

Treasurer

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Mr P Harris
Chairman
Productivity Commission
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Attention: Jane Doolan, Commissioner

Dear Mr Harris

Tasmanian Government submission to the Inquiry into National Water Reform

The Tasmanian Government is pleased to provide this submission to the Productivity Commission Inquiry into progress towards achieving the objectives and outcomes of the National Water Initiative (NWI).

The draft report released by the Productivity Commission on 15 September 2017 highlights the extensive progress made by all jurisdictions of Australia since the National Water Initiative was developed in 2004. We are pleased to note that in many areas, the Commission has found that Tasmania has made very significant progress in implementing water reform, including in the areas of urban water reform, environmental management and water infrastructure for agriculture.

The Tasmanian Government continues to be committed to the objectives of the NWI and to progress reforms in the public interest, which includes taking into account economic development objectives and ensuring that reforms are delivered at a pace that is affordable for Tasmanian households and businesses.

Urban Water

Overview of Tasmanian Government's proposed reforms

The draft report contains some statements relating to Tasmanian Government legislation to continue the path of reform in Tasmania's water and sewerage industry.

It is important to set out the public interest reasons for the measures in the Government's legislation, which has passed through the House of Assembly and will soon be considered by the Legislative Council.

Tasmania's water and sewerage industry currently faces a set of very significant challenges. This was due initially to the poor quality of the water and sewerage infrastructure that the regional corporations inherited from Tasmania's councils when these corporations were established in 2008. The problems have remained, and in some areas have become worse, due to the modest rate of infrastructure investment since that time, including since July 2013 when the regional corporations were merged into a single entity, TasWater. The industry has remained in local government ownership, which has not proved a successful ownership and governance model.

Since the reforms almost 10 years ago, the water and sewerage industry under council ownership has failed to meet community expectations. TasWater and its predecessors have made slow, and often delayed, progress in improving water quality. Over this time, many environmental outcomes have also declined.

The Tasmanian Economic Regulator, in his *Tasmanian Water and Sewerage 2015-16 State of the Industry Report*, found that:

- delays in TasWater's capital works program meant that improvements to drinking water quality were not delivered as scheduled and Tasmania's water and sewerage assets are deteriorating faster than they can be replaced;
- 25 water systems were operated under a temporary or permanent boil water alert while another five systems had a public health (do not consume) alert in place;
- despite significant investment in terms of both expenditure and effort, drinking water quality and environmental compliance are not at the levels expected or required for contemporary water and sewerage networks;
- compliance with regulatory discharge limits for sewage effluent has worsened by around eight per cent over the past six years from 2009-10;
- only one of TasWater's 79 Level 2 sewage treatment plants was 100 per cent compliant in 2015-16; and
- the operating performance of the 13 largest sewage treatment plants that process approximately 70 per cent of treated volume remains well below expectations.

Of particular relevance to the objectives of the NWI, the Economic Regulator reported that water losses were very high, with only two litres out of every three litres of treated water being accounted for in 2015-16, such that 24 610 mega litres of water were treated by TasWater but this water was either lost or not charged to customers.

Current investment levels are inadequate. The Chair of TasWater, Mr Miles Hampton, has stated that Tasmania's water and sewerage assets are deteriorating faster than they can be replaced. The Economic Regulator also made this point in his report. In the future decade a substantial infrastructure investment program is required to address these very important issues.

Tasmanian households and businesses have faced very significant price increases since the initial reforms were introduced in 2009. Average household bills have increased by around 60 per cent over this period. For many households and businesses, the increases have exceeded 100 per cent. Of concern to the Government is that, since 2009, and despite the delays in removing boil water alerts and the substantial level of non-compliance with its environmental obligations, TasWater, and its predecessors, have paid councils around \$207 million in returns. For 2016-17, for example, for every \$100 TasWater collected from its customers, around \$10 was passed on to its owner councils.

