

# EXECUTIVE SUMMARY

This Draft Report presents the preliminary outcomes of the independent Economic Regulator's third price determination investigation for the Tasmanian water and sewerage industry. The final outcomes of the investigation will depend on feedback received during consultation on this Draft Report.

The water and sewerage industry is critical to public health, environmental health and economic development potential across Tasmania.

Under the *Water and Sewerage Industry Act 2008* (Industry Act), the Economic Regulator is responsible for the independent regulation of TasWater's water and sewerage services. The Economic Regulator bases its price regulation activities on the legislated pricing principles set out in the Industry Act and proposed Price and Service Plans submitted by TasWater.

The Economic Regulator's purpose in conducting this particular investigation is to determine the appropriate prices and service levels for regulated water and sewerage services that will apply to TasWater during the third regulatory period (1 July 2018 to 30 June 2021).

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 Economic Regulator aims to propose prices for TasWater's services that will provide it with sufficient revenue to:

- maintain financial sustainability;
- fund its proposed capital expenditure (capex) program, including its initiatives addressing non-compliance with required health, environmental and dam safety standards; and
- achieve the above objectives while managing the impact on customers of required increases in prices.

## Building block approach

As it did for the first and second regulatory periods, the Economic Regulator has used a building block approach in calculating TasWater's maximum allowed regulated revenue (MARR) for the third regulatory period. The MARR caps the amount of revenue that TasWater can earn which, in turn, determines TasWater's prices. A building block approach calculates the MARR taking into account the costs involved in providing regulated services.

## Revenue and prices

TasWater's calculation of its MARR for the third regulatory period translated into a 7.9 per cent price increase. However, having regard to customer feedback about price increases, TasWater proposed annual price increases of 4.6 per cent for the period.

The Economic Regulator's proposed adjustments to the various building cost components and its subsequent calculation of a lower MARR have resulted in TasWater's forecast regulated revenue (with a 4.6 per cent annual price increase) exceeding the Economic Regulator's calculation of TasWater's MARR by \$9.2 million over the third regulatory period.

To ensure that TasWater's forecast regulated revenue does not exceed the Economic Regulator's calculation of TasWater's MARR, the Economic Regulator has proposed lower annual price increases for fixed water, fixed sewerage and variable water charges of 4.16 per cent.

The Economic Regulator's proposal will result in TasWater's prices increasing, relative to 2017-18 prices, over the third regulatory period, as shown in the following tables.

**Economic Regulator's proposed target fixed water tariffs per connection for full service customers (\$)**

Water Connection Size	2017-18	Third regulatory period		
		2018-19	2019-20	2020-21
20mm	329.48	343.19	357.46	372.33

**Economic Regulator's proposed target variable water charges per kilolitre of water (\$)**

	2017-18	Third regulatory period		
		2018-19	2019-20	2020-21
Full service (ie water of drinking water quality)	1.02	1.06	1.11	1.15

**Economic Regulator's proposed target fixed sewerage tariffs for full service customers per Equivalent Tenement (ET) (\$)**

Number of ETs	2017-18	Third regulatory period		
		2018-19	2019-20	2020-21
1 ET	632.24	658.54	685.94	714.47

Under the Economic Regulator's proposed price increase, a typical residential customer using 200 kL of water per annum will see their annual bill increase by \$50.

The Economic Regulator's estimate of TasWater's efficient costs together with the Economic Regulator's resultant estimate of TasWater's MARR for the third regulatory period is outlined in Chapter 11.

Since its formation in 2013, TasWater has been working to transition those customers currently paying below target tariffs for their water and/or sewerage services to the relevant targets. TasWater notes in its proposed Price and Service Plan that there will be approximately 7 500 customers still paying below target tariffs at the beginning of the third regulatory period. The legislation requires TasWater to complete the transition of all customers to target tariffs by 1 July 2020.

To achieve this outcome, the Economic Regulator intends to accept TasWater's proposed price transition arrangements:

- Customers within \$50 of fixed target tariffs will move straight to the relevant target tariff in 2018-19.
- Customers more than \$50 from fixed target tariffs will see annual increases of one third of the difference between the target tariffs in 2020-21 and the prices they are paying as at 30 June 2018.

In both cases the \$50 cap increases in proportion to the size of the water connection and the estimated demand placed on the sewerage system.

