SUBMISSION:

SEQ LONG-TERM REGULATORY FRAMEWORK REVIEW

TECHNICAL PAPER

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EXECUTIVE SUMMARY

Queensland Urban Utilities (QUU) is pleased to be making this submission to the Queensland Competition Authority's (QCA) Technical Paper. QUU acknowledges the QCA's work in developing a long term framework that will apply from July 2015 and welcomes the opportunity to contribute to this process.

QUU acknowledges that the QCA has had to develop the long term regulatory framework under a tight time frame. However, having considered the QCA's Technical Paper and the preceding Long Term Framework Position Paper, QUU is concerned that various components of the framework remain unclear, and the release of the Technical Paper either fails to bring clarity to these issues or introduces further uncertainty to the framework.

Overall, QUU still does not fully understand how the long term framework will operate in practice.

In light of these overarching concerns, QUU seeks further clarity regarding the following matters:

- Information Requirement
- Multi-year scenarios
- Exercising of monopoly power – multiple years
- Information level thresholds
- Trigger Scenarios
- Reference MAR
- Under and Over Recovery

<u>Information Requirement</u>

A significant issue to date is the information burden that the QCA is recommending under Level 1[1] (i.e. when there is no breach of the CPI-X price threshold).

QUU is concerned with the level of information the QCA is requiring DRs to submit even when there is no breach of the CPI-X price threshold. If a DR's self-assessment reveals that it is at Level 1 (i.e. no breach of CPI-X), it is still required to provide a significant amount of information. An attachment to our submission highlights the various pieces of information being requested by the QCA at each of the levels identified in the Technical Paper.

There is a risk (as outlined in the Position Paper on the Long Term Regulatory Framework[2]) that in attempting to improve the performance monitoring over time, the QCA will further expand its data requirements and impose higher compliance costs. QUU suggests that the QCA should consider, for each piece of information that it is requesting, whether that piece of information will assist it in determining whether a DR is exercising market power or not.

QUU is also concerned that under the lowest level of information requirements (Level 1), the QCA is requesting examples of how processes are being

[1] Appendix A

[2] p.17, Position Paper, Long Term Regulatory Framework for SEQ Water, QCA, Feb 2014

implemented. QUU is of the view that under Level 1 (where no breach of the CPI-X price threshold has occurred), DRs should only provide governance and process documentation; however where a significant breach of CPI-X has occurred and further investigation is required, then further documentation (i.e. examples) can be provided to show how the DR has applied the processes.

QUU is of the view that currently, the level of information that is sought by the QCA at Level 1 is significant, especially given the light handed intent of the regulatory framework provided for in the Direction Notice.

Multi-year scenarios

The information presented by the QCA only considers the application of the threshold in a one-off scenario (i.e. in one year), there does not appear to be a consideration of multi-year scenarios. An example of this is, if a DR breaches the threshold in one year, but is accepted by the QCA, what happens to the Reference MAR and analysis for the next year if the threshold is breached again? Alternatively, if a DR breaches the threshold and it is not accepted by the QCA, what happens to the assessment in the subsequent years? QUU considers that explanation of multi-year scenarios by the QCA will assist in the DRs' understanding of the application of the framework over time.

Exercising of monopoly power – multiple years

The QCA has previously stated that:[3]

> *"The most evident exercise of market power would occur where prices were set by entities to explicitly result in forecast revenues in excess of MAR over a sustained period"*

A consideration of performance over multiple years recognises the fact that breaches of a CPI-X constraint in a single year, including minor breaches, will not be indicative of the exercise of market power by a DR. It is well accepted in regulatory and competition literature that any such assessments of market power must be based on evidence revealed over a number of years.

Therefore the QCA needs to be mindful of this during its assessment of the DR with regard to Level 3 and Level 4 breaches, and in considering whether to undertake a Cost of Service Review.

Trigger scenarios

It is apparent from reading the QCA's Technical Paper and the Position Paper on the Long Term Regulatory Framework that the QCA's position in relation to the thresholds and how it will be applied has changed. The trigger scenarios identified in the Position Paper have been replaced in the Technical Paper with a simplified focus on price changes as the trigger. QUU supports the move away from the complicated trigger scenarios outlined in Table 9 of the Position Paper to the simpler assessment outlined in the Technical Paper.

Information level thresholds

QUU does not understand the difference between Level 1 and Level 2 of the information requirement and assessment process outlined in Table 4. The

[3] p.60, Ibid

imposition of the CPI-X "constraint" on individual tariffs and the components of each tariff class has no economic basis, as the impacts on customers from changes in retail tariffs is based on the interaction between the components of the relevant tariff structure and the customer's demand profile, and not the impact of each tariff component in isolation. Furthermore, CPI-X constraints seen in other Australian jurisdictions are applied at a higher aggregate level to MAR or to Weighted Average Prices, they are not applied at the individual tariff level.

QUU considers that it will be more meaningful for the QCA to consider average water and sewerage, residential and non-residential, retail tariff changes as proposed for Level 2. As a result, QUU proposes that the focus on components of prices be removed from the long-term framework.

QUU also does not understand the difference between Level 3 and Level 4 thresholds. The QCA states that the difference between the levels relates to number of costs increases ("limited" vs "wide range") that lead to the breach of CPI-X. QUU considers that the number of cost items that change from one year to the next is not an appropriate metric to consider whether a business should trigger a more stringent level of information burden. That is because it is not a relevant indicator of whether a business is exercising monopoly power. QUU suggests that the threshold between Level 3 and Level 4 be related to the materiality of the breach of CPI-X rather than the number of costs items that increased. This price threshold needs to be clearly specified prior to the commencement of the long term framework.