The legislation includes the transfer of ownership of TasWater to the State Government. It also sets out revised governance arrangements for investment planning in the industry, with the new State Government business being required to prepare a 10 year infrastructure investment plan, which will be publicly released. The Government considers that this will address the concern in the Commission's draft report that there should be greater transparency in investment planning in Tasmania, as TasWater has not published comprehensive planning documents.

The legislation also transfers responsibility for price setting from the Economic Regulator to the Government. Importantly, the legislation does not permit the new State Government business to make any dividend or income tax equivalent payments to the Government. It will also have a lower cost of debt as it will not be required to pay government guarantee fees. These measures are hardwired in the legislation to ensure that the new business is able to maximise its capacity to invest in new infrastructure from its retained earnings, without requiring further large price increases to customers.

The Government considers that it is unfair to expect Tasmanian households and businesses to face unnecessarily large increases in water and sewerage charges because the investment needed to meet environmental and other obligations is allowed to earn a commercial rate of return. For a business that will be required to acquire significantly more capital over the decades ahead, this would only result in further unnecessary price increases for Tasmanian households and businesses.

Role of the Tasmanian Economic Regulator

The draft report states that the proposed legislation will constrain the role of the Tasmanian Economic Regulator. There is an implicit suggestion that the Tasmanian Government's plans for economic regulation and the removal of the Economic Regulator's price setting function is inconsistent with NWI commitments about independent economic regulation.

The Tasmanian Government's proposed legislation retains an investigatory, advisory and reviewing role for the Economic Regulator. These roles and functions are consistent with the NWI commitment that jurisdictions agree that independent bodies should set or review prices or price setting processes so they are consistent with NWI pricing principles.

The Tasmanian Government accepts that under the proposed reforms, the Tasmanian Economic Regulator will have a changed role and will no longer be responsible for determining prices. However, the Economic Regulator retains significant functions and powers. The Economic Regulator will have a critical role in investigating, reviewing and advising the Tasmanian Government about pricing and pricing principles.

Economic Regulator continues to review and make recommendations about pricing and pricing principles

The Water and Sewerage Tasmania (Consequential and Transitional Provisions) Bill 2017 makes a number of amendments to the regulatory framework established in the *Water and Sewerage Industry Act 2008*. Many of the features of the economic regulatory framework are retained, including a requirement for licensing, compliance with licence conditions, customer service codes and performance monitoring. The Consequential and Transitional Provisions Bill also retains provisions in the Water and Sewerage Industry Act that allow for entry into the market by new service providers.

The Water and Sewerage Industry Act 2008 and subordinate legislation include a number of pricing principles consistent with NWI commitments, including promoting economically efficient and sustainable use of water resources and infrastructure, applying user pays principles, which excludes cross subsidies, and ensuring that there are sufficient revenue streams to allow for efficient delivery of water and sewerage services. The pricing principles specified in the Act include principles that allow TasWater to have a reasonable opportunity to recover efficient costs, provide for two-part pricing, and the incremental removal of inequitable cross subsidies.

The Tasmanian Government recognises that the application of these principles has achieved many of the outcomes sought in the original reforms and the NWI. Most Tasmanians now pay a uniform tariff with pricing that include cost reflective volumetric charges to ensure the efficient and sustainable use of water resources.

For these reasons, all pricing principles that are currently included in the Water and Sewerage Industry Act will be retained in the Tasmanian Government's proposed reforms, except the requirement for prices to allow for a commercial return on the assets, which are no longer appropriate in the Tasmanian context.

However, the manner in which the pricing principles are applied will change.

Instead of a price determination by the Economic Regulator, the Consequential and Transitional Provisions Bill provides that prices are to be set by two methods, depending on the relevant period:

- for the period of the third Price and Service Plan between 2018-2021, prices are to be set in a Price and Service Plan approved by the Economic Regulator with the annual price increases set out in the legislation, though they can be changed by the Treasurer on advice of the Economic Regulator; and
- for subsequent periods, prices are to be set in a Treasurer's pricing order, after the Economic Regulator conducts a pricing investigation and makes a recommendation about maximum prices.

