



Draft Report

SEQ Interim Price Monitoring

Part A - Overview

February 2011

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SUBMISSIONS

This report is a draft only and is subject to revision. Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (the Authority). Therefore submissions are invited from interested parties concerning the monitoring of water and wastewater distribution and retail activities in South East Queensland. The Authority will take account of all submissions received.

Written submissions should be sent to the address below. While the Authority does not necessarily require submissions in any particular format, it would be appreciated if two printed copies are provided together with an electronic version on disk (Microsoft Word format) or by e-mail. Submissions, comments or inquiries regarding this paper should be directed to:

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The **closing date** for submissions on the Weighted Average Cost of Capital for 2011/12 is **Monday 21 February 2011**. Submissions on all other matters are due by **Monday 28 February 2011**.

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (i.e. the complete version and another excising confidential information) could be provided. Again, it would be appreciated if each version could be provided on disk. Where it is unclear why a submission has been marked “confidential”, the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt information and information disclosure of which would be contrary to the public interest (within the meaning of the *Right to Information Act 2009 (RTI)*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997* (the QCA Act), the Authority must take all reasonable steps to ensure the information is not disclosed without the person’s consent, provided the Authority is satisfied that the person’s belief is justified and that the disclosure of the information would not be in the public interest. Notwithstanding this, there is a possibility that the Authority may be required to reveal confidential information as a result of a RTI request.

Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office of the Authority, or on its website at www.qca.org.au. If you experience any difficulty gaining access to documents please contact the office (07) 3222 0555.

Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority’s website.

PREAMBLE

The Authority's price monitoring role relates to the prices, costs and revenues of the South East Queensland (SEQ) water and wastewater retail/distribution entities – Queensland Urban Utilities (QUU), Allconnex Water (Allconnex) and Unitywater.

In this first year of the three-year price monitoring period, the Authority has focussed on the entities' forecast costs and revenues for 2010/11. The impact of recent floods has not been taken into account.

Although the entities adopted different approaches to setting prices and estimating costs, prices generally rose across SEQ. Average water prices in 2010/11 were between 13.9% and 23.0% higher than those set by councils in 2009/2010. Average wastewater prices rose by between 12.1% and 18.9%. Residential bills (which include water and wastewater) increased across all SEQ council areas, with increases ranging from \$37 to \$311 per household, except in Somerset where bills fell by \$7.

Not all necessary information was able to be provided by the entities. After reviews of the prudence and efficiency of capital expenditure and allowing for efficiency gains, the initial capital expenditure programs of the entities have been materially reduced by the entities and the Authority.

The Authority has found that its estimates of the costs of providing services in 2010/11 (the Authority's maximum allowable revenue or MAR) were not significantly different from those of the entities.

The Authority has found that for 2010/11:

- (a) QUU's forecast total water and wastewater revenues of \$718.9 million marginally exceed the MAR of \$708.3 million;
- (b) Allconnex's forecast total water and wastewater revenues of \$591.7 million fall well below the MAR of \$765.2 million; and
- (c) Unitywater's forecast total water and wastewater revenues of \$372.3 million fall below the MAR of \$392.3 million.

Overall, on the information available to date, the Authority has not found evidence of an exercise of monopoly power in 2010/11.

Substantial expenditure, some of which is not currently adequately justified, is proposed by the entities in future years. This will form a particular focus of the Authority's future annual reviews over the interim price monitoring period to 1 July 2013.

This Draft Report is being released for consultation in order to inform the Authority's Final Report, due to the Ministers by 31 March 2011.

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1. OVERVIEW

1.1 Ministerial Direction

In the past, water and wastewater prices in South East Queensland (SEQ) were set by individual councils. As from 1 July 2010, the water and wastewater activities of the Brisbane, Ipswich, Somerset, Lockyer Valley and Scenic Rim councils were amalgamated into Queensland Urban Utilities (QUU). Those of the Gold Coast, Logan and Redlands councils were amalgamated into Allconnex Water (Allconnex) and those of the Moreton and Sunshine Coast councils into Unitywater.

