Memorandum

To	Michael Grimley Manager Regulatory and Investment Governance	**From**	Adam Kay-Spratley, Economic Analyst
Date	18 December 2014		
Subject	QCA draft report response: Contract Services Escalation		

QCA Comment	Seqwater submitted a materials and services escalation factor developed by PwC based on a sample of Seqwater's service contracts and accepted regulatory practice in Australia. PwC proposed a weighted index based on the following indices (and weights): • forecast of the Queensland WPI (38%) • forecast of CPI based on RBA estimates (15%) • 10-year average of the non-residential building construction index (NRBCI), Queensland (46%). After reviewing PwC's methodology, CH2M HILL stated that it considered Seqwater's proposed approach to escalating contract services costs to be reasonable. However CH2M HILL recommended adjusting Seqwater's weighted escalation rate for updated information for each of the indices adopted by PwC. CH2M HILL did not make any changes to PwC's proposed weightings. In summary, CH2M HILL recommended that the QCA accept the updated escalation rates. The QCA accepts CH2M HILL's recommended escalation rates.

Response

Seqwater previously addressed this point its response to CH2M HILL's draft prudency and efficiency report in October 2014.

Seqwater agrees that the approach CH2M Hill has taken to update the inputs used in the index calculations to the latest available is reasonable. For the Non-Residential Building Construction Index (NRBCI) Queensland the latest release is for June 2014, however using these figures Seqwater calculates an average growth rate of 2.45%, compared to 2.28% nominated by CH2M Hill.

The discrepancy appears to arise from CH2M Hill's application of a compound average annual growth formula, but for unknown reasons have selected September 2004 as the starting value (ie, September 2004 to June 2014), which provides a CAGR of 2.