximum allowable revenue TasWater can earn;
- providing for the establishment of pricing zones<sup>5</sup>;
- requiring fixed and variable charges to be set on a cost reflective basis;
- limiting pass-through events to changed legislative requirements and/or tax events that materially affect TasWater;

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<sup>3</sup> The previous regulated entities were Ben Lomond Water, Cradle Mountain Water and Southern Water.

<sup>4</sup> The transition period is defined in the Pricing Regulations as the period from 1 July 2012 to 1 July 2020 inclusive.

<sup>5</sup> A pricing zone is a geographic area divided into zones according to the cost of supplying services in that zone. Different prices are charged for different zones but prices are the same within a zone. This is also referred to as 'nodal pricing'.

- outlining the structure and imposition of service introduction charges;
- outlining the structure and calculation of developer charges;
- defining, and explaining the treatment of, capital contributions;
- requiring a variable charge to be imposed on the volume of water supplied to a property;
- imposing variable charges on strata title schemes with a single meter and/or for common property; and
- clarifying that residential owners will be liable for both fixed and variable charges.

#### **2.1.4 Customer service standards**

The economic regulatory framework requires TasWater, as a regulated water and sewerage entity, to comply with a number of service standard obligations set out in the Water and Sewerage Industry Customer Service Code (the Code) issued by the Regulator.

The Code reflects the minimum service standard requirements and conditions for regulated services, as specified in the *Water and Sewerage Industry (Customer Service Standards) Regulations 2009*, with which TasWater must comply. These include:

- minimum service standards;
- connection and service provision;
- fees;
- complaints, disputes and customer enquiries;
- billing and payments;
- circumstances for restriction and disconnection;
- quality and reliability of services; and
- guaranteed service levels.

The Code is also able to address other matters in addition to those required under the Regulations. Version 4 of the Code was issued by the Regulator on 1 July 2015.

In addition, the Code requires TasWater to develop, issue and comply with a customer charter which meets the procedural and substantive requirements of the Code.

The Code also set out the process for approval of TasWater's customer charter.



## **3 PRICE AND SERVICE PLAN GUIDELINE**

The purpose of the Guideline is to set out the Regulator's minimum requirements for the information that should be provided in TasWater's proposed price and service plan for the third regulatory period commencing 1 July 2018. It is designed to assist TasWater in the preparation of, and the Regulator in the approval of, TasWater's proposed price and service plan for the third regulatory period. It also provides information on how the price determination investigation will be conducted (including consultation) and specifies the actions TasWater must take in preparing its proposed price and service plan.

TasWater's proposed price and service plan must provide sufficient information for the Regulator to assess and determine prices, revenues, terms and conditions in relation to TasWater's provision of water and sewerage services.

The draft Guideline has been developed based on:

- requirements under the Industry Act and the Pricing Regulations;
- a review of the outcomes from the second price determination investigation (2015 Price Determination Investigation); and
- consideration of the circumstances currently facing the Tasmanian water and sewerage industry.

The draft Guideline is divided into Chapters that relate to key processes in, or inputs to, the price determination investigation. A summary of information required in TasWater's price and service plan is provided at the end of each Chapter.

### **3.1 Regulatory approach to third price determination**

Chapter 2 of the draft Guideline sets out the Regulator's approach to the price determination investigation for the third regulatory period including its priorities for assessing TasWater's proposed price and service plan.

The overarching efficiency objective of the Industry Act will be given priority to resolve any conflicts between pricing objectives and principles.