The Premier and the Treasurer (the Ministers) have referred the water and wastewater monopoly business activities of QUU, Allconnex and Unitywater (the entities) to the Authority for price monitoring until 30 June 2013. Under the Ministerial Direction (see Appendix A to Part B), the Authority must, among other things:

- (a) inform customers of the costs and other factors underlying the annual increase in water and wastewater prices (distinguishing the bulk and distribution/retail components);
- (b) monitor the revenues of each water and wastewater activity against the maximum allowable revenue (MAR) which results from the Authority's view of prudent and efficient capital expenditure, and reasonable operating costs, of each activity; and
- (c) advise the entities by 1 March 2011 and 1 March 2012 of the WACC benchmark it will consider in 2011/12 and 2012/13 respectively.

1.2 Approach

For this first review, the Authority has focussed on the entities' forecasts of annual costs and revenues for 2010/11. Such a focus was foreshadowed in the Authority's April 2010 report, *SEQ Interim Price Monitoring Framework*, which noted that a detailed review of past year performance is not intended until the second year of price monitoring.

In doing so, the Authority has recognised the magnitude of the task involved in establishing the new entities, given the amalgamation of the water and wastewater activities of 17 councils into 10 and now into three entities. The entities' submissions were based on council information and, in some cases, the information requested by the Authority could not be provided.

Nonetheless, the Authority has reviewed the entities' capital expenditure forecasts for their prudence and efficiency and has commented on the reasonableness of operating costs. In undertaking this review, the Authority is required to accept:

- (a) the initial regulatory asset base as at 1 July 2008 as advised by the Minister for Natural Resources, Mines and Energy and Minister for Trade (the Minister);
- (b) actual capital expenditure, excluding establishment costs, included in council financial accounts from 1 July 2008 to 30 June 2010;
- (c) allowable establishment costs as advised by the Minister;
- (d) contributed, donated and gifted assets and those funded through capital contributions from 1 July 2008 to 30 June 2010; and
- (e) the operational constraints imposed by the SEQ Urban Water Arrangements Reform Workforce Framework and the prices charged by the SEQ Water Grid Manager (WGM) for bulk water storage, treatment and delivery.

Details of the allowable establishment costs and audited values of actual expenditure in councils' financial accounts for 2009/10 are yet to be provided to the Authority. In their absence, the Authority has used the entities' estimates.

There are a wide range of prices for the many services and customers of the three entities as a result of council pricing policies in 2009/10. Accordingly, the Authority has only compared average prices. As residential customers consume around 70% of retail water in SEQ, a comparison of total residential bills is also provided.

While costs were not always the primary drivers of prices, it is noteworthy that, in setting prices, QUU and Unitywater only took 2010/11 costs into account. Allconnex set prices to (notionally) recover costs over 10 years.

The Direction requires the Authority to take into account any revenue glide path submitted by the entity for the purpose of avoiding price shocks over the interim period. Only Allconnex set prices on such a basis, but only provided cost data to 2012/13. On this occasion, therefore, the Authority has calculated its MAR on 2010/11 data only.

There are also substantial differences in service standards and the classification and allocation of costs. These differences limit the meaningfulness of comparisons of costs between entities.

In monitoring revenues, the Authority has used forecasts of revenue made at the time of setting prices. The Authority's MAR is based on more detailed costs provided in the entities' submissions (31 August 2010). These estimates are thus more appropriate to establishing the prudence and reasonableness of costs. Material differences in costs between price setting and the submissions have, however, been identified.

Under section 26 of the *Queensland Competition Authority Act 1997* (the QCA Act), the Authority must have regard for a range of related matters. Where relevant to this report, these have been taken into account. The impact of recent floods in SEQ has not been taken into account in this Draft Report.

1.3 Consultation

The Authority has liaised extensively with the entities and relevant agencies prior to, and during, this review. To facilitate the review the Authority has:

- (a) prepared a framework for price monitoring and supporting information requirements (*SEQ Interim Price Monitoring Information Requirements* (December 2010) and *SEQ Interim Price Monitoring Framework* (April 2010));
- (b) prepared draft information templates and associated guidelines (May 2010);
- (c) finalised its information requirements for 2010/11 (*SEQ Interim Price Monitoring Information Requirements for 2010/11* (July 2010));
- (d) met with the entities to identify and address relevant issues;
- (e) invited submissions from interested parties;
- (f) commissioned independent consultants to review aspects of the entities' submissions;
- (g) published all submissions on its website;
- (h) considered all submissions and reports in preparing this draft report for comment; and
- (i) given relevant stakeholders the opportunity to correct any factual errors in the Draft Report.