Furthermore, QUU would like to understand what the difference is between Level 4 and a Cost of Service Review. At this current stage, the information requirements and assessments under Level 4 look very similar to a Cost of Service Review, while the Technical Paper does not actually outline what analysis QCA will be undertaking under Level 4 (unlike its analysis with the other levels).

<u>Reference MAR</u>

QUU has significant concerns about how the QCA will update its Reference MAR from year to year. More specifically, how will the QCA be escalating its MAR? Under the proposed framework, it is possible that the QCA will not be receiving information on costs and capital contributions when the DRs are operating within Level 1 and Level 2 of the information requirements. Thus there is a strong possibility for a significant divergence between the QCA's Reference MAR and QUU's MAR.

<u>Calculation of under/over recovery</u>

The QCA has not revealed how it will determine the under/over recovery for the DRs. Will the QCA determine the under/over recovery based on the QCA's Reference MAR or the calculation of the MAR based on actual information provided by the DRs. In addition, how will the under/over recovery be determined in years where DRs are not providing cost information to the QCA?

QUU is of the view that any under/over recovery should be based on DRs' actual information as the inherent incentives of the regulatory framework will seek to ensure that expenditure by the DRs is efficient.

Given that there is likely to be a divergence between the Reference MAR and the actual MAR over time, it is important that this issue is clarified before the long term framework commences.

Revenue

The QCA comments that:[4]

> *"Water retailers' price and revenue performance would be assessed against CPI-X. Costs would only be reported and reviewed by retailers' if price or revenue changes exceed CPI-X or where service quality issues arise".*

QUU does not understand why the QCA is considering revenue performance against CPI-X? If revenue is to be considered, then the QCA will also need to consider the issue of growth.

In the QCA's comment above, the word "retailers'" in the second line should be the "QCA".

Structure of this submission

The remainder of this paper responds to the QCA's Technical Paper in a structure that is similar to the structure of the QCA's Technical Paper as follows:

- Section 2 – CPI-X
- Section 3 – Under and over-recovery
- Section 4 – Information requirements
- Appendix A – Proposed information requirements under long term framework.

[4] Paragraph 6, Page1, Technical Paper, SEQ Long Term Framework – Annual Performance Reporting – Implementation Issues, QCA, June 2014

1. CPI-X

1.1 CPI

RBA Forecasts

QUU considers that the use of the word "actual" in bullet point (d)[5] is confusing. The QCA may be attempting to state that the DRs should use existing or publicly available RBA forecasts. QUU suggests that instead of using the word "actual", the QCA should use "existing" or "published".

Multiple CPIs

QUU is concerned that there are multiple CPIs being used within the proposed regulatory framework. Firstly, there will be the CPI associated with the midpoint of the RBA's forecast of inflation used by the QCA to assess the DR's prices (draft recommendation). Secondly, QUU understands that the current approach of rolling forward the RAB to estimate the MAR is to use the mid-point of the RBA target range. Thirdly, the Brisbane All Groups March to March CPI (ABS) is used for the roll forward of the RAB once actual information is known.

QUU suggests that the two forecasts of CPI be based on the same approach (i.e. the midpoint of the RBA's forecast of inflation in its Monetary Policy Statement at the time of setting prices), while the actual CPI figure used to roll forward the RAB should be left as it currently stands.

Divergence in Target Range

The QCA comments that:[6]

> *However, where prices are reset annually, such as is the case for SEQ water retailers, the forecast for any particular year may diverge from the RBA target range, leading to accumulated under- or over-recovery.*

QUU does not understand this statement, as the fact that prices are reset annually is not related to the divergence from the target range. In fact, resetting prices annually reduces the risk of accumulated under or over recovery related to divergence from the RBA target range. QUU suggests that the QCA clarify this statement.

Draft Recommendation 2.1

QUU has no issue with this draft recommendation. However, QUU requests that the QCA provide further clarification of the issues highlighted above regarding use of CPI estimates.

Draft Recommendation 2.2

QUU has no issue with the X factor being proposed. Traditionally, X factors in Australia have been used in price deterministic regimes where it is part of a 'harder' weighted average price cap or revenue cap. In this case however, the X factor is proposed to be a part of a threshold, where breaching the CPI-X threshold will trigger a request for further information and explanation from

[5] Page 3, Ibid
[6] paragraph 3, page 4, Ibid

DRs. This should be reflected in the discussion by the QCA, that is, the X factor is for a light handed framework.

QUU notes that the practical effect of the QCA's proposed CPI-X mechanism will be to establish a medium term quasi price constraint for the SEQ DRs of 2.25% growth per annum.[7] QUU notes that minor breaches of such a strict price constraint would not provide any meaningful indication that a DR is exercising market power. It is simply a quasi-deterministic price control mechanism.

Outperformance

The QCA comments that:[8]

> *The Regulatory Framework Position Paper (QCA 2014a) noted that, where entities demonstrate that price increases are in line with CPI-X but costs increased by less than CPI-X due to efficiency initiatives, these gains may be retained by the entities for up to three years before being passed through to customers.*

For reasons explained in our previous submission[9] QUU suggests that this recommendation should be removed.