During both periods, the Economic Regulator will investigate and review operational and capital expenditure to consider whether expenditure is efficient, and also consider whether pricing is consistent with pricing principles set out in the Water and Sewerage Industry Act.

In the second period, where prices are to be determined in a Treasurer's pricing order, the Consequential and Transitional Provisions Bill specifies certain matters that the Economic Regulator is to consider when conducting a price investigation and making a recommendation that will inform the Treasurer's pricing order. For example, the Economic Regulator is to consider in its investigation:

- the efficient and effective supply of water and sewerage services;
- the financial sustainability of the business;
- the business' current infrastructure investment plan; and
- the pricing principles

During its investigation, the Economic Regulator may conduct public hearings. The Regulator's draft report is to be made publicly available and a copy of the final report is to be laid before Parliament.

While the Treasurer is not bound by the Economic Regulator's recommendation about maximum prices, the Treasurer's pricing order must be consistent with the legislated pricing principles. In effect this means that a pricing order should not be so low such that revenue levels will prevent the new government business from achieving sustainability and meeting the efficient costs incurred in providing a regulated service.

The publication and tabling of the Economic Regulator's final report in Parliament also means that there is full transparency if there is a deviation between the Regulator's recommendation about maximum prices and the Treasurer's pricing order.

The draft report also notes that jurisdictions require flexibility to tailor their regulatory regimes to their particular needs. The Tasmanian Government is doing so. The proposed legislation makes it clear that the objectives of the new government business are to efficiently and effectively provide water and sewerage functions in Tasmania and ensure sustainable, efficient and effective investment

in water and sewerage infrastructure. These objectives have been developed to promote the long term interests of Tasmanian consumers, to ensure that Tasmanians have access to fully compliant water and sewerage infrastructure. To date, this has not occurred in many parts of the State.

The economic regulatory regime that will apply to the new Government business recognises that the Government will have a greater role in, operational and capital expenditure decisions, as a result of the particular challenges in ensuring improvements to Tasmania's ageing and non-compliant infrastructure. However, the actions of the new business and its Shareholding Minister will be subject to investigation and review by the Economic Regulator. This will allow scrutiny of the prudence and efficiency of expenditure, and will support sound operational and investment decisions. The Tasmanian Government considers that this framework is consistent with NWI commitments for independent review of price and price setting processes.

Underpricing - lower bound pricing

The Productivity Commission's Draft Finding 6.1 states that there is some evidence of underpricing in Tasmania, below lower bound levels. The commentary explains, without detail, that this is explicitly provided for in legislation, with prices moving towards more cost-reflective levels over time [page 166].

TasWater's second Price and Service Plan approved by the Economic Regulator contains a lower revenue limit that is consistent with NWI lower bound pricing principles, and which allows TasWater to recover the minimum revenue required to achieve sustainability, cover its operating and capital expenditure, service its debt and pay distributions to owners.

We assume that the reference to pricing below lower bound pricing in the draft report is a reference to prices chargeable to customers who are yet to transition to the target tariff, which is a tariff that generates revenue between the lower and upper bound.

Before 2009, water and sewerage services were provided by Tasmania's local councils and prices varied markedly between municipalities, with some customers paying much more than others for the same services. Since then, there has been a gradual transition of customers to the target tariff. It has been necessary to set a long transition time to bring all customers to the target tariff to avoid unacceptable price increases.

TasWater's draft third Price and Service Plan states that there will be approximately 7 500 customers below the target tariff at the end of TasWater's second Price and Service Plan, representing around five per cent of all TasWater's customers. Most of these customers have bills that are 10 per cent or less below the target tariff, though a small number of customers have bills that are more than 40 per cent below the target tariff. The *Water and Sewerage Industry (Pricing and Related Matters) Regulations 2011* requires that all customers are on uniform prices by 1 July 2020. This would require yearly price increases of around 24 per cent for a customer who is currently 40 per cent under the target tariff.