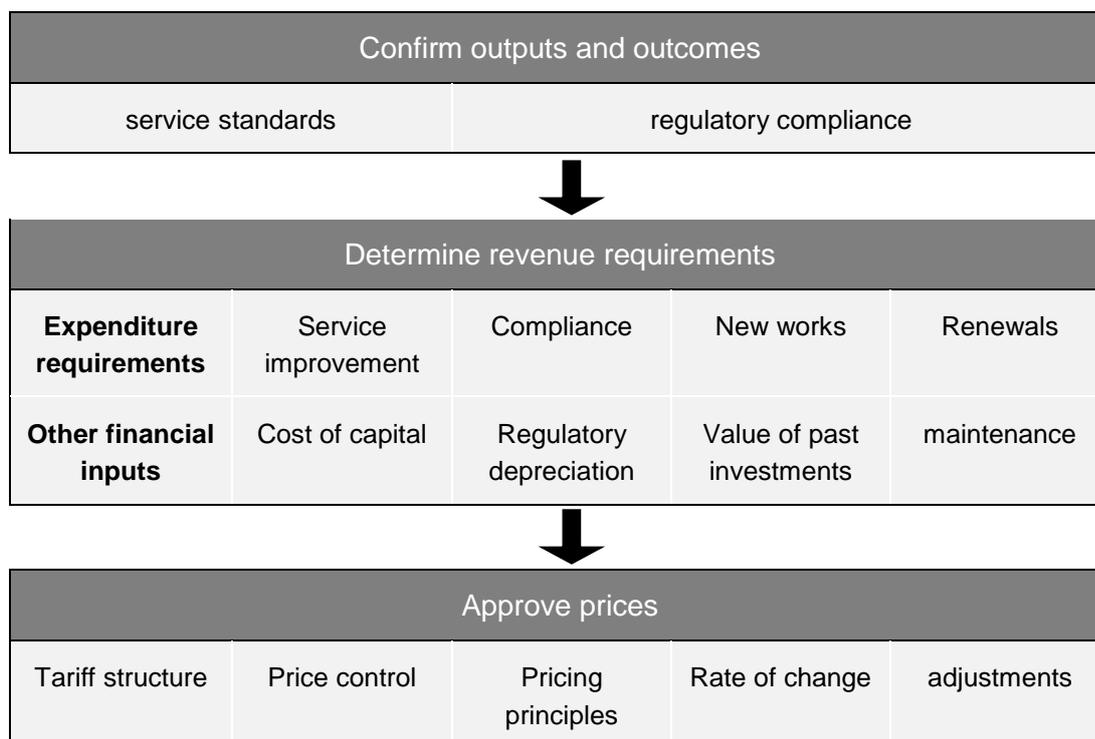
For the third regulatory period the Regulator intends adopting an approach that reflects the following priorities:

- funding compliance investment in line with regulatory expectations;
- ensuring sufficient revenue for the efficient delivery of the required services; and
- continuing to manage the impact of price changes on customers.

The Regulator seeks comments on its proposed priorities and whether any other matters should be given a high priority in the Regulator’s assessment of TasWater’s proposed price and service plan.

The Regulator will use the building block methodology to calculate revenue limits and regulate price movements. This method of direct regulation is considered appropriate for TasWater’s services which are provided under monopoly or near-monopoly conditions.

The building block approach has three steps which are set out below:



The Regulator notes that there are other regulatory approaches available to directly regulate revenue, such as CPI-X incentive regulation. Best practice is to adopt methodologies that maximise the benefits from regulation and minimise the associated costs. However, given the current circumstances where compliance improvements are a key driver of capital expenditure (rather than service levels) the Regulator considers the building block approach is best able to achieve the regulatory objectives given the current industry and market conditions. Other regulatory models may be considered by the Regulator in the future if appropriate.

The Regulator seeks comments on its proposed regulatory approach including its proposed application of the ‘building block’ methodology.

The Regulator will issue a draft report and draft price determination for consultation towards the end of the 2017 calendar year. After considering issues raised during consultation, the Regulator will issue a final report and final price determination in April 2018. TasWater will be required to change its price and service plan to reflect

the decisions in the final report and the final price determination and, once approved by the Regulator, publish its price and service plan.

### **3.2 Data collection template and financial model**

The Regulator will provide TasWater with a data collection template to populate and include as an attachment to its proposed price and service plan.

The information provided in the data collection template will assist the Regulator in undertaking the required analysis to complete its investigation and make a price determination within the required timeframe.

The Regulator will consult with TasWater in the development of the data collection template which will be finalised and issued in September 2016. At this stage, the Regulator does not propose undertaking public consultation on the data collection template as it is unlikely to be of interest to other stakeholders. However, the Regulator will liaise with TasWater on the format and content of the template prior to its finalisation.