Draft Recommendation 2.3

QUU agrees that the X factor be reviewed; however, this should be part of a holistic review of the long term regulatory framework to assess its effectiveness, including whether the framework objectives are being met and that the framework remains relevant. This review of the framework was proposed in our previous submission (the periodic framework review).

[7] The figure of 2.25% is based on a mid-point of the RBA's target range for inflation of 2.5% minus the QCA's proposed X-factor of 0.25%.

[8] 1st paragraph, Page 12, Ibid

[9] Paragraph 5, Page 38, *QUU Submission to QCA on Long Term Regulatory Framework Position Paper 2014*

2. UNDER AND OVER-RECOVERY

2.1 Introduction

The QCA comments that:[10]

> *The Regulatory Framework Position Paper (QCA 2014a) recommended that under-recoveries incurred in 2013-14 and 2014-15 as part of a price path can [that is, are eligible to] be carried forward into the maximum allowable revenue (MAR) from 1 July 2015. Where a water retailer is considered to have over-recovered revenue during the 2013-15 period, the over-recovery must be passed back through future price adjustments.*

The QCA's comments imply that a price path needs to have been in place for a past under recovery to be carried forward. These comments are at odds with the QCA's knowledge that DRs undertake pricing on an annual basis. Therefore, from this perspective, QUU would like the reference to price path removed. From QUU's perspective, an internal price path reflective of recovery of the DR's MAR should be sufficient for the QCA.

<u>QUU MAR versus QCA Reference MAR</u>

It is not clear from the Technical Paper (or the previous Position Paper) whether the QCA intends to calculate the under (or over) recovery with regard to the QCA's Reference MAR or the calculation of the actual MAR from QUU's actual costs for the year.

QUU suggests that the calculation of the under (or over) recovery should be based on the difference between actual revenue and the actual MAR calculated from audited information for the year.

2.2 Past Under or Over Recovery

<u>Foregone Revenues</u>

The QCA states that:[11]

> *For previous years (before 2013-14), under-recovery may only be recognised where it relates to flood impacts. QCA's view in the Position Paper is that under-recovery prior to 1 July 2013 was the result of a legitimate exercise of the retailers' discretion to forgo these revenues and accept a lower rate of return.*

In this discussion, the QCA does not mention the *Fairer Water Prices for SEQ Amendment Act 2011* that was enacted to cap DRs' price increases at CPI for 2011/12 and 2012/13. The above statement is also very broad and assumes all DRs in the SEQ region decided to forego revenues. As QUU understands, both Unitywater and QUU set prices below the CPI price cap for 2012/13, and therefore did not recover the full amount of revenue that they could have under the price cap. However, the size of this under-recovery was not

[10] 2nd paragraph, Page 13, Technical Paper, SEQ Long Term Framework – Annual Performance Reporting – Implementation Issues, QCA, June 2014
[11] Paragraph 8, page 13, Ibid

significant compared to the under recovery related to the CPI price cap. Therefore the primary source of under-recovery was the legislated CPI-based price cap.

Eligibility of Under Recovery

The QCA comments that:[12]

> *To assist entities, the QCA proposes to estimate the amount of under-recovery that is eligible to be accommodated in pricing decisions in future years (for its Final Report).*

QUU is seeking clarity from the QCA as to what it means when it states "eligible" under-recoveries.

Under and Overs Mechanism

The QCA comments that:[13]

> *"The QCA recommends that the appropriate mechanism to address unders and overs is to smooth out the impact on prices, with prior under-recoveries to be recouped on an NPV-neutral…."*

At this stage, QUU is of the view that the QCA has not provided a clear and detailed mechanism for addressing unders and overs for future pricing purposes. An example of what this mechanism looks like and how it would work, under the different Levels (1, 2, 3 and 4) outlined in Table 4 of the paper would be a worthwhile addition to the Technical Paper.

To avoid potential misunderstanding and rework in the future, QUU suggests that the QCA develop (in partnership with the DRs) a template that outlines the calculation of an under-recovery and how it can be incorporated into the MAR.

Draft Recommendation 3.1 and 3.2

QUU has no issue with these draft recommendations.

Draft Recommendation 3.3

QUU has no particular issues with this recommendation; however, QUU suggests that there should be a time frame over which DRs should 'hand back' over recoveries through future price adjustments. QUU suggests a time period of five years.

2.3 Revenue Risks

Under and Overs – Revenues

The QCA comments that:[14]

> *In other jurisdictions where a deterministic regulatory framework is applied for water utilities' unders and overs mechanisms are often, but not in all cases, used to manage variances between actual and forecast revenues.*

[12] 1st Paragraph, page 14 ibid
[13] 2nd paragraph, page 14, Ibid
[14] 3rd paragraph, page 14, Ibid

The above statement needs further clarification. Unders and overs mechanisms are used to manage the difference between actual revenue and forecast maximum allowable revenue. While this may not be an issue where the DR is pricing to recover the full costs of service provision, there is a difference when a business is in an under recovery position. QUU suggests that this by clarified.

Draft Recommendation 3.4 and 3.5

As these draft recommendations are drafted, QUU is unclear whether it is that under-recoveries are to be recovered over a 10-year period from the time that they are incurred post 1 July 2015, or that any and all under-recoveries are to be recovered by 10 years from 1 July 2015 (i.e. 2024).

QUU agrees with the concept that under recoveries should be recovered by DRs over a maximum of 10 years from the time they are incurred.