The Authority’s Final Report for 2010/11 is due by 31 March 2011. This Draft Report has two parts. Part A presents a broad overview of the Authority’s findings. Part B details the Authority’s assessment of the entities’ proposed costs.

1.4 Prices

There is a wide range of prices set by the entities as a result of the wide range of services provided to each of the previous council areas and customer groups in SEQ. As noted, the Authority has not sought to review prices (or tariff structures) in detail in this first review but, for broad comparative purposes, notes changes in average prices.

Average prices have been calculated by dividing total revenues by volumes – per kL (for water) and per connection (for wastewater)¹. Average prices provide, at best, a broad overview of changes in prices.

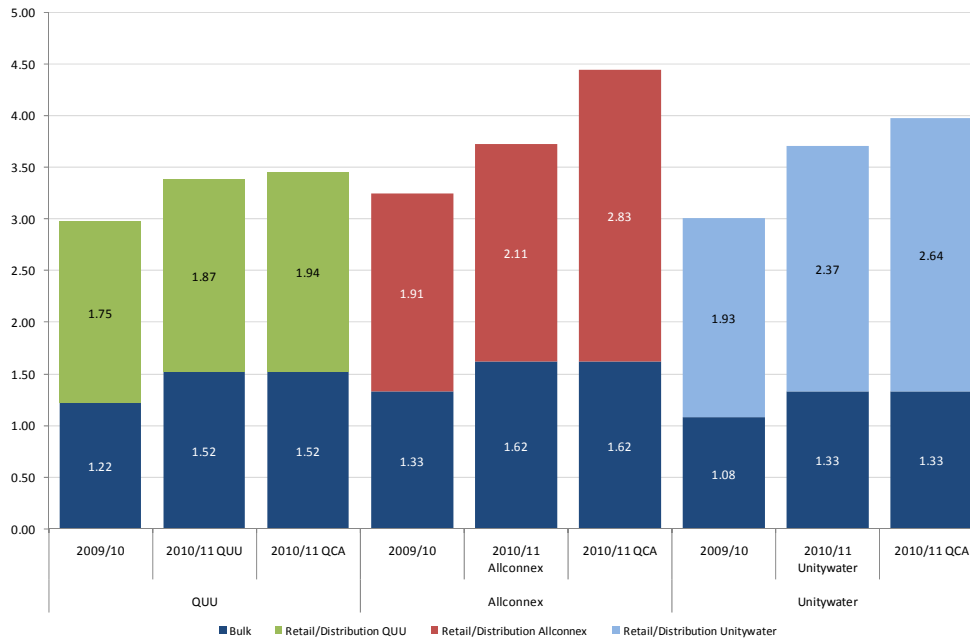
Average Prices

Average water prices in 2010/11 were between 13.9% and 23.0% higher than those set by councils in 2009/2010. Average wastewater prices rose by between 12.1% and 18.9%. Charts 1 and 2 refer.

Bulk water charges represent around one third of the average water price estimated by the Authority. The bulk water charge is set by the State Government to recoup some of the costs of the State-owned bulk water providers. There is no material bulk component of wastewater prices.

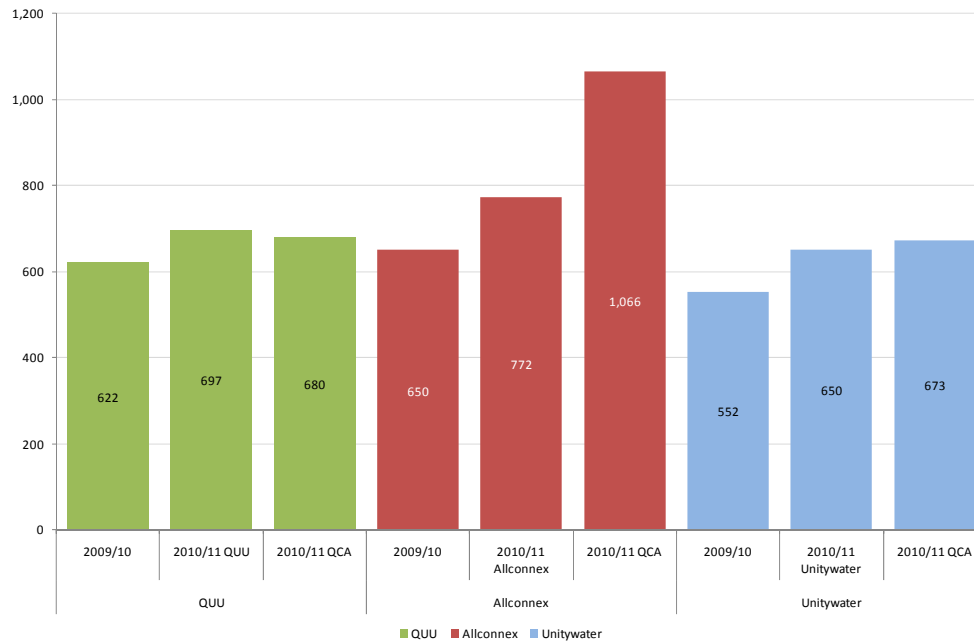
In most cases, the average price charged by the entities is below that implied by the Authority’s analysis of costs and demand for 2010/11. See subsequent sections and Part B.