The Guideline also requires any price changes proposed by TasWater in its price and service plan to be supported by a detailed financial model, which TasWater is required to provide to the Regulator if requested.

### **3.3 Customer consultation**

The Regulator expects TasWater to consult with customers and stakeholders during the development of its proposed price and service plan. TasWater must detail the extent and nature of the consultation process including matters on which it has consulted and customer feedback received in response.

TasWater must consult with other industry regulators during the preparation of its proposed price and service plan, particularly in relation to the finalisation of its wastewater management plan, drinking water quality plan and dam safety management plan.

The Regulator seeks comments on TasWater's consultation requirements set out in the draft Guideline, including consultation with industry regulators.

### **3.4 Setting customer service standards**

Customer service standards and conditions should reflect customers' priorities and expectations in relation to service delivery and should underpin TasWater's expenditure plans.

The draft Guideline notes that a working group has been established between the Regulator and TasWater to assist in the development of an appropriate service standards framework. The working group expects to develop an agreed framework by January 2017. TasWater is then required to specify in its proposed price and service plan, the minimum service standards that will apply in the third regulatory

period consistent with the agreed service standards framework, or justify any proposed departures from this framework.

### 3.5 Estimating revenue requirements

The Regulator considers the building block approach for estimating TasWater's revenue requirements is appropriate for the third regulatory period.

Under this approach the revenue requirement reflects operating expenditure and a return on and of the regulatory asset base (RAB) updated each year to reflect any additional capital expenditure net of contributions, asset disposals and regulatory depreciation.

Previously, the Regulator has calculated three revenue limits; upper, statutory and lower. Calculation of the three limits was considered necessary during the transition of revenues to a level that represented at least a lower bound of cost recovery. The upper revenue limit represents full cost recovery based on a commercial return and was calculated as a theoretical maximum under NWI<sup>6</sup> principles.

By the end of the second regulatory period, it is possible that TasWater's revenue will be approaching, or meet, the Regulator's calculated statutory revenue limit. Therefore, to avoid onerous calculations, in its 2018 price determination investigation, the Regulator will calculate only the statutory revenue limit which is the maximum revenue permitted under the Industry Act. TasWater will have to demonstrate that its proposed revenue is at or below this limit in its proposed price and service plan.

The Regulator seeks comments on its proposal to only calculate TasWater's statutory revenue limit.

Chapter 7 of the draft Guideline explains the revenue limit components and specifies how the Regulator will calculate them.

For assets transferred to the previous regulated entities before 1 July 2011, the rate of return or WACC (weighted average cost of capital) will incorporate a commercial rate of return on the debt component and a legislated pre-tax rate of return of three per cent on the equity component.

For new assets, the WACC will incorporate a commercial rate of return on both debt and equity.

There is little consistency across Australia in terms of the type of WACC adopted for the water and sewerage industry. In line with its practice for the first and second water and sewerage price determination investigations, the Regulator proposes maintaining its current approach of using a real pre-tax WACC.

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<sup>6</sup> National Water Initiative pricing principles were developed jointly by the Australian Government and state and territory governments to provide a set of guidelines or road map for rural and urban pricing practices and to assist jurisdictions to implement the NWI water pricing commitments in a consistent way.

The Regulator seeks comments on its proposed approach to setting the WACC parameters.

For the third price determination investigation the Regulator intends engaging third party advisors to undertake an independent review of TasWater’s actual, budgeted and forecast capital and operating and maintenance expenditure to assess whether TasWater’s proposals are based on only those assets used to deliver regulated services and do not include costs which are not efficient costs.

### **3.6 Tariff levels and structures**

Chapter 8 of the draft Guideline outlines and discusses the design of tariffs and tariff structures.

TasWater is required to develop tariffs that:

- are consistent with the pricing principles under the Industry Act and Pricing Regulations; and
- meet its customers’ needs while managing its risks and delivering its desired business outcomes (this includes the definition of pricing zones and customer classes).

The Regulator will consider TasWater’s tariff proposals against the pricing principles outlined in section 68 of the Industry Act.