The Consequential and Transitional Provisions Bill extends the transition period for the remaining customers who are yet to transition to the target tariff, to mitigate against sharp price shocks. The Bill provides a longer transition path for these customers.

The pricing principles retained in the Consequential and Transitional Provisions Bill provide for the recovery of the efficient costs incurred in providing the regulated service. These principles are consistent with the NWI lower bound pricing principles as they will ensure that efficient costs are recovered and prices remain at levels that ensure the ongoing sustainability of the new Government business.

Underpricing - upper bound pricing

An immediate move towards upper bound pricing in Tasmania would result in unacceptable large prices increases to Tasmanian households and businesses. If TasWater had priced at upper bound levels during the period of the second Price and Service Plan (2015-18), the annual water and sewerage bill for households would have been, on average, around 17 per cent higher than the actual bills they faced. For 2017-18, this represents an additional \$176 for the average household. Over the three years, the additional charge would have been \$565.

In the decades ahead, there will be very substantial investment in Tasmania's water and sewerage industry. The industry will therefore accumulate capital, which would result in further steep increases in water and sewerage prices if all capital were to make a commercial rate of return.

Equally, it is not acceptable that households and businesses must face higher water and sewerage charges just so that the owners can receive larger dividends and other returns. For this reason, the Water and Sewerage Tasmania Bill 2017 does not require the new business to provide returns to the State Government. This allows the new business to reinvest its earnings in infrastructure, resulting in the business' borrowing requirement being lower than otherwise and therefore reducing its interest costs.

The rationale for allowing utilities to make a commercial rate of return on their capital is to provide incentives for efficient investment, reflecting how investment decisions are made by private sector businesses. In the case of Tasmania's water and sewerage industry, the situation is quite different as investment decisions are driven largely by the requirements of the relevant regulators, including the Environment Protection Authority and the Director of Public Health. The new Government business will be required to develop a 10 year infrastructure investment plan to improve compliance with statutory health and environmental requirements. It is not necessary to have the incentive of a commercial rate of return to determine these major investment decisions.

As set out above, the new Government business has a statutory obligation to ensure its investment is 'sustainable, efficient and effective'. The Government therefore does not agree with the statement in the draft report that the measures in the legislation are unlikely to promote the objectives of the NWI, such as the efficient use of water infrastructure.

Water infrastructure for agriculture

Overview

The Tasmanian Government, in partnership with the Australian Government and private investors, has supported the development of irrigation schemes across the state. Not all irrigation schemes in Tasmania are publicly funded: a number of schemes have been developed without government support.

Given that many local communities have not the capital or the capacity to develop irrigation schemes on prime agricultural land, there is a strong economic argument for why successive Tasmanian Governments have led the development of irrigation schemes through the expertise of Tasmanian Irrigation, a State-owned Company.

The public-private partnership model for irrigation infrastructure development adopted by Tasmania, with the support of the Australian Government, ensures that government support is prudently directed to assisting with capital costs for schemes designed to last 100 years. This is

supporting the Tasmanian Government's Agri-Vision 2050 plan which aims to increase the value of agriculture in Tasmania ten-fold to \$10 billion by 2050.

The model also ensures that risks associated with each scheme are shared with private sector investors and that an appropriate due diligence process is followed prior to scheme construction being approved.

This leadership has included setting benchmarks for asset longevity as well as setting prudent benchmarks to ensure supporting governments receive value for money for their capital contributions.

The first stage of irrigation development (known as Tranche 1) has delivered ten irrigation schemes which distribute stored winter flows for summer irrigation. In total, these ten schemes can deliver around 75 000 ML of high reliability irrigation water to a potential area of approximately 133 000 ha. The first three of these schemes commenced operations in the 2011-12 season and by the 2015-16 season all ten were operational.