Chart 1: Average Water Prices (\$/kL)



Source QUU (2010), Allconnex (2010), Unitywater (2010), QCA calculations (see Part B)

¹ The ABS adopts a similar approach to calculate an average water price in national water accounts – the ABS average price is derived by dividing a state’s total residential water revenue (\$) by residential water consumption (kL).(ABS, 2010).

Chart 2: Average Wastewater Prices (\$/connection)

Source QUU (2010), Allconnex (2010), Unitywater (2010), QCA calculations (see Part B)

Residential Bills

Total residential bills for households increased across SEQ, except in Somerset (chart 3). Bill increases ranged from \$37 in Lockyer Valley up to \$311 in Redcliffe. In Somerset, bills fell by \$7, as a decrease in the wastewater bill offset a smaller increase in the water bill².

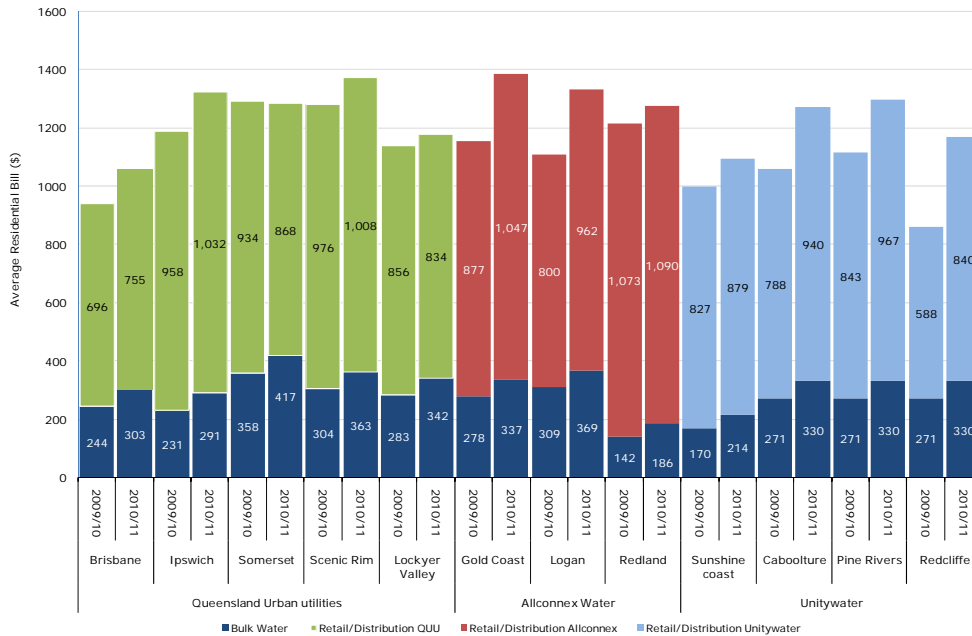
The residential bills used in the Authority's analysis have been estimated on the basis of usage of 200kL of water per year, the level adopted for national performance reporting (NWC 2010). As there is no national standard for wastewater, the analysis has been based on the approach adopted in each council area. For Somerset, Lockyer Valley and Logan this was one pedestal per household while in other council areas the wastewater component of the bill is based on a fixed access charge.

Bulk water accounts for a smaller proportion of residential bills than for average water prices as the residential bill includes water and wastewater (the latter has no bulk water component).

The Authority did not calculate a residential bill consistent with Authority estimates of efficient costs in 2010/11, as there is no alignment of the entities' cost information with particular tariffs.

