Redland City Council

Response to QCA Position Paper: SEQ Long Term Framework –Annual Performance Reporting – Implementation Issues June 2014

Summary of QCA Position Paper

This paper has been released in conjunction with several others, including Long Term Regulatory Framework for SEQ Water Entities February 2014 and Transition to performance monitoring – Redland Water April 2014.

These papers are in response to the Ministers' Direction Notice instructing the QCA to 'investigate and report on a long-term regulatory framework for the monopoly distribution and retail water and sewerage activities of the five SEQ distributor-retailers'. These papers are aimed at Unitywater, Queensland Urban Utilities and Logan, Gold Coast and Redland City Councils.

The Ministerial Direction also required that the regulatory framework ensure that the costs of implementation do not exceed the benefits, take into account the different characteristics of each of the entities and must be proportionate with the risk of misuse of market power. A full cost of service review is triggered only if price or revenue changes exceed CPI-X, or in the case of service quality issues occurring.

Response to the paper is due to be lodged to the QCA by 31 July 2014. The final report is due to be released 30 September 2014. If accepted, the framework is to apply from 1 July 2015.

CPI-X

QCA have identified that retailers are using the prior year's observed CPI for setting the following year's water prices. Their recommendation is that a more forward-looking approach would be to use the RBA forecast CPI, which is similar to electricity pricing, as prices are forward looking at the time they are set. Where the CPI figure is published as a range, the mid-point of that range should be adopted.

QCA define the X factory as "a measure of the productivity gain that should be achievable by water retailers going forward". They have proposed an X factor of 0.25% for each of the five retailers – Queensland Urban Utilities, Unity Water, Logan, Gold Coast and Redland City Councils. The X factor is scheduled to be reviewed 5 years hence or earlier if there are indications to review in favour of a more appropriate estimate.

In the words of the QCA the CPI-X approach will:

a) Provide suitable incentives for improved productivity as it reduces the possibility of gaming and, to avoid more detailed reviews encourages water retailers to seek out potential efficiency gains (particularly when in conjunction with X)
b) Promote the financial sustainability of an entity to the extent that CPI reflects the general movement in input prices. The recommended performance monitoring framework incorporates various means for addressing any particular concerns should these arise – these including binding rulings and unders and overs accounts.

To establish the X factor, the QCA assert that the historical performance of the water retailers has been reviewed, the performance of like businesses in other jurisdictions and the X-efficiency targets as set by other regulators.

QCA further declare that an average efficiency gain of 6.2% was identified for Redland Water for the 2013-14 and 2014-15 years, although no detailed information on how this was calculated is provided. Continuing efficiency improvements in other jurisdictions are known to range in between 0.25% to 2.2% per annum. QCA have acknowledged that efficiency gains diminish as a business matures and thus an X at the lower end of the range is reasonable for all water businesses.

Under- and over-recovery

The Minister's Direction stipulates that the treatment of under and over recoveries should be considered as part of the framework. The QCA acknowledge that by including an unders and overs methodology it grants a level of financial security to the entities and allows price shocks to customers to be managed.

QCA is recommending that the suitable method to manage under- and over-recovery is by smoothing out the impact on prices on an NPV-neutral basis, over a period of up to 10 years from 1 July 2015 onwards. They specifically state that in the case of a water retailer being deemed to have over-recovered revenue during the 2013/15 period, over-recovery must be passed back through future price adjustments.

QCA have identified that revenue risks arise through variations to demand. They suggest that this can minimised and controlled through appropriate tariff structures.

Cost risks are also addressed, and transpire when actual expenses change compared to forecast expenses. The regulatory framework has stated that uncontrollable costs, like bulk water charges, will be tolerated as pass-throughs. The pass-through process ought to only permit the component of the cost that couldn't be controlled or circumvented by the service provider. Cost pass-throughs would be considered appropriate for changes in taxation, regulatory compliance requirements, law, government policy (in the case of a major change) or bulk water prices. These cost pass-throughs are to be accounted for on an NPV neutral base for a period up to 10 years. Further information regarding cost pass-throughs will be required to be provided to the QCA.

The issue of outperformance of the CPI-X framework is also examined. Where entities determine that price increases are consistent with CPI-X but that their costs increased by less, due to efficiency gains, the these gains can be held by the entity for up to three years, before having to pass through to the customer.

Information requirements

The light handed regulatory framework is aimed at minimising the costs of regulation and the level of information required, providing the CPI-X threshold or service level standards aren't breached. However the QCA is able to request further information at any point.

QCA have identified four scenarios which will require additional levels of information in order to facilitate the determination as to whether market power is being exercised. These are:

a) Level 1: prices and tariff schedules, details relevant to customer engagement and strategic investment, service quality indicators and pricing principles
b) Level 2: if any price increases, or changes in particular components of the tariff structure exceed CPI-X, the QCA will need to review average prices for water and sewerage. In addition to the financial information requirement for Level 1, retailers will need to provide revenue data for water and sewerage, residential and non-residential
c) Level 3: if average prices increase by more than CPI-X, and this is due to a limited number of cost increase, retailers will need to provide details of reasons (including relevant costs) for the increase and the MAR equivalents
d) Level 4: where average prices increase by more than CPI-X due to increases in a wide range of costs, retailers will need to submit full details, including RAB, depreciation, WACC and operating costs.

Effectively, it is the responsibility of the water retailer to self-assess that a suitable level of information is presented in order to defend pricing decisions.

Redland City Council response to QCA paper

The following topics and draft recommendations contained within this QCA position paper are areas that Redland City Council wishes to respond to:

- Redland City Council concurs to using a forward looking CPI figure, as issued by the RBA. One potential issue for Redlands with using this number is the timing of the release (February). A lot of our pricing preparation is commenced earlier than this time, with much workshopping with Council already finalised. We agree that it is possible to use this number, released in February, however should the release of this CPI by the RBA be delayed in any way this will certainly impact on our timeliness of pricing the water and presenting it to the Council.

- Whilst understanding the way in which QCA have assigned the X factor – 0.25% for each of the five water entities – Redlands would like to highlight that no consideration has been made toward the small size of our water business. Seeking out efficiency gains is a more challenging undertaking for a business that reaps no benefits from economies of scale.

In larger water businesses, advantages are certainly possible for the sheer size of the customer base, certainly operational efficiencies reflective of economies of scale. This is not a benefiting factor for Redland Water. Redland Water are still required to deliver comparable services to their customers that would be expected from the likes of Queensland Urban Utilities or Unity Water, however the customer base that the costs are spread over is much smaller than the afore-mentioned water businesses.

It is more than likely, in the case of Redland Water, that the proposed CPI-X would actually become more like a CPI+X scenario. In the transition back from Allconnex, Redland Water established a very lean operating structure, with several key roles not returning. Due to this trim structure, it is unlikely that there are further operational efficiencies that can be identified amounting to 0.25%.

Conclusion

Review of this draft paper of SEQ Long Term Framework – Annual Performance Reporting – Implementation Issues, as released by the QCA in June 2014 would highlight that the one-size fits all approach in regards to the X factory simply isn't sustainable for a water business the size of Redland Water.