QUU suggests that the QCA clarify the wording of these draft recommendations.

Capital Contributions

QUU suggests that the QCA should also consider forecasting error in relation to capital contributions, as capital contributions have an impact on the calculation of the RAB and the subsequent derivation of MAR. QUU suggests that the QCA explicitly outline how it will address any over or under-recovery related to capital contributions (either using a revenue or asset offset approach)

2.4 Cost Risks

Government Policy Impact

With regard to bullet point (d) on page 17, QUU agrees that Government policy can be a potential risk for QUU, in terms of costs.

QUU considers that the QCA also needs to acknowledge that Government policy can also impact on revenues. For example, Government policy changes with regard to infrastructure charges can have a large impact on QUU's revenues, as well as its costs. This, in turn, has implications for QUU's retail prices because there is a direct linkage between infrastructure charges and retail prices, which are both used by QUU to recover its costs.

2.5 Outperformance

Please refer to comments made above regarding outperformance.

3. INFORMATION REQUIREMENTS

3.1 Overview of information requirements

Draft Recommendations

QUU notes that unlike the previous sections of the Technical Paper, there are no draft recommendations under section 4 guiding DRs and the reader as to what the QCA is proposing. Not having draft recommendations makes it difficult for DRs to differentiate between the QCA's discussion, analysis and draft recommendations.

Again, this highlights the need to have a Governance Framework Document that outlines the rules of the framework as highlighted in our submission to the QCA's Position Paper on the Long Term Regulatory Framework. QUU is of the view that a *"Performance Monitoring Determination"* would assist the QCA in the governance of the regulatory regime.

Average Price

Under the Level 2 information requirements, under the *"If, in the retailer's self-assessment"* column, the QCA mentions average prices. Is the QCA referring to average prices at the QUU whole-of-business level, or average prices at the regional level?

QUU considers that the whole-of-business level is the most appropriate and this is consistent with what the QCA has previously considered average prices.

Relationship between Table 4 and Table 9

QUU seeks clarification from the QCA to explain how Table 9 from the QCA's Position Paper on Long Term Regulatory Framework for SEQ Water Entities aligns with Table 4 from this Technical Paper.

It appears to QUU that Table 4 has reduced the number and nature of review trigger scenarios to simply be changes in a DR's retail water and sewerage retail prices relative to the CPI-X constraint. That is, changes in costs (MAR) and service standards, will no longer form part of the various review trigger scenarios. QUU seeks clarification whether this interpretation is correct. If so, QUU supports the proposed simplification.

Information level thresholds

However, in a general sense, QUU struggles to understand whether it makes any sense to distinguish between Levels 1 and Level 2 in terms of information requirements and the QCA's associated assessment process. This is primarily because the imposition of the CPI-X constraint on each tariff class and its individual component parts does not have a sound economic basis. This is because the customer impact of any retail tariff changes will be based on the interaction of the components of the relevant tariff structure with the customer's demand profile, not the impact of each tariff component in isolation. QUU is not aware of any price capping arrangement operating in Australia that applies a CPI-X mechanism to individual tariff components.

QUU considers that it will be more meaningful for the QCA to consider average water and sewerage, residential and non-residential, retail tariff changes as proposed for Level 2. As a result, QUU proposes that the consideration of components of prices be removed from the long-term framework.

In addition, QUU does not understand the nature of the threshold between the Level 3 and 4 scenarios. Table 4 indicates that the Level 3 threshold is based on price increases greater than CPI-X due to 'increases in a limited number of cost items', while the Level 4 threshold is based on price increases greater than CPI-X 'in a wide range of costs'.

QUU considers that the number of cost items that change from one year to the next is not an appropriate metric to consider whether a business should trigger a more stringent level of information burden. That is because this is not a relevant indicator of whether a business is exercising monopoly power. QUU suggests that the threshold between Levels 3 and 4 should be related to the materiality of the breach of the overall CPI-X price threshold.

Finally, QUU requests the QCA to explain how its assessment of information provided by a DR at each of the four levels relates to the likelihood of a Cost of Service review being triggered. At this stage, the information requirements under Level 4 look very similar to a Cost of Service Review, while the Technical Paper does not actually outline what analysis the QCA will be undertaking under Level 4.

Level of information required

QUU is concerned with the level of information the QCA is requiring DRs to submit even when there is no breach of the CPI-X threshold. If a DR's self-assessment reveals that it is at Level 1 (i.e. no breach of CPI-X), it is still required to provide a significant amount of information. Appendix A of this submission highlights the various pieces of information being requested by the QCA at each of the levels identified in the Technical Paper.

There is a risk (as outlined in the QCA's Position Paper on the Regulatory Framework[15]) that in attempting to improve the performance monitoring over time, the QCA will further expand its data requirements and impose higher compliance costs. QUU suggests that the QCA consider, for each piece of information that it is requesting, whether that piece of information will assist it in determining whether a DR is exercising market power or not.

QUU is also concerned that under the lowest level of information requirements (Level 1), the QCA is requesting examples of how internal business planning and operational processes are being implemented. QUU is of the view that under Level 1 (where no breach of the CPI-X threshold has occurred), DRs should only provide governance and process documentation; however where a significant breach of CPI-X has occurred and further investigation is required, then further documentation (i.e. examples) can be provided to show how the DR has applied the processes.

QUU is of the view that currently, the level of information that is sought by the QCA at Level 1 is significant, especially given the light handed intent of the regulatory framework.