² The Somerset bill fell as QUU applied any previous council discounts for early payment to 2009/10 fixed access charges before an increase in water and wastewater prices was applied. A 15% discount was applied to Somerset's 2009/10 fixed access charges before a 5% increase in water prices and a 10.5% increase in wastewater prices was applied. The Authority has used published prices for its calculations.

Chart 3: Total Residential Bills



Notes Based on metered usage of 200kL per annum and one pedestal (where relevant).

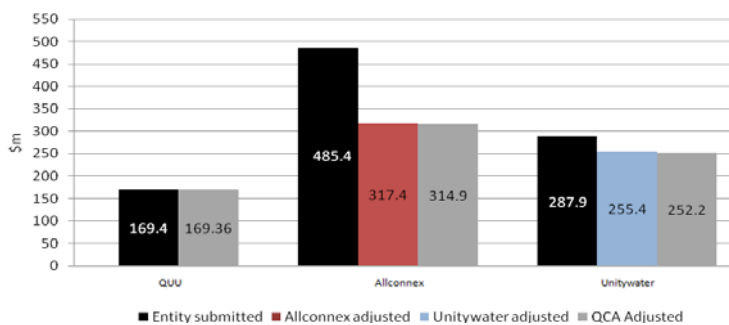
1.5 Costs

The cost of supply is a key factor that affects the entities’ pricing and revenue decisions, but not the sole factor. The Authority’s estimate of the prudent and efficient costs forms the MAR against which the entities’ revenues are compared to determine whether they are exercising monopoly power.

In some cases, the Authority was unable to subject the entities’ 2010/11 cost estimates to the usual degree of rigour of review, due to the lack of historical or disaggregated data and the time available for this initial review.

The Authority conducted an independent review of the prudence and efficiency of the entities’ available capital expenditure forecasts (Chart 4). Two entities have also identified significant efficiencies arising from a further review of their original forecasts submitted to the Authority. The Authority’s analysis found that the initial estimates of capital expenditure in 2010/11 provided by QUU and virtually all of the revised estimates of capital expenditure in 2010/11 provided by Allconnex and Unitywater were prudent and efficient.

Chart 4: Prudence and Efficiency Review of Capital Expenditure in 2010/11



The Authority also conducted an independent review of the reasonableness of the entities' recurrent costs. Charts 5 to 7 outline the entities' proposed costs and a comparison of the entities' and the Authority's estimate of costs for 2010/11. Part B provides more detail.

In assessing the reasonableness of proposed operating costs, the Authority was aware of the \$43 million saving in 2010/11 achieved by QUU and therefore has not sought to impose a further efficiency target upon QUU in 2010/11. For the other entities (and for the remainder of the interim period for QUU) the Authority considers that operating efficiencies of at least 2% per annum in non-bulk operating costs should be achievable.

Chart 5: QUU Components of Proposed and Estimated Costs (2010/11)

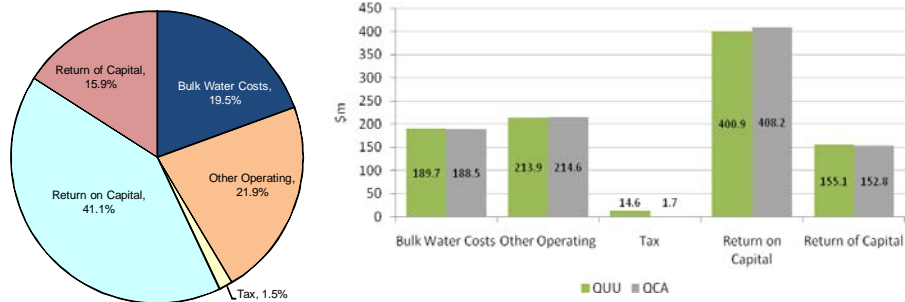


Chart 6: Allconnex Components of Proposed Costs and Estimated Costs (2010/11)

