

## 2 APPROACH TO SECOND PRICE DETERMINATION INVESTIGATION

This chapter provides an overview of the approach adopted by the Economic Regulator for the second independent price determination investigation for the Tasmanian water and sewerage industry.

The chapter also outlines the approach taken by the Economic Regulator with respect to assessing the appropriateness of TasWater's proposed operating and capital expenditure (including asset values).

The chapter also provides background on key regulatory issues and explains how they were managed during the price determination investigation.

### 2.1 Investigation process

#### 2.1.1 Overview

As part of the 2015 price determination investigation, TasWater was required to prepare its proposed price and service plan setting out its costs and proposed prices and services by 29 August 2014.

TasWater's proposed price and service plan was submitted to the Economic Regulator on 29 August 2014. However, the Plan was initially incomplete in that it did not include a number of policies. Draft policies for Water Metering, Developer Charges, Service Introduction, and Service Extension were provided on 3 October 2014.

The Economic Regulator reviewed the information contained within TasWater's proposed price and service plan including its proposed:

- service obligations;
- revenue requirements, including operating and maintenance expenditure (Opex) and Capex needs;
- demand forecasts; and
- pricing proposals and customer impact analysis.

Where the Economic Regulator considered the information was deficient or did not comply with the Industry Act, the Pricing Regulations, the Code or the PSP Guideline, the Economic Regulator requested TasWater to resubmit additional or revised information.

This Draft Report outlines the Economic Regulator's draft decisions on TasWater's proposed service levels, revenue requirements, demand forecasts and pricing

proposals, taking into account any additional or revised information submitted by TasWater.

The Economic Regulator has also made a draft Price Determination (Appendix 1) for TasWater specifying the method for determining the maximum prices that TasWater can charge for the supply of regulated water and sewerage services for the second regulatory period.

## 2.1.2 Consultation

### 2.1.2.1 *Consultation undertaken to date*

On 3 May 2014, the Economic Regulator notified, through the three regional Tasmanian newspapers, its intention to conduct a price determination investigation and make a Price Determination.

Prior to publishing that notice, the Economic Regulator:

- on 5 June 2013, declared that the duration of the second regulatory period would be three years from 1 July 2015 to 30 June 2018; and
- on 1 November 2013, published its PSP Guideline for the price determination investigation.

The PSP Guideline specifies the legislative and regulatory requirements that TasWater must comply with when submitting its proposed price and service plan.

TasWater was required to prepare its proposed price and service plan in accordance with the PSP Guideline, including consulting with customers and other stakeholders, and submit it to the Economic Regulator by 29 August 2014.

The Economic Regulator also published a draft guideline and complementary Consultation Paper which highlighted the issues addressed in the draft guideline and sought stakeholder feedback on the draft guideline.

The Economic Regulator considered the comments made in submissions on the draft guideline before releasing a final version of the PSP Guideline. The Economic Regulator also released a Statement of Reasons discussing issues raised in submissions on the draft guideline and the Economic Regulator's responses to those issues.

### 2.1.2.2 *Further consultation*

The Economic Regulator invites written comments (preferably by email) on this Draft Report and the draft Price Determination. Submissions will be considered prior to the Report and the Price Determination being finalised and must be received by the close of business on 27 February 2015.

### 2.1.3 Key steps and timelines

**Table 2.1 Timetable for the second price determination investigation**

Action	Due date
Draft Report and draft Price Determination released for public consultation	9 January 2015
Consultation on Draft Report and draft Price Determination closes	27 February 2015
Consultation with the TasWater on draft of Final Report and draft of final Price Determination	10 April 2015
Final Report published and final Price Determination gazetted	30 April 2015
TasWater to submit revised 2015-18 price and service plan reflecting the requirements outline in the Price Determination and Final Report	29 May 2015
Economic Regulator approves price and service plan	15 June 2015
Second Price Determination commences	1 July 2015

## 2.2 Approach to revenue and price regulation

In 1995 the Council of Australian Governments (CoAG) agreed on a number of competition policy reforms. The Tasmanian Government was a signatory to these reforms. These National Competition Policy reforms centred on:

- the review and reform of regulation that restricted competition;
- the introduction of competitive neutrality (where government services are provided in competition to the private sector);
- the restructure of public monopoly businesses; and
- providing rights of access to infrastructure (for example, railway lines and gas pipelines) to promote greater competitive pressure and, thereby, encourage greater efficiency.

CoAG recognised that effective competition may not always be achievable. The competition policy reforms provided for government regulation of pricing as an appropriate action where effective competition was not achievable. In such circumstances, it has become common practice for monopoly, or near monopoly, providers of goods and services to be subject to revenue and/or price regulation, particularly where the goods and services provided are considered to be essential services such as electricity and water.