Chapters 12 and 13 provide further information on the structure and basis of TasWater's proposed water and sewerage prices and price transition arrangements, along with the Economic Regulator's assessment of customer impacts.

## Regulatory compliance

One of the key goals of TasWater's proposed Price and Service Plan for the third regulatory period is to improve its levels of compliance with regulatory obligations.

Broader regulatory compliance improvement and enforcement across the water and sewerage industry remains the responsibility of the Tasmanian industry regulators, being the Environment Protection Authority (EPA), Director of Public Health and the Secretary of the Department of Primary Industries, Parks, Water and Environment (DPIPWE), who is the Delegate for Dam Safety Regulation.

The Economic Regulator notes that TasWater has liaised with the other Tasmanian industry regulators in preparing its proposed Price and Service Plan. The Economic Regulator has also consulted with the other Tasmanian industry regulators to ensure TasWater's proposed Price and Service Plan meets their expectations and reflects the compliance improvement outcomes agreed to between TasWater and industry regulators.

Chapter 3 of this Draft Report provides more detail on regulatory compliance improvement.

## Customer service

The Economic Regulator reviewed TasWater's proposed minimum customer service standards for the third regulatory period. Given the large investment required to improve water quality, dam safety and environmental outcomes, TasWater has proposed not to put further upward pressure on expenditure and prices by raising service standards in the third regulatory period.

Instead, TasWater proposed to maintain current targets for most service standards and to focus on meeting, rather than exceeding, these targets to avoid unnecessary expenditure. The Economic Regulator judged that, subject to minor amendment, TasWater's proposed minimum customer service standards satisfy the requirements of the Tasmanian Water and Sewerage Industry Customer Service Code (the Code).

TasWater's proposed Price and Service Plan for the third regulatory period also 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. The policies deal with issues such as:

- imposing developer charges;
- extending water and sewerage infrastructure;
- introducing new services;
- connecting customers to water and sewerage infrastructure;
- sub-metering arrangements; and
- charges in relation to unconnected properties.

The Economic Regulator reviewed the content of the policies proposed by TasWater and requested that TasWater make changes to ensure that these documents, and the customer contract, are satisfactory and comply with the relevant regulatory and legislative provisions.

Chapter 4 of this Draft Report provides a detailed discussion of TasWater's proposed policies, customer contract and customer service standards. The customer contract and policies are attached as appendices to this Draft Report.

## Capital and operating expenditure

TasWater's cost components or building blocks include:

- operating and maintenance expenditure (opex);
- regulatory depreciation (return of capital); and
- cost of capital (return on capital).

Other key inputs that the Economic Regulator has used in calculating TasWater's maximum allowed regulated revenue are:

- capex; and
- regulated asset base (RAB).

To help with its investigation and to ensure TasWater's maximum regulated revenue is based on efficient costs, the Economic Regulator engaged an external consultant, the Arup Group (Arup), to conduct an independent review of TasWater's capex and opex. A copy of Arup's draft report is available on the Economic Regulator's website: [www.economicregulator.tas.gov.au](http://www.economicregulator.tas.gov.au)

Based on Arup's review, and its own analysis of TasWater's opex and capex, the Economic Regulator identified several areas in which it intends to require that TasWater reduce its proposed capex and opex for the third regulatory period, including:

- facilities, fleet and plant renewals capex;
- gifted assets capex;
- salaries opex;
- materials and services opex;
- chemicals opex; and
- fleet opex.

The Economic Regulator intends to require that TasWater achieve additional productivity savings on its proposed opex for the third regulatory period.

The Economic Regulator seeks stakeholder feedback on the possibility of changing the current timing for the recognition of TasWater's new capex assets in its RAB. The Economic Regulator believes that changing from the current practice of recognising assets once construction commences to recognising assets once they are fully operational may provide an increased incentive for TasWater to deliver its agreed capex projects on time and on budget.

The Economic Regulator notes that TasWater has made significant improvements in its capex planning and prioritisation for the third regulatory period. However, the Economic Regulator, industry regulators

and the Tasmanian Audit Office (TAO) have identified a need for TasWater to develop a long-term plan to achieve full regulatory compliance and operational efficiencies to avoid the risk of TasWater investing in redundant or stranded assets. Such a plan is considered a logical next step in TasWater's asset management and capex planning journey.