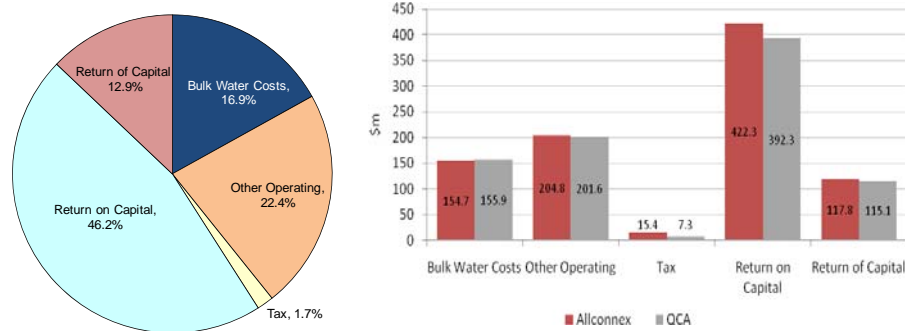
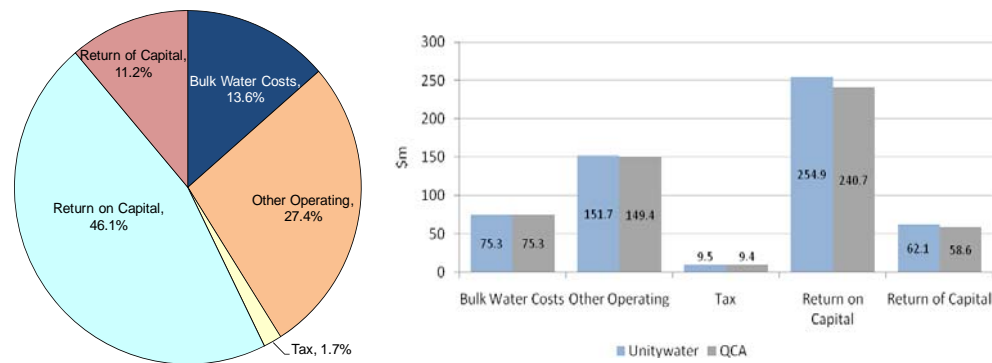


Chart 7: Unitywater Components of Proposed Costs and Estimated Costs (2010/11)



In the main, the differences between the entities proposed costs for 2010/11 and the Authority's arise from:

- (a) bulk water costs – the Authority has different estimates of bulk water costs due to the Authority's revised demand volumes – the same bulk water prices have been assumed;
- (b) other distribution and retail operating costs – the Authority has derived alternative estimates for some costs and includes efficiency targets;
- (c) tax – the Authority's approach reflects recent advice relating to the treatment of tax under the Local Government Tax Equivalents (2010) which indicates that less tax is payable than expected by the entities;
- (d) return on capital – the Authority has adopted a weighted average cost of capital (WACC) of 9.35%, compared to the 9.2% for QUU and 9.88% submitted by Allconnex and Unitywater, and this is applied to a smaller capital base arising from the Authority's estimates of prudent and efficient capital expenditure. It should be noted that the actual returns on capital achieved by Allconnex and Unitywater are below their WACC as they have set prices which do not recover their full costs; and
- (e) return of capital – the Authority has lower cost estimates consistent with its estimates of prudent and efficient capital expenditure.

Under the Direction, the entities have a choice of approaches to the treatment of capital contributions and the Authority has recognised their choice in its calculations.

Estimates of costs cannot be directly compared between entities, as they reflect differences in data and methodology. For example, the MAR for QUU reflects the cost of assets when they provide productive capacity to the system, and the revenue offset approach to the treatment of capital contributions. In contrast, the MAR for Allconnex reflects capital expenditure data as at the year of expenditure, rather than the (later) commissioning year, and the asset offset approach to the treatment of capital contributions which has a lesser immediate impact than the revenue offset approach.

1.6 WACC

Under the Ministerial Direction, the Authority is required to advise the entities by 1 March 2011 and 1 March 2012 of the WACC benchmark that it will consider in 20011/12 and 2012/13 respectively.

The Authority is proposing to use a WACC of 9.35% for each year of the interim price monitoring period. A detailed assessment and analysis of the Authority's WACC parameters is set out in Appendix B to Part B.