In the absence of effective competition, regulation of such industries is usually undertaken to ensure that consumers do not pay more than the efficient cost for the provision of the goods or service, and to ensure that services meet prescribed standards.

Revenue regulation generally involves determining the revenue required (referred to as the “revenue limit”) for the regulated business to meet its costs to produce the goods and services to prescribed standards and deliver them to customers.

Prices are then set based on the revenue limit, customer numbers and the volume of goods and services to be delivered over a defined period.

Under price regulation, the price the entity can charge for each regulated service may be set by reference to:

- the maximum amount of revenue the entity can earn;
- maximum prices; or
- maximum rates of change in prices.

As was the case for the first price determination investigation, the regulatory approach adopted for the second price determination investigation reflects that TasWater expects to earn revenue that is substantially below the level required to achieve full cost recovery.

The requirement under section 15(d) of the Industry Act to take into account the impact on customers of the rate of change in prices, combined with the current level of revenue under-recovery by TasWater, means that movements in annual prices will again be regulated ie prices will be determined by applying a limit on annual price movements.

However, the revenue limits applying to TasWater are expected to become more relevant in the near future as revenue approaches the statutory revenue limit. For this reason, the Economic Regulator has calculated all three revenue limits for the second regulatory period. More detail on the calculation and analysis of revenue limits is included in Chapter 4.

## 2.3 Assessing Opex, Capex and asset values

For the second price determination investigation, the Economic Regulator engaged Jacobs Group (Australia) Pty Ltd to undertake an independent review of TasWater’s proposed Opex and Capex (including asset values). The objective of the consultancy was to assess TasWater’s expenditure proposals and provide advice so that the Economic Regulator could ensure that only those assets used to deliver regulated services and only efficient costs were taken into account when calculating revenue limits for the purpose of determining water and sewerage prices. The report produced by Jacobs Group has been released with this Draft Report.

TasWater provided, as part of its proposed price and service plan, its proposed capital expenditure (Capex), operating cost and depreciation expense data to determine annual revenue limits reflecting the amount to be invested in new regulated assets required to deliver its proposed water and sewerage services.

In assessing the proposed capex programs, the Economic Regulator has consulted with officers of the other Tasmanian water and sewerage industry regulators to

ascertain whether the proposed Capex program will achieve their respective expected outcomes in relation to regulatory compliance improvement over the second regulatory period.

Chapter 3 provides further details about regulatory compliance improvement expectations during the second regulatory period.

## 2.4 Assessment of price and service plan

In assessing TasWater’s proposed price and service plan, the Economic Regulator considered:

- whether the proposed price and service plan was consistent with, or was working towards, the Pricing Principles;
- how and to what extent the proposed price and service plan addresses the price reform priorities established by the Economic Regulator; and
- the customer impacts flowing from the proposed price and service plan.

The Pricing Principles and reform priorities are listed in sections 5.1 and 5.2 respectively.

Consistent with the “propose and respond” nature of the regulatory framework, the Economic Regulator considered that TasWater was best placed to develop models to support pricing proposals and assess customer impacts as it holds detailed customer and usage information.

The PSP Guideline required TasWater to propose the structure and the amount of constraints on annual price changes in its proposed price and service plan. During the price determination investigation the Economic Regulator also required TasWater to have the capability to model alternative price constraint scenarios.

For TasWater’s proposed price constraints, its proposed price and service plan was required to specify the estimated total regulated revenue and Net Profit After Tax for each financial year of the second regulatory period.

In relation to customer impacts, the PSP Guideline required TasWater to provide the following information for each financial year from 1 July 2015 until the end of the transition period on 1 July 2020 the percentage of customers whose tariffs are:

- expected to be above the target tariffs (target tariffs represent a single tariff structure to apply across Tasmania rather than the current structure of different tariffs in different regions. The target tariffs will, over the regulatory period, increase towards the level required to achieve full cost recovery revenue);
- on the target tariffs (ie their tariffs will increase at the target tariff rate proposed by TasWater);
- below the target tariffs by an amount less than the proposed price constraint (ie these customers will reach the target tariff during that year); and

- below the target tariffs by an amount greater than the proposed price constraint but whose annual tariff increase will be capped at the proposed price constraint limit (ie those customers who will not reach the target tariff during that year).

In addition to its proposed price constraints, for any alternative price constraint scenarios, the Economic Regulator expected TasWater to have a model capable of producing the same information in relation to customer impacts and financial outcomes as required for TasWater's proposed price constraint.

The Economic Regulator determined the structure and amount of the proposed price constraints developed by TasWater by assessing TasWater's ability to deliver price reform in a manner that manages the complex and competing objectives facing the industry.