[15] p.17 Position Paper, Long Term Regulatory Framework for SEQ Water, QCA, Feb 2014

Reporting to Technical Regulator

The QCA comments in section 4.2 of its Technical Paper that:[16] "*where details of service quality indicate changes, breaches of standards set by technical regulators will be referred to the relevant regulator*".

QUU agrees with this comment but queries its purpose. In accordance with its legal obligations, QUU has always, and will continue to refer all breaches of service standards to the relevant regulator, as stipulated by legislation.

3.2 Level 1

Our detailed comments below in relation to the Level 1 scenario apply equally to the Level 2 scenario given the associated requirements are the same under both.

Customer engagement

QCA requests for a customer engagement strategy:[17]

> *"The water retailers are required to develop a customer engagement strategy, and by September 2015 provide an initial statement to the QCA of how the strategy complies with the above requirements."*

In its previous submission to the QCA, QUU informed the QCA that it was already meeting the minimum engagement practices required by the QCA. QUU considers that the development of a specific strategy document is unnecessary if the DRs can provide examples of how it is meeting minimum customer engagement requirements.

QUU suggests that rather than producing a specific customer engagement strategy document, DRs should notify the QCA (and provide examples) of how they are meeting the minimum customer engagement best practice. The DRs can then provide any necessary documentation to the QCA.

Strategic Approach to Investment

QUU has an overarching concern about the purpose and likely effect of the QCA's proposed reporting requirements in relation to DRs' capital plans and programs. The Technical Paper appears to envisage detailed annual capital project monitoring by DRs for Level 1 and 2 information requirements, which could potentially be administratively onerous for the DRs (and the QCA) and simply demonstrate that capital projects are not always undertaken and completed in line with annual capital plans. Such requirements appear to be contrary to the intent of the Direction Notice. As discussed further below, QUU considers that a far less administratively onerous process is required for situations where no market power concerns arise.

[16] Technical Paper, SEQ Long Term Framework – Annual Performance Reporting – Implementation Issues, QCA, June 2014

[17] 2nd paragraph, page 22, Ibid

The QCA state in bullet (b) of page 23 that:

> *"annual capital works plans or annual performance plans are consistent with the Netserv Plan (or that any variations have the appropriate approvals)"*

The QCA is not clear in what it is requiring the DRs to do. Could the QCA please clarify whether or not it is proposing to require capital plans be provided each and every year under the long-term framework? Or is there a difference in what the QCA needs in the first year compared to the later years?

More importantly, QUU's proposed capital plans can change from one year to the next depending on a number of reasons such as:

- strategic intent
- budget constraints
- prioritisation of work i.e. a more urgent work may replace a planned project
- staging of projects.

Annual capital work plans contain a list of proposed projects and the proposed capital spends for each project. This means that the annual capital work plans do not necessarily reconcile with all the actual capital projects and spends for that year, let alone, *the as-commissioned capital for the year which impacts on MAR.*

These differences between proposed capital work plans and actual capital projects can occur for a whole number of reasons which could relate to:

- Prioritisation of capital projects based on asset condition and risk, growth, and compliance with regulations
- Capital budgeting
- Staging of projects

There is also a threshold for reporting individual projects/programs for annual capital works, which is currently set at $15m.

In light of the above, QUU is not sure of the benefits that will accrue from the proposed annual capital plan and project reporting to offset the associated administrative costs imposed on the DRs.

<u>Asset Management Compliance</u>

With regard to Level 1 requirements for assessing investment, the QCA has stated the following:[18]

> *It is envisaged that the annual capital works plan (or annual performance plan) developed by each entity will serve as the initial reference for annual monitoring of capital investments.*
>
> *The QCA does not propose to further monitor co-ordination with other planning instruments (other than the Water Netserv Plan) unless prices and/or costs are considered to have exceeded CPI-X after allowing for relevant adjustments.*

[18] page 24, Ibid

> *In relation to asset management standards, the QCA will review the statement of practices and evidence of compliance and review progress in improvements towards good industry practice.*
>
> *The water retailers' approach to project evaluation will be assessed to ensure that for material capital expenditure, a process has been undertaken that incorporates:*
>
> - *Cost-benefit analysis or cost-effectiveness analysis of various options, including non-infrastructure alternatives and reviewing non-quantifiable costs and benefits*
> - *risk assessments including costs of risk mitigation measures.*

QUU has a number of issues with the above statement.

Firstly, QUU does not understand the QCA's intent and use of annual capital plans to assess prudent and efficient investment by the DRs. As noted above, annual capital plans are basically a list of proposed capital projects, and the budget for the projects within the capital plan. In addition, QUU does not understand the QCA's statement about monitoring of capital investments; can the QCA elaborate what the purpose of this information will be?

Secondly, could the QCA provide information on what evidence they are seeking with regard to compliance with asset management standards? QUU expressed a number of concerns in its previous submission about the QCA's expectations regarding DRs' 'compliance' with voluntary asset management standards and the implications for a DR under the long-term framework if not doing so.

Thirdly, if the CPI-X price threshold is breached, how does the QCA propose to monitor co-ordination with other planning instruments?

QUU is of the view that the QCA is requiring a significant amount of information under Levels 1 and 2, which are supposed to be the most light-handed levels of the framework (see Appendix A for a list of the information being requested).

