

1 INTRODUCTION

This chapter provides an overview of the context, background and legislative and regulatory framework for the second independent price determination investigation of the Tasmanian water and sewerage industry.

The chapter also discusses the role of the various industry regulators including the Tasmanian Economic Regulator and the purpose and scope of the price determination investigation.

1.1 Background

Independent regulation of prices in the Tasmanian water and sewerage industry commenced on 1 July 2012 with the first regulatory period covering the three financial years from 1 July 2012 to 30 June 2015. During the first regulatory period the three previous regulated entities (Ben Lomond Water, Cradle Mountain Water and Southern Water) were required to comply with a Price Determination outlining prices and service standards to apply during the period.

On 1 July 2013, a new, single regulated entity, the Tasmanian Water and Sewerage Corporation Pty Ltd (TasWater) was formed. Under the provisions of the *Water and Sewerage Corporation Act 2012* (Water and Sewerage Corporation Act) the Price Determinations made, and Price and Service Plans approved, as part of the 2012 price determination investigation continue to apply to TasWater for the remainder of the first regulatory period.

In accordance with powers granted under the *Water and Sewerage Industry Act 2008* (the Industry Act), the Treasurer fixed the duration of the first regulatory period at three years and specified the minimum duration of each subsequent regulatory period (ie after the conclusion of the first regulatory period) to be three years. The Industry Act requires the Regulator to declare the duration of each subsequent regulatory period.

On 5 June 2013, the Economic Regulator declared that the second regulatory period would be for a period of three financial years from 1 July 2015 to 30 June 2018 inclusive.

In accordance with the Industry Act and as part of the price determination investigation, TasWater was required to submit a proposed Price and Service Plan to the Economic Regulator. TasWater's proposed Price and Service Plan was required to clearly articulate and commit to a set of outcomes and prices to be delivered over the second regulatory period. TasWater's proposed plan has been published on the Economic Regulator's website.

One of the principles of recent reforms, to the water and sewerage industry has been to achieve much greater equity and fairness in water and sewerage service pricing across Tasmania. Prior to the reforms municipalities used a range of different

methodologies for pricing. As a result customers were paying widely varying amounts for similar services across Tasmania.

Since the commencement of the industry reforms, one of the key focuses of the previous regulated entities, and now, TasWater, has therefore been to transition customers from the myriad of different pricing regimes to common target tariffs to achieve a level playing field for all customers. TasWater is required by law to achieve this for all customers by no later than 1 July 2020.

1.2 Industry structure

TasWater owns, controls and operates water supply and sewerage systems in Tasmania. TasWater 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. TasWater is subject to various public health, environmental and customer service regulatory requirements.

TasWater is incorporated as a proprietary company limited by shares and owned by Tasmania's 29 local government councils. The councils, as shareholders, receive dividends, income tax equivalents and guarantee fee payments.

TasWater is controlled by an independent board of management consisting of a chairperson and six directors. The board reports to the Owners' Representatives who in turn report to the council owners.

1.3 Legislative and regulatory framework

Economic regulation of the Tasmanian water and sewerage industry, and the conduct of the price determination investigation in particular, are governed by the:

- Water and Sewerage Corporation Act;
- Industry Act;
- *Water and Sewerage Industry (Pricing and Related Matters) Regulations 2011* (Pricing Regulations);
- *Water and Sewerage Industry (Customer Service Standards) Regulations 2009* (Customer Service Regulations);
- Customer Service Code; and
- Price and Service Plan Guideline (PSP Guideline).

Economic regulation of the Tasmanian water and sewerage industry and the resultant price determination is focussed on both price and service outcomes.

1.3.1 Water and Sewerage Corporation Act

The Water and Sewerage Corporation Act provided for, amongst other things, the formation of TasWater, the transfer of liabilities, employees and water and sewerage

assets from the previous regulated entities to TasWater and the continued application of the Economic Regulator's 2012 Price Determinations and Price and Service Plans to TasWater until the end of the first regulatory period on 30 June 2015.

1.3.2 Water and Sewerage Industry Act

The Industry Act is the primary legislative instrument governing the economic regulation of the industry.

In relation to pricing, the Industry Act provides for:

- an independent regulator (the Economic Regulator) for the sector with clear accountabilities and responsibilities to ensure effective and efficient outcomes for the sector and the protection of customers;
- independent pricing regulation with a regulated entity required to submit a proposed Price and Service Plan to the Economic Regulator which outlines a regulated entity's services, revenue requirements and operational requirements. The Economic Regulator bases its price determination on an assessment of the proposed Price and Service Plan submitted by the regulated entity; and
- the Economic Regulator to be guided by legislated pricing principles when making a price determination.