TasWater has therefore had to balance the impact of the rate of change of prices on customers and the need to move to efficient pricing in the long term in order to meet future investment and regulatory compliance requirements.

## 2.5 Structure and administration of the Price Determination

### 2.5.1 Draft price determination

The Industry Act and Pricing Regulations set out scope and content of, and the process for making, the Price Determination. Before making the Price Determination, the Economic Regulator is required by the legislation, amongst other things, to publish a draft Price Determination for consultation.

The draft Price Determination (Appendix 1) reflects the legislative requirements.

The draft Price Determination requires TasWater's price and service plan (which includes various policies and the customer contract) to be, amongst other things, consistent with the Economic Regulator's decisions and requirements in the Final Report. The Final Report will clearly set out the Economic Regulator's decisions and requirements regarding TasWater's price and service plan and the associated draft policies and customer contract. The Economic Regulator will only approve the final draft of the proposed price and service plan and the associated policies and customer contract if they are consistent with the Economic Regulator's decisions and requirements in the Final Report. Any subsequent proposed amendments to the price and service plan and/or the associated policies and customer contract (after they have been approved) would require the Economic Regulator's approval. Consultation would be undertaken in accordance with the Economic Regulator's Consultation Policy and Procedures of the Regulator (Consultation Policy) for substantive proposed amendments.

Sub-section 65(5) of the Industry Act states that the Economic Regulator must approve TasWater's draft proposed price and service plan if it fulfils the requirements as set out in the PSP Guideline and the Price Determination. Embedding in the draft Price Determination the requirement that TasWater's price and service plan must be consistent with the Economic Regulator's decisions and requirements in the Final Report will ensure that the Economic Regulator's final

decisions and requirements will be taken into account when TasWater revises its draft price and service plan and the associated policies and customer contract before resubmitting them for approval.

It is noted that Regulation 21 of the Pricing Regulations requires the Price Determination itself to require the price and service plan to include miscellaneous fees and charges. Hence, the draft Price Determination will not include a table of all miscellaneous fees and charges but will instead specifically require these fees and charges to be included in the price and service plan in accordance with Regulation 21 and to be consistent with the Economic Regulator's decisions and requirements in the Final Report. Similarly, Regulation 7 of the Pricing Regulations requires the Price Determination itself to require the price and service plan to include '*anticipated changes, over time, of any prices specified in the Plan*'. This requirement has been included in the draft Price Determination.

### 2.5.2 Amending Price Determination within the regulatory period

The need for certainty is considered important as the industry moves through a reform transition period. To maximise certainty for TasWater, owner councils, stakeholders and customers, the Pricing Regulations permit price adjustments in limited specified circumstances. That is, prices may be adjusted only if there has been a material change in the costs incurred by a regulated entity as a result of complying with one or more of the following events, which may occur after the Price Determination has been made:

- new or amended legislative requirements; or
- a tax event (as defined in the Pricing Regulations).

Prices will not be reviewed annually. Rather, TasWater will be responsible for proposing any adjustments in line with the terms of the Price Determination and the requirements of the Pricing Regulations.

All other variations between forecasts and actual outcomes over the second regulatory period will, therefore, need to be managed by TasWater, including any differences between forecast and actual CPI.

The next (third) price determination investigation will review any differences between forecast and actual outcomes that occurred during the second regulatory period and recommend appropriate actions to account for those variations.

## 2.6 Regulatory Accounting

The Economic Regulator requires an understanding of the nature and substance of TasWater's business activities to effectively monitor TasWater's compliance with the relevant price determination and conduct pricing inquiries and investigations.

Section 64(2) of the Industry Act gives the Economic Regulator the power to issue guidelines requiring the separation of a regulated entity's accounts and functions. In this regard, in May 2013 the Economic Regulator issued a Ring Fencing Guideline.

The objectives of the Ring Fencing Guideline are to establish the detailed accounting and information requirements necessary to enable the Economic Regulator to undertake its responsibilities under the Industry Act.

The objectives of accounting ring fencing are to:

- provide the Economic Regulator with sufficiently detailed and accurate information to undertake price determination investigations;
- facilitate the monitoring of compliance with any relevant price determinations;
- facilitate the effective regulation of monopoly activities by identifying and attributing expenditure and revenue to relevant business segments;
- facilitate the introduction of competition wherever possible by identifying and ring fencing regulated and unregulated services;
- avoid the anti-competitive effects of cross-subsidies between regulated and unregulated activities; and
- ensure that unfair competitive advantage is not secured by using information acquired by the monopoly activity for the benefit of an unregulated activity.