The second phase of irrigation development – Tranche 2 – is well underway with a further five schemes either under construction or in the final stages of approval. These schemes will have a combined capacity of 28 000 ML and with potential to reach 82 000 ha. Tranches 1 and 2 combined will make over 100 000 ML of irrigation water available– delivering a major boost to agricultural productivity in Tasmania.

The Commonwealth Government is also jointly investing with the Tasmanian Government to investigate a potential third stage of development. Eight possible schemes are being considered for development, with the potential to make in excess of approximately 45 000 ML of summer irrigation water available. Opportunities to capitalise on unmet irrigation demand and water capacity in other districts are also being explored.

These schemes are all developed on a partnership investment model which shares the capital risk between the Tasmanian and Australian Governments and private investors. The capital cost of developing all 15 Tranche 1 and 2 schemes is expected to be \$483 million, with private investors (mainly irrigators) contributing \$121 million. As well as the 25 per cent of capital costs contributed by the private sector, irrigators are investing heavily in on-farm systems which include pipelines, irrigators and pumps. Tasmanian Irrigation in developing the original Tranche 2 program conservatively estimated the additional on-farm private investment for the five schemes at \$1.69 for every \$1 of public contribution. This investment in regional economies is expected to contribute substantially in terms of additional employment opportunities, with the usual flow-on benefits to maintaining the viability of regional communities. Tasmanian Irrigation's modelling for the Tranche 2 program (by economic consultants Marsden Jacob Associates) also estimated the flow on economic benefit, based on combined NPV farm gate, to equate to an economic multiplier of three.

The Tasmanian and Australian Governments have taken care to ensure that compliance with the NWI is a key factor in scheme development. All schemes are carefully scrutinised to ensure that all planning and environment approvals are in place and that the local community supports the development of particular schemes. Water for the schemes is allocated under a National Water Initiative-compliant licensing and allocation system which also provides environmental protections. The economic assessment of proposed schemes is designed to ensure that the schemes will deliver a net benefit and offer good value for money. Operating costs of these schemes are recovered from irrigators through water entitlement-based fixed charges and volumetric tariffs applied to water deliveries.

Irrigation scheme development in Tasmania is proving to be very successful and it is expected that that success will continue to build into the future. The Tranche 1 schemes have more than 430 irrigator customers and the Tranche 2 schemes have around 220 water entitlement commitments.

The Tasmanian Department of Primary Industries, Parks, Water and Environment calculates that less than 10% of the state's agricultural land is irrigated and yet produces almost 55% of the gross value of Tasmania's agricultural production. Irrigated land is estimated to produce over 10 times the value per hectare compared to improved agricultural land that was not irrigated.

Accordingly the Tasmanian Government considers that government support for irrigation scheme development is vital. It is underpinning an active policy to develop irrigated agriculture which will realise very significant benefits, economic and other, in local economies throughout Tasmania. The Government considers funding support for irrigation infrastructure to be a well justified investment in Tasmania's future. This justification is based on a broad view of the economic and social benefits from these schemes, which will underpin regional economies and regional communities for decades to come.

For example, the Midlands Irrigation Scheme, the largest scheme completed so far, is expected to contribute economic benefits valued at \$193 million, with a benefit-cost ratio of 1.2. For this scheme, it is very clear that job creation and additional value are two benefits that have been provided to the Tasmanian economy through the recent program of investment in irrigation. The availability of water through the Midlands Irrigation Scheme is providing substantial benefits to land that was formerly used for marginal dryland sheep farming. For example, a major cherry grower has invested \$3 million plus a \$1 million innovation grant from the Federal Government to set up a state of the art cherry orchard in the Tasmanian midlands. The orchard includes the first commercial retractable roof greenhouse used for cherry production in the world and water is supplied from the Midlands Irrigation Scheme.

We trust this information is useful for the Productivity Commission Inquiry and look forward to the Commission's final report.

Yours sincerely

Hon Peter Gutwein MP

Treasurer

Hon Jeremy Rockliff

**Minister for Primary Industries
and Water**