The pricing principles specified in section 68 of the Industry Act are as follows:

- a regulated entity is to be given a reasonable opportunity to recover the efficient costs it incurs in:
 - providing a regulated service; and
 - complying with a regulatory obligation; or
 - complying with a requirement to make a regulatory payment under the Industry Act (except where the Industry Act provides otherwise);
- the price is to provide for efficient pricing by:
 - applying two-part pricing for water services based on the recovery of fixed costs and variable costs by way of a fixed charge and a variable charge (with the variable charge determined by the volume of water used as measured by a water meter); and
 - reflecting the costs of servicing particular customers or classes of customers in different locations, regions or schemes;
- the price is to provide effective incentives, with respect to a regulated service to:
 - promote economic efficiency;
 - reduce costs; or

- otherwise improve productivity;
- the price is to allow a regulated entity to receive a return on assets used in providing the regulated service; and
- the price charged to a particular customer or class of customers is to reflect at least the costs that relate directly to providing the regulated service to that customer or class of customers to the extent that it is commercially and technically reasonable to do so.

In addition, section 68AA of the Industry Act acknowledges that the full application of the pricing principles will require a significant transition period. During this transition period, it is unlikely that all the pricing principles will be achieved and, therefore, reform objectives will need to be prioritised.

Section 68AA enables some of the Pricing Principles during the transition period not to be applied in price and service plans and price determinations to the extent that the application of those principles would:

- result in a significant impact on customers, or a particular class of customers, due to the rate of change in prices;
- adversely affect the sustainability of a regulated entity in so far as it provides regulated services; or
- adversely affect the ability of a regulated entity to deliver regulated services.

For the purpose of section 68AA, the Transition Period is defined in the Pricing Regulations as the eight year period from 1 July 2012 to 1 July 2020 inclusive.

Due to the requirement for regulatory periods to be at least three years duration, the third regulatory period will not align with the end of the Transition Period, on 1 July 2020.

As a result, TasWater was required to demonstrate, in its proposed Price and Service Plan, how target tariffs and price transition paths for the second regulatory period and the first two years of the third regulatory period would enable it to comply with all pricing principles in the Industry Act by the end of the transition period ie by the beginning of the third year of the third regulatory period (1 July 2020).

Section 68AA does not apply to the matters the Economic Regulator is to take into account under section 15 of the Industry Act, including the need for the Economic Regulator to consider the impact of the rate of change of prices on customers.

1.3.3 Water and Sewerage Industry Pricing Regulations

In addition to the pricing principles set out in the Industry Act, the Pricing Regulations contain additional pricing principles in relation to:

- pricing zones (nodal pricing);

- the structure of service introduction charges;
- the calculation of developer charges;
- the treatment of contributed assets¹; and
- the basis for setting fixed and variable charges (including the removal of free water allowances).

1.3.4 Customer Service Regulations and the Code

The Customer Service Regulations stipulate minimum service standards for the water and sewerage industry. As required by the Customer Service Regulations, and to regulate the standards and conditions of supply for water and sewerage services, the Economic Regulator has:

- developed the Code;
- established minimum service standard targets within the Code; and
- required TasWater to develop a customer charter.

TasWater is required to comply with the Code. The Code was last updated in April 2013 and will be amended as part of this investigation.

Chapter 7 provides more detail about service standards and TasWater's regulatory obligations with respect to service standards.

1.3.5 Price and Service Plan (PSP) Guideline

In November 2013, the Economic Regulator issued a PSP Guideline to assist TasWater in preparing its proposed Price and Service Plan for the second regulatory period.

The PSP Guideline sets out the legislative and regulatory requirements that TasWater had to comply with when submitting its proposed Price and Service Plan. The PSP Guideline also sets out the key steps and timing for the second price determination investigation.

The Economic Regulator acknowledges that it is unlikely that TasWater will be able to comply with all the Pricing Principles by the end of the second regulatory period. This is primarily due to the need to manage the impact of the rate of price changes on customers as well as ensuring the ongoing financial sustainability of TasWater. Consequently, there is a need to prioritise the price reform objectives for the second regulatory period, as was necessary for the first regulatory period.