1.7 Revenues

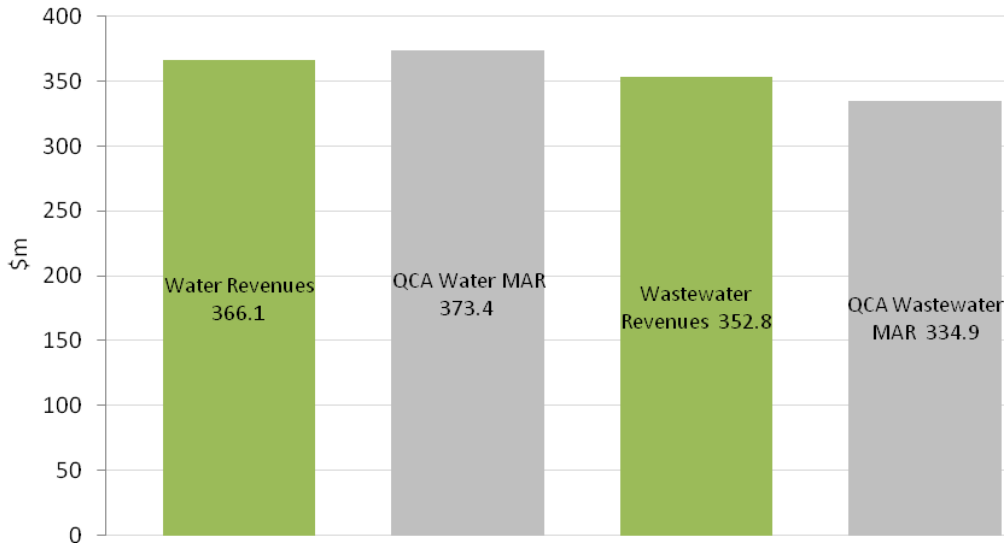
Under the Ministerial Direction, the Authority must monitor the revenues of each water and wastewater activity against the MAR. As noted above, the levels of under- or over-recovery should not be compared between entities, as they reflect differences in data and methodology.

For QUU for 2010/11:

- (a) forecast water revenue of \$366.1 million is marginally below the MAR of \$373.4 million;
- (b) forecast wastewater revenue of \$352.8 million is marginally above the MAR of \$334.9 million;

- (c) as a whole, QUU’s forecast revenue of \$718.9 million marginally exceeds the MAR of \$708.3 million.

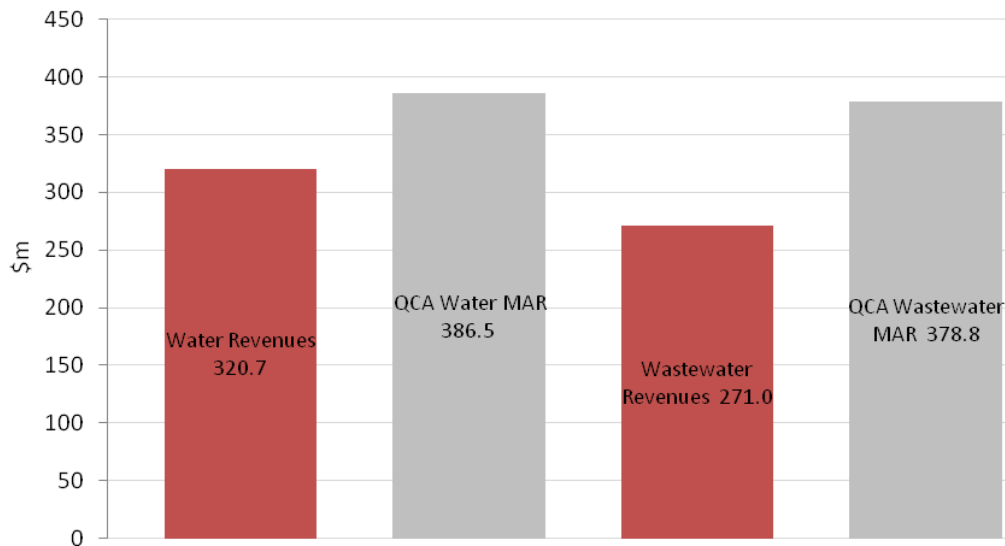
Chart 8: QUU Revenues and QCA MAR (2010/11)



For Allconnex for 2010/11:

- (a) forecast water revenue of \$320.7 million is below the MAR of \$386.5 million;
- (b) forecast wastewater revenue of \$271.0 million is below the MAR of \$378.8 million;
- (c) as a whole, Allconnex’s forecast revenue of \$591.7 million falls well below the MAR of \$765.2 million.