The Economic Regulator's proposed changes to TasWater's opex and capex are set out in the following table.

Table 1 Opex and Capex for the third regulatory period (\$000's)

	TasWater proposal	TER proposal	Reduction
Capex	466 616	431 743	-34 873
Opex	538 732	521 859	-16 873

Chapters 6 and 7 of this Draft Report cover the Economic Regulator's analysis and intended reductions in TasWater's proposed capex and opex for the third regulatory period.

## Regulatory depreciation

For the second regulatory period, the Economic Regulator applied a value weighted average approach to regulatory depreciation, and calculated regulatory depreciation rates for each of TasWater's asset categories after determining their useful lives. In its proposed Price and Service Plan for the third regulatory period, TasWater proposed applying a line by line approach to calculate the regulatory depreciation rates on all of its assets, ie new assets and existing assets.

The Economic Regulator intends to continue using a weighted average approach to calculating regulatory depreciation for TasWater's existing assets, but proposes using a line by line approach to calculate the regulatory depreciation on TasWater's new assets. Applying these approaches would lead to a reduction in TasWater's proposed regulatory depreciation for the third regulatory period.

Table 2 Regulatory depreciation for the third regulatory period (\$000's)

	TasWater's proposal	Economic Regulator's proposal	Reduction
Existing Assets	218 509	149 412	-69 097
New Assets	126 223	124 179	-2 044
<b>Total</b>	<b>344 732</b>	<b>273 590</b>	<b>-71 142</b>

Chapter 8 provides more detail on regulatory depreciation.

## Weighted Average Cost of Capital (WACC) and Return on Capital

As well as proposing to reduce TasWater's capex, opex and regulatory depreciation, the Economic Regulator proposes a lower WACC (Chapter 9) than that proposed by TasWater. The following table compares TasWater's proposed WACC components to those proposed by the Economic Regulator, along with the resultant WACC values.

Table 3 TasWater's and Economic Regulator's proposed WACC components and values

WACC component	TasWater's proposal	Economic Regulator's proposal
Gearing	60%	60%
Risk free rate	3.50%	2.90%
Debt risk premium	2.49%	2.03%
Debt issuance	0.10%	0.10%
Cost of debt (pre-tax)	6.09%	5.02%
Market risk premium	6.50%	6.50%
Equity beta	0.70	0.65
Statutory return on equity <sup>(Existing)</sup> (pre-tax nominal)	3.00%	3.00%
Gamma	0	0.4
Cost of equity <sub>(New)</sub> (post-tax)	8.05%	7.12%
<b>WACC<sub>EXISTING</sub></b>	<b>4.49%</b>	<b>4.00%</b>
<b>WACC<sub>NEW</sub></b>	<b>6.87%</b>	<b>5.86%</b>

Applying the Economic Regulator's proposed WACCs to its calculation of TasWater's RAB will also lead to a lower return on capital of \$43.3 million for the third regulatory period as explained in Chapter 10.

## Summary of the Economic Regulator's adjustments to TasWater's MARR

Table 4 provides a summary of the adjustments the Economic Regulator proposes making to TasWater's MARR for the third regulatory period.

Table 4 Summary of Economic Regulator's adjustments to TasWater's MARR for the third regulatory period (\$000's)

Description	TasWater's proposed PSP	Economic Regulator's Draft Report	Proposed Adjustment
Opex	538 732	521 859	-16 873
Regulatory depreciation	344 732	273 590	-71 142
Return on capital	494 781	454 418	-43 363
Inflationary gain offset	-228 419	-221 374	7 045
Working capital	4 867	0	-4 867
Tax allowance	70 489	34 757	-35 732
<b>TOTAL</b>	<b>1 225 185</b>	<b>1 060 249</b>	<b>-164 936</b>

## Finalisation of investigation

A summary of the Economic Regulator proposals from this Draft Report is included in a separate section below. An overview of the impact of those proposals on TasWater's MARR is also included in another separate section below.

The Economic Regulator encourages all interested parties to comment on the preliminary proposals set out in this Draft Report and the attached Draft Price Determination. The closing date for submissions is 25 January 2018.

Following consultation and consideration of submissions, the Economic Regulator will complete its investigation and publish its Final Report and Final Price Determination by April 2018.