Under Levels 1 and 2, the QCA should be more concerned that the DRs have an appropriate governance framework in place in relation to planning and operational activities to provide comfort that expenditure and investment is being managed prudently and efficiently. Therefore, the QCA should be requesting that DRs provide evidence that this governance framework exists. The QCA should not be requesting that DRs provide more detailed operational information for the purpose of prudency and efficiency testing, as this is required later on under Levels 3 and 4.

Therefore, the assumption should be that if appropriate processes (governance framework) are in place and CPI-X thresholds are not being breached then justification should not be required. Where thresholds are breached, the QCA would then require examples of how the processes are being applied to determine if there are issues in application.

<u>Service Quality</u>

The QCA comments that:[19]

> *"The QCA has established a range of service quality indicators to enable assessment of whether market power is being exercised through reductions in quality of service."*

QUU is concerned with this statement, as it is quite definitive. The QCA had previously commented that: [20]

> *"38 identified service quality indicators be monitored annually. Definitions be refined in conjunction with the entities and DEWS for the Final Report"*

While QUU agrees with a service quality performance reporting framework, the QCA and the DRs have yet to discuss and agree on the following issues:

(i) the service quality indicators to be monitored

(ii) the definition of those service quality indicators

(iii) the manner in which the QCA will use the results of those service quality indicators.

With regard to bullet point (i) (immediately above), the QCA and the DRs have yet to agree on the 38 indicators proposed by the QCA. As highlighted in our submission to the QCA's Position Paper on the Long Term Regulatory Framework, QUU agrees with the use of pre-agreed NPR indicators, however, QUU does not agree to the use of non-NPR indicators.

The QCA states that:[21]

> *Against each performance indicator, the QCA will apply a score – attributing performance to be good (surpassing targets, or demonstrating improving standards), average (meeting targets or maintaining standards) or poor (below targets or indicating declining standards). This approach is comparable to the 'traffic light' method used by Ofwat (2013).*

QUU notes that the QCA has not established targets for any of the 39 service quality indicators it has proposed so it is impossible for the DRs to understand whether their current performance exceeds, meets, or is below target.

Nor has the QCA indicated how a target for a specific indicator will be set; will it be based solely on SEQ DRs; or DRs in other jurisdictions; or a DR's own history? QUU considers that this fundamental aspect of the long term framework needs to be addressed in the Technical Paper and more importantly in a *"Performance Monitoring Determination"* in relation to the long term framework.

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[19] 1st Paragraph, page 25, Ibid

[20] Draft Recommendation 7.2, Position Paper - Long Term Regulatory Framework for SEQ Water Entities, QCA, Feb 2014

[21] Paragraph 8, page 26, Technical Paper, SEQ Long Term Framework – Annual Performance Reporting – Implementation Issues, QCA, June 2014

In addition, the QCA's statement about surpassing targets is difficult to understand given the QCA has previously stated, that: [22]

> *"Where service quality standards are significantly higher than the minimum set by a regulator or changed, evidence that the difference is supported by customers will be required when considering whether to trigger a more complete review".*

Furthermore, QUU argued in its previous submission that service quality should not be a trigger event in its own right for a cost of service review, including because of the large number of indicators chosen by the QCA and lack of specified service quality targets. Rather, QUU proposed that service quality should be considered more generally along with other factors, such as customer engagement, in determining the need for such a review.

Further to this broader concern, QUU has a number of concerns about the service quality issues raised in the Technical Paper.

The QCA comments that:[23]

> *The QCA initially proposes to analyse service quality through a combination of comparative analysis and scoring techniques involving:*
>
> *a) a comparison against customer service targets where relevant*
>
> *b) a comparison against other SEQ retailers*
>
> *c) a comparison against other jurisdictions, where provided in NPR*
>
> *d) over time, compare trends in performance for the retailer.*

QUU has issues with these proposed comparisons. This is because there are significant difficulties in undertaking meaningful comparisons across DRs – let alone across other jurisdictions. A simple comparison as appears to be proposed in bullet point (b) and (c) above is flawed as it ignores numerous factors that are unique to the DR's which have an impact on service standards. These factors include the overall business environment the DR is operating in, the level of maturity of the business, and the business model employed by the businesses to deliver its services.

Finally, the QCA comments that:[24]

> *As service quality performance data is accumulated over a number of years, the QCA proposes to explore the use of more holistic approaches to performance measurement perhaps using such techniques as data envelopment analysis (DEA).*

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[22] Page 9, Position Paper - Long Term Regulatory Framework for SEQ Water Entities, QCA, Feb 2014

[23] Paragraph 6, page 26, Technical Paper-SEQ Long Term Framework – Annual Performance Reporting – Implementation Issues, QCA, June 2014

[24] 2nd last paragraph, page 26, Ibid

QUU notes that there are significant issues associated with the adoption of this holistic approach to measuring service performance, to which the QCA does not refer. Firstly, the DEA and Total Factor Productivity (TFP) approaches are fundamentally based on the identification of a production function for the specified services (or set of services) and the key inputs and outputs required to deliver those services. In this way, the DEA/TFP approaches are often used to assess the technical efficiency of service delivery. Secondly, it is clear that to apply DEA would be a fundamentally different and heavy handed approach to service performance assessment and would be very onerous on the DRs. This is not in keeping with a light handed framework as envisaged in the Directions Notice.

QUU considers that the focus should be on considering and explaining how the QCA intends to apply the proposed 'traffic light' mechanism to make a meaningful overall assessment of the potential exercise of market power by DRs rather than considering these types of performance measurement techniques.