### **3.7 Price regulation**

TasWater has been subject to price regulation with a side constraint on price movements. This was to ensure that during the transition period, the impact of price changes on customers was managed while revenue was transitioned to the statutory revenue limit.

Given that TasWater's prices currently provide for revenues that are approaching the statutory revenue limit, and that by the start of the third regulatory period, TasWater expects most customers to be on target tariffs, the Regulator will require TasWater to propose price changes in its proposed price and service plan and demonstrate that the resulting estimated revenue is equal to or below the statutory revenue limit for each year of the third regulatory period.

TasWater will also need to demonstrate that all remaining customers not currently on target tariffs, will be transitioned to the relevant target tariff by the statutory deadline of 1 July 2020.

TasWater is to forecast the customer impacts resulting from its proposed price changes to enable the Regulator to assess whether the customer impacts are being effectively managed.

The Regulator seeks comments on the proposed approach TasWater is to follow in developing its proposed price changes and to the Regulator's proposed approach to assessing the price changes that are proposed to apply during the third regulatory period.

### **3.8 Customer contracts and policies**

Chapter 10 sets out the Regulator's expectations in regards to:

- developing a customer contract for regulated services;
- describing serviced land;
- developing policies for connections, service charges, sub-metering, developer charges, trade waste charges, extensions and expansions and service introduction charges; and
- service replacement proposals.

TasWater's proposed price and service plan must, as required by the Industry Act, the Pricing Regulations and the draft Guideline, include copies of all policies relating to customers, connections and charges. TasWater must explain and justify any differences between its current policies and the policies it is proposing for the third regulatory period.

TasWater is free to combine policies where it can demonstrate that this provides for a more efficient approach and improved clarity for customers and provided it does not contravene any relevant legislative requirements.

The Regulator seeks feedback on the proposed approach to the development and assessment of TasWater's customer contract and policies.

### **3.9 Demand forecasts**

Chapter 11 requires TasWater to provide information on forecasts of demand, customer numbers and miscellaneous services. So the Regulator is able to compare forecasts in relation to the third regulatory period to baseline data from the second regulatory period, both historic actuals and forecasts are required.

TasWater must include in its proposed price and service plan the key assumptions that underlie its demand forecasts. The same forecasts must be used for both revenue estimates and for future capital expenditure.

### **3.10 Regulatory compliance**

As set out in Chapter 12 of the draft Guideline, the Regulator requires TasWater to provide information on how it will address regulatory non-compliance issues including the amount of capital expenditure allocated for improving regulatory compliance and details of specific projects that will improve regulatory compliance during the third regulatory period.

TasWater is expected to consult with other industry regulators to ensure that compliance improvement outcomes contained in its proposed price and service plan are as agreed between TasWater and each industry regulator.

The Regulator seeks feedback on the requirements in the draft Guideline in terms of regulatory compliance.

### **3.11 Duration of regulatory period**

Section 65(13) of the Industry Act requires the Regulator to declare the duration of the regulatory period (that is, the period covered by a price determination made by the Regulator).

The current regulatory period concludes on 30 June 2018, while the transition period<sup>7</sup> ends on 1 July 2020.

In 2009 the Treasurer fixed the minimum duration of the each subsequent regulatory period (ie after the first regulatory period) to be three years.

In determining an appropriate length for the third regulatory period the Regulator has considered the regulatory risks and costs of regulation as well as underlying incentives.

A number of issues arose during the second regulatory period. These concerned the availability of data and the lack of certainty associated with TasWater's capital works program. Also, a degree of uncertainty currently exists around what TasWater is required to do to achieve regulatory compliance. As a result, at this stage, maintaining a three year regulatory period is considered appropriate.

The Regulator proposes declaring a three year regulatory period from 1 July 2018 to 30 June 2021.

The Regulator seeks comments on the proposed three year duration of the third regulatory period.

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<sup>7</sup> The Regulator has discretion in terms of the extent to which TasWater is required to comply with the pricing principles during the transition period. The transition period is defined in the Pricing Regulations as the period from 1 July 2012 to 1 July 2020 inclusive.