¹ Contributed assets include developer charges and government grants but exclude equity contributions from the owner of a regulated entity. Furthermore, the three previous regulated entities' assets which were transferred to TasWater are not treated as capital contributions.

The PSP Guideline sets out the following price reform priority objectives for the second regulatory period:

- continuing to transition customers to a rational price structure consistent with National Water Initiative (NWI) pricing principles;
- transitioning customers paying above the target tariff towards the target tariff;
- continuing to transition all other customers towards the target tariff;
- generating revenue that, at a minimum, equals the lower revenue limit to achieve sustainability; and
- managing the impact of price changes on customers.

The PSP Guideline also sets out the following price reform objectives which are considered secondary priorities for the second regulatory period:

- ensuring all customers pay the same price for the same services; and
- transitioning revenue to the statutory revenue limit.

Whilst it is desirable that TasWater work towards achieving these secondary objectives during the second regulatory period, the Economic Regulator accepts that achieving these objectives may require additional time.

In assessing TasWater's proposed Price and Service Plan, the Economic Regulator considered the Pricing Principles and the requirements contained in the PSP Guideline.

1.4 National reforms and legislation

Tasmania is a signatory to the National Water Initiative (NWI) Agreement which provides a blueprint for water reform in Australia. As a signatory to the NWI, the Tasmanian Government has developed and published a plan of how it will implement its commitments to the NWI.

The Implementation Plan² sets out the actions that Tasmania has already completed and provides information on the tasks and timelines to complete the remaining commitments, and the context within which these actions are being implemented.

In relation to establishing limits on the revenue that can be earned by a regulated water and sewerage business, the NWI prescribes two revenue limits:

- the upper revenue limit (full cost recovery); and
- the lower revenue limit (sustainability threshold).

² [www.dpipwe.tas.gov.au/water/water-legislation-policies-and-strategies/national-water-initiative/nwi-implementation-plan-\(tas\)](http://www.dpipwe.tas.gov.au/water/water-legislation-policies-and-strategies/national-water-initiative/nwi-implementation-plan-(tas))

Under the NWI, a water and sewerage business should recover revenue at least equal to the lower revenue limit but no greater than the upper revenue limit.

Revenue above the upper revenue limit represents monopoly profits.

Consistent with the:

- commitments made under the NWI;
- pricing principles specified in the Industry Act; and
- Pricing Regulations,

TasWater should be moving towards recovering revenue at the upper revenue limit as a longer-term objective.

More information about the calculation of the revenue limits, is outlined in Chapter 4.

1.5 Industry regulators

The Economic Regulator is responsible for implementing and administering the economic regulatory framework for the Water and Sewerage Industry, in accordance with the Industry Act and its subordinate legislation. Responsibility for environmental, fire safety, public health and dam safety regulation of the industry lies with the Director of the Environment Protection Authority (EPA), the Director of Public Health, Chief Officer of the Tasmania Fire Service (TFS), and the Secretary of the Department of Primary Industries, Parks, Water and Environment (DPIPWE), who is the Delegate for Dam Safety Regulation, respectively.

Economic regulation of the industry and, more specifically, the price determination investigation, focuses on both price and service outcomes. Through the development of the Code and the PSP Guideline, the Economic Regulator has sought to assist the previous regulated entities, and now TasWater, in addressing the Industry Act requirements in their respective proposed Price and Service Plans, by:

- identifying regulated water and sewerage services, and determining service standards, to be delivered to customers over the second regulatory period;
- determining the revenue required to deliver the regulated services to the agreed standards, based on efficient costs; and
- determining regulated prices (or tariffs) that meet the Pricing Principles.

The PSP Guideline required TasWater, in conjunction with the other Tasmanian water and sewerage industry regulators, to establish regulatory compliance improvement outcomes to be achieved during the price determination investigation. These outcomes will be based on compliance improvement priorities identified by the Tasmanian industry regulators. Capital expenditure (Capex) programs proposed in TasWater's Price and Service Plan were required to reflect these compliance improvement priorities.

The price determination authorises prices and, therefore, directly or indirectly, revenues, which, among other things, fund agreed Capex programs.

The Price Determination does not, however, authorise Capex as being sufficient to meet the compliance improvement priorities of the Tasmanian industry regulators. Compliance improvement and compliance enforcement remain the responsibility of the relevant Tasmanian industry regulators, being the EPA, Director of Public Health, the TFS and the Delegate for Dam Safety Regulation.