<u>Pricing Principles</u>

QUU in its previous submission raised a number of concerns about the apparent prescriptiveness of the QCA's proposed pricing principles. These concerns have not been addressed in the Technical Paper.

The QCA states that:[25]

> *"To assess water retailers' performance against pricing principles, the QCA will refer to the full tariff schedule submitted under Level 1 information requirements. The QCA will also review water retailers' calculation of LRMC".*

QUU seeks clarification regarding this matter as follows:

What purpose will this review of the calculation serve? Without knowing the LRMC of Bulk Water, which is a large component of the retail water price, any price signal based on the LRMC calculated by QUU will be muted.

QUU suggests that if the QCA want to review the DR's calculation of a LRMC, the QCA should provide a standard template (containing either the preferred approach or each alternative) with guidance on how to use the template to ensure consistency across the DRs. This would reduce the potential work in reviewing different calculations from the DRs.

Given the nature of the framework, QUU does not envisage that the QCA would be seeking to review the inputs of such a calculation, therefore providing a consistent template will remove the need for potential re-work later in the process.

Secondly, the Technical Paper does not previously state that any cost information is to be provided at Level 1 of the framework. Some of the pricing principles require cost information to assess whether a DR is complying. How does the QCA propose to assess these principles with no cost information?

[25] paragraph 5, page 27, Ibid

Further below, the QCA comments that:[26]

> *The QCA will then seek to prioritise the actions required by water retailers to address the identified shortcomings.*
>
> *While non-performance against the approved pricing principles will not on its own trigger a review, it may be a contributory factor in such decisions.*

The above statement implies that the pricing principles are mandatory. QUU does not consider that this is the intent of the proposed, light handed nature of the regulatory framework as provided for in the Direction Notice. This apparent mandatory requirement contradicts the light handed nature of the proposed long-term framework.

In the first bullet point (b) on page 27, the QCA states that DRs should include information to support their application of the QCA's pricing principles by submitting their basis for LRMC for residential and non-residential customers. QUU will not be providing this. QUU is of the view that going into this level of detail would impose an additional and unnecessary administrative burden on the DRs.

Sundry Charges

QUU seeks clarification from the QCA as to whether sundry charges will be assessed through this process.

3.3 Level 2

The QCA notes that the Level 2 information requirement will only be required 'if the tariff structure has changed substantially'[27]. Given the QCA's proposal for a CPI-X tariff constraint of around 2.25% to apply to individual tariff components in the medium-term, QUU expects the Level 2 requirements to apply regardless of substantial tariff change.

QUU have the following comments with regard to Table 9.

- The total volume of water delivered by Seqwater to QUU is not equal to the total volume charged to customers due to non-revenue water. Therefore, is the QCA requesting information on the total cost of bulk water as a charge (paid to SEQ Water), or the revenues from bulk water supplied to customers?
- QUU would like to confirm that the information being sought here is at the QUU whole-of-business level and not at the council level. QUU suggests that this should be at the QUU whole-of-business level.
- QUU would also like to have clarity from the QCA if trade-waste is included in sewerage revenue? QUU suggests that trade-waste revenue should be considered as part of sewerage revenue.

[26] paragraph 6 and 7, page 27 Ibid
[27] Paragraph 1, page 28, Ibid

3.4 Level 3

Reference MAR

In section 4.5 of its paper, the QCA comments that:[28]

> *The QCA proposes to assess the proposed changes in prices against the cost items identified by retailers. In addition, the QCA proposes to monitor the impact of the changes in costs against a Reference MAR that will be calculated and updated annually for each retailer using principles consistent with the CPI-X framework. The Reference MAR will be based upon that carried forward from the 2013-15 price monitoring investigation.*

QUU has a number of issues with this statement.

Firstly, QUU understands that under the proposed long-term framework, DRs will not be providing proposed changes in prices to the QCA, but rather actual prices.

Secondly, the QCA needs to provide further information on how it will be calculating (and updating) its Reference MAR, given that it will not have actual information available to it when the CPI-X threshold is not breached. For example, under Level 1 scenario, the QCA will not have information on infrastructure charges to offset against its Reference MAR.

Thirdly, will the QCA publish its Reference MAR in any documentation? For example, will the Reference MAR determination be published in the QCA's annual report prior to or on March 31?

Lastly, the QCA's comments that the Reference MAR will be based on that carried forward from the 2013-15 price monitoring investigation does not make sense, assuming QUU is interpreting this correctly. QUU seeks confirmation that the QCA proposes to use actual information from 2013-15 if the DRs can demonstrate that the cost differences during that time are prudent and efficient. This would result in an updated and far more relevant Reference MAR.

Level 3 versus Level 4

It is currently not clear to QUU how the QCA will determine whether a DR must satisfy information requirements relating to Level 3 or Level 4.

QUU considers that the materiality of the CPI-X price breach should form the basis for determining whether the QCA deems that the Level 4 information requirements are more appropriate than Level 3

Simply basing it on the number of cost items that have changed from the previous year is too vague and will not be a reflection of the likelihood of misuse of market power.

3.5 Level 4

With regard to Level 4, QUU would like to gain a better understanding as to how it is different from a Cost of Service Review? Level 4 seems to be an

[28] Paragraph 4, page 29, Ibid

onerous level for the DRs as the QCA will review additional cost information related to a wide range of costs. While QUU understands that there needs to be an escalation of the burden of proof (i.e. going from Level 1 to Level 4) to ensure DRs are not exercising monopoly power, at some point, the light handed framework moves from DRs providing justification and explanation under Level 4 to it being a Cost of Service Review. At this point, QUU does not consider that there is a clear delineation between the Level 4 and Cost of Service Review. This is a significant issue given the CPI-X price review trigger will be assessed annually by the QCA.

Furthermore, the Technical Paper does not actually outline what the QCA will be assessing in Level 4.

<u>Balance sheet reconciliation</u>

The QCA comments that, "*The capital expenditure recorded for the water retailer as a whole must reconcile to the relevant entries in its balance sheet*".[29]

QUU recommends that this requirement be removed as it is an onerous requirement. It is for this reason that it was also removed from the price monitoring regime that has been in place from 2010 to 2015. Furthermore, this is the responsibility of the Queensland Audit Office.

<u>Table 11 – 'Other'</u>

QUU is unsure what the column titled 'Other' in Table 11 is referring to? If trade waste is being considered under sewerage services and non-regulated services are not being reported on, it is unclear what type of service information the QCA expects to receive.

[29] Paragraph 5, page 30, Ibid

4. APPENDIX A: PROPOSED INFORMATION REQUIREMENTS UNDER LONG TERM FRAMEWORK

Level 1	Category	Description
	Prices	(i) Bulk water charges per kL (ii) Tariff schedules and charges by each region, residential and non-residential, water and sewerage, trade waste (iii) Residential bill by Council area, water and sewerage
	Customer engagement	(i) Customer Engagement Strategy (ii) Evidence of newsletters and media releases (iii) Details of customer forums (iv) Description of Customer Consultation Committee, including membership and meeting frequency (v) Evidence of issues raised by customers and responses to issues (examples being meeting minutes and submissions) (vi) Customer Surveys and Studies a. Purpose and objectives b. Process and methodology (i.e. sampling approach) c. Findings and policy implications (vii) Customer Charter (viii) Customer feedback on Customer Charter (ix) Customer Service Standard (CSS) document (x) Customer feedback on CSS
	Strategic Planning	(i) Water Netserv Plan Part A (as at 1 Oct 2014) a. Part B may be requested by QCA (ii) Annual capital work program (iii) Statement of Asset Management Standards being implemented a. Steps to address areas of improvements (iv) Statement of processes applied for project evaluation and options analysis. a. Examples of options analyses for significant capital expenditure project
	Service Quality	(i) Provision of service quality indicators

		(ii) Statement providing explanation on variations from year to year (iii) Service quality reports be compiled each year and placed on entities' websites by 31 October (QCA LTRF Position Paper)
	Pricing Principles	(i) Statement to establish that pricing principles are being applied (by Sept 2015) a. Advise of any departures from the principles b. Provide reasons and supporting information for any departures (ii) Advise on progress of implementing actions required for identified shortcomings related to applying pricing principles (iii) Supporting documentation for changes in tariff structure, including: a. analyses and studies used as a basis for the changes, including any assessments of demand responses, cost attribution, any material administration costs of changes, implications for cross subsidies b. customer consultation processes and outcomes (see also customer engagement section of the information requirements) c. anticipated implications if any for long term investment (iv) LRMC calculation, including: a. Basis for estimating LRMC for water and sewerage services (differentiated by residential and non-residential where possible or appropriate). (v) Details of any tariff differentiation or structural change that has been introduced over the previous year
Level 2	**Category**	**Description (In addition to Level 1)**
	Water Revenues	(i) Revenues from Bulk Water (ii) Revenues from Distribution/Retail – Residential (iii) Revenues from Distribution/Retail – Non Residential
	Sewerage Revenue	(iv) Total sewerage revenue – Residential (v) Total sewerage revenue non residential
Level 3	**Category**	**Description (In addition to Level 2)**
	Cost information	(i) Documentation to justify an increase above the CPI-X threshold driven by limited costs, such as: a. Cost pass throughs

		b. Overs and Unders carried forward c. Other adjustments
Level 4	**Category**	**Description (In addition to Level 3)**
		(i) Details of the RAB roll-forward since 2014 (ii) Capital expenditure – details of total water and sewerage capital expenditure as commissioned for the monitored and preceding year (2013-14 and 2014-15 in the first year of annual performance monitoring). (iii) Details of largest capital expenditure projects for water and sewerage and recycled water commissioned in the monitored year. a. For the largest capital expenditure (above), any variations from the annual capital works plans, or projects not previously identified be supported by relevant documents outlining why variations have occurred. (iv) Updates to Water Netserv Plan (v) Actual costs compared to costs indicated in the annual capital works plan – where a project was not identified in the annual capital works plan, DRs are to provide evidence that an appropriate approach to project evaluation, including options and risk analyses, has been applied (vi) Where depreciation profiles are applied that are not straight-line, the following is to be provided: a. Reconciliation to the straight-line method for the initial year b. The assets to which the alternative method is applied, including the value of assets c. The profile adopted, and the basis for adopting the alternative profile d. The estimated depreciation for the asset(s) (vii) Parameters and method used for calculating the WACC (including relevant cost of debt details) (viii) Actual capital contributions (ix) Operating costs, separated into the following types/activities: a. Types – bulk water, employee expenses, electricity, other materials and services, and tax b. Activity – operations, maintenance, and corporate