Chart 9: Allconnex Revenues and QCA MAR (2010/11)

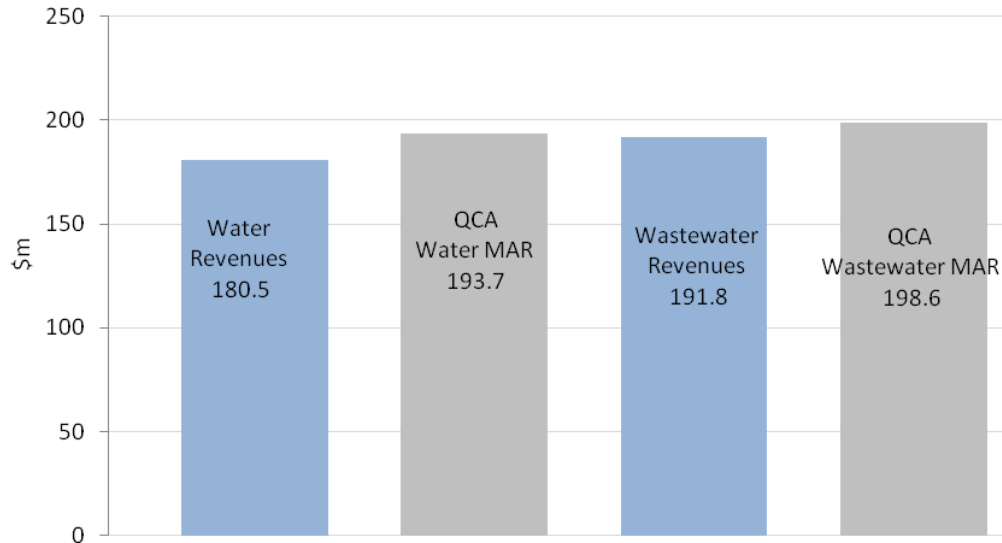


For Unitywater for 2010/11:

- (a) forecast water revenue of \$180.5 million is below the MAR of \$193.7 million;
- (b) forecast wastewater revenue of \$191.8 million is below the MAR of \$198.6 million.

- (c) as a whole, Unitywater's forecast revenue of \$372.3 million falls below the MAR of \$392.3 million calculated by the Authority.

Chart 10: Unitywater Revenues and QCA MAR (2010/11)



Some of the differences between the entities' forecast revenues and the Authority's MAR arise from differences in estimates of costs. Further differences relate to the difference between costs at the time of price setting compared to those submitted to the Authority. However, other factors have also been noted by the entities in their submissions, in particular Allconnex and Unitywater. These other factors include:

- (a) a desire to avoid further significant price shocks that would arise if prices were set to achieve full cost recovery in 2010, arising from a legacy of past under-recovery in pricing;
- (b) a reluctance to overhaul tariff levels and structures in 2010/11 to achieve full cost recovery, pending the development of approved pricing principles.

Based on the Authority's analysis, QUU achieves cost recovery in 2010/11. Allconnex and Unitywater do not. As revenues in 2010/11 do not significantly exceed the MAR based on the available information, there is no evidence of an exercise of monopoly power in 2010/11.

1.8 Future Reviews

Substantial increases in capital expenditure are proposed by the entities in future years. The Authority notes that considerable justification is required to substantiate such increases and opportunities appear to exist to improve efficiencies both for capital expenditure and operational expenditure costs. These will form a particular focus of the Authority's future reviews.

However, the Authority does note that the entities are developing their process and systems to ensure that the prudence and efficiency of all projects can be demonstrated over time. Further, the Authority notes that, since providing their submissions to the Authority, the entities have deferred some capital expenditure due to efficiencies being identified as the entities consolidate their businesses. The Authority supports initiatives to develop their internal processes to allow for:

- (a) a documented approach to forecasting demand for all purposes, with procedures and protocols established for the collection and collation of data;

- (b) the consideration of prudence and efficiency of capital expenditure, and the reasonableness of operating costs, from a regional perspective;
- (c) only commissioned capital expenditure to be included in the regulatory asset base and therefore prices;
- (d) a standardised approach to cost estimating, including a standardised approach to estimates for items such as contingency, preliminary and general items, design fees and contractor margins, so that there is uniformity of cost estimating across all proposed major projects;
- (e) a summary document to be prepared for identified major projects so as to facilitate standardised reporting;
- (f) an implementation strategy to be developed for each major project that includes recommendations on delivery methodology, program and a risk review process;
- (g) a 'toll gate' or 'gateway' review process to be implemented so that appropriate reviews are undertaken at milestone stages for selected projects; and
- (h) pricing to be demonstrably based on costs and other relevant factors.