1.5.1 Director, Environment Protection Authority

The Director of the EPA is one member of the Board of the EPA.

The EPA administers and enforces the provisions of the *Environmental Management and Pollution Control Act 1994*. The functions of the EPA, with respect to the water and sewerage sector, include the assessment and regulation of significant wastewater treatment plants (WWTPs), defined as ‘Level 2’ WWTPs (ie plants discharging greater than 100 kilolitres per day).

The responsibilities of the EPA in regulating Level 2 WWTPs include:

- undertaking environmental impact assessments, in relation to proposals for new WWTPs or significant changes to existing WWTPs;
- developing legally binding environmental conditions for approved WWTPs, which are included as part of the planning permit or as a stand-alone environment protection notice (EPN);
- applying the Tasmanian policy framework in relation to water quality management as is relevant for wastewater activities and updating environmental conditions where necessary; and
- ensuring compliance with environmental conditions, largely through collection and evaluation of data on specified discharge limits and the impacts on the receiving environment.

The EPA also offers advice and guidance in relation to a broad range of wastewater issues including pumping stations, wastewater reuse, trade waste and biosolids reuse through the provision of policies and guidelines.

The EPA has released environmental guidelines governing the use of recycled water and biosolids and the recycling of wastewater and biosolids in Tasmania. The guidelines provide a framework for the sustainable reuse and recycling of water, wastewater and biosolids in a manner which is not only practical and safe for agriculture, the environment and the public but consistent with industry standards and best practice environmental management.

1.5.2 Director of Public Health

The functions of the Director of Public Health with respect to drinking water are to:

- protect public health with respect to the supply of drinking water;
- establish drinking water quality performance standards;
- monitor water suppliers' performance against the standards and requirements prescribed by the *Public Health Act 1997* (and the associated Tasmanian Drinking Water Quality Guidelines 2005), the *Fluoridation Act 1968*, the *Fluoridation (Interim) Regulations 2009* and the *Australian Drinking Water Guidelines 2011*;
- enforce compliance with the requirements prescribed by the above mentioned Acts, Regulations and Guidelines;
- report on the water suppliers' compliance with the prescribed standards;
- provide oversight of the fluoridation program in Tasmania through the Fluoridation Committee; and
- develop and implement strategies to promote and improve public health.

1.5.3 Chief Officer of the Tasmania Fire Service (TFS)

The regulatory authority for fire safety in Tasmania is the TFS. The responsibilities of its Chief Officer, who is also Chairperson of the State Fire Commission, include:

- developing and implementing appropriate fire prevention and community preparedness strategies;
- establishing fire brigades that are trained, resourced and available to respond to fires;
- maintaining other arrangements as are necessary to ensure ongoing capacity to deliver effective and efficient fire prevention and protection measures throughout Tasmania.

Under the *Building Regulations 2014* and *Fire Service (Miscellaneous) Regulations 2007*, the TFS is required to, amongst other things, inspect and report on the installation of new fire hydrants. The TFS is also required to comment on the suitability of the water flows and pressure as part of this reporting. Testing to ensure the required flows and pressures is also required to be undertaken when a new hydrant is commissioned.

TasWater's obligations under the Industry Act, with respect to fire safety, relate to:

- the installation of fire hydrants in TasWater's water infrastructure at distances and locations as are necessary for the ready supply of water to control and extinguish fires; and
- the need to keep TasWater's water infrastructure charged with water where that infrastructure supplies water to a fire hydrant.

The Industry Act provides that TasWater can also impose a ban on the use of outdoor water on days declared by the TFS to be days of total fire ban. Limiting non-essential water use such as garden watering or lawn sprinklers on days of total fire ban can help to help to ensure that the TFS and residents who may be facing a bushfire threat have water available for fire fighting and prevention.

1.5.4 Delegate for Dam Safety Regulation

The Minister for Primary Industries and Water has regulatory oversight for dam safety through administration of the *Water Management Act 1999* and the *Water Management (Safety of Dams) Regulations 2003*. The key functions of the Minister concerning dam safety regulation, which have been delegated to the Secretary of the DPIPWE, include:

- developing prescribed standards required for the design, construction, maintenance, surveillance and decommissioning of dams, and ensuring compliance with those standards (these standards are largely based on the criteria and guidelines produced by the Australian National Committee on Large Dams); and
- formulating measures to ensure the safety of dams and, in particular, plans to remove or minimise risks to persons, property or the natural environment arising from a dam safety incident.

The Water Management Branch of the Water and Marine Resources Division of DPIPWE administers the dam safety legislation. In relation to dam safety this is primarily implemented through:

- reviewing new dam applications to ensure dams are constructed to contemporary safety standards and in accordance with the statutory requirements; and
- a program ensuring owners of existing dams meet their statutory dam safety responsibilities by monitoring, reviewing and managing dam safety as required by the above mentioned Act and Regulations which incorporate the national dam safety guidelines.

1.6 Purpose of price investigation and price determination

The purpose of the price determination investigation has been to gather information to enable the Economic Regulator to make a price determination in respect of regulated water and sewerage services provided by TasWater.

The Price Determination specifies the method for determining the maximum prices that TasWater can charge, for the supply of regulated water and sewerage services for each financial year of the regulatory period ie for the 2015-16, 2016-17 and 2017-18 financial years.

The Price Determination is based on information provided by TasWater in its proposed Price and Service Plan which was submitted to the Economic Regulator

on 29 August 2014 together with additional information provided by TasWater during the course of the Economic Regulator's investigation.

1.7 Scope of the investigation

The price determination investigation estimates annual revenue limits for TasWater for each financial year of the second regulatory period. However, the maximum prices that TasWater can charge, for the supply of regulated water and sewerage services for each financial year of the second regulatory period has been determined by placing limits on annual price increases.

1.7.1 Regulated and unregulated services

The price determination applies only to prices charged for regulated services. Regulated services are services or activities requiring a licence under the Industry Act. In general, regulated services include reticulated water and sewerage services (including trade waste), activities that support those services (including the treatment of water and wastewater) and any ancillary activities where a miscellaneous fee is charged.

The Industry Act exempts some activities from economic regulation under the Industry Act. In addition, section 31 of the Industry Act allows the Minister to decide if an activity is to be regulated or unregulated. In terms of the services provided by the regulated entities, the Industry Act, and clause 3 of the *Water and Sewerage Industry Declaration Order 2011*, specifies the provision of the following services to be unregulated services:

- water for irrigation;
- reuse water; and
- stormwater services via a combined sewerage/stormwater system.

The Minister has also exempted a number of entities providing water and sewerage services from the requirement to be licensed under the Industry Act. This effectively means that currently, TasWater is the only entity required to be licensed.

A person or entity is exempt from the requirement to be licensed if the person (including a body corporate or an unincorporated body of persons) owns or operates infrastructure used for the provision of a water or sewerage service to another person, or provides a water or sewerage service to another person, but whose primary function is not being a provider of the relevant service ie the provision of the relevant service is ancillary to their primary purpose.

The following activities are also exempt from the requirement to be licensed:

- providing water and/or sewerage services, while owning or operating a caravan park, to a person occupying a site within the caravan park;
- providing water and/or sewerage services, while owning or leasing a building, to occupants of the building;

- providing water and/or sewerage services, while owning or managing a shopping centre, to occupants of the centre;
- providing water and/or sewerage services to another person for free; and
- providing water and/or sewerage services to not more than 250 customers.

1.7.2 Price regulation

Under the Industry Act, the price determination investigation involves two key steps:

- determining revenue limits based on appropriate services, service standards, regulatory compliance improvement, efficient costs and appropriate returns; and
- approving an appropriate tariff structure that continues the transition towards meeting the requirements of the Pricing Principles but does not generate revenue in excess of annual revenue limits.

For the second price determination investigation the Economic Regulator has adopted an approach that reflects:

- the current status of the industry reform process;
- TasWater's financial position; and
- the need to manage the impact of price increases on customers.

The Economic Regulator is also required to assess TasWater's proposed Price and Service Plan against a number of principles and objectives outlined in the Industry Act and in the Pricing Regulations (see sections 1.3.2 and 1.3.5 respectively).

The Economic Regulator must decide whether to approve the pricing proposals contained in the proposed Price and Service Plan, or require TasWater to amend its proposed Price and Service Plan. In approving the Price and Service Plan, the Economic Regulator must be satisfied that TasWater will have sufficient revenue to meet its obligations and deliver agreed standards of customer service, while also taking into account the impact of price increases on customers.

The Economic Regulator is also required to ensure that any reform of tariffs is consistent with the pricing principles under the Industry Act, or represent a transition towards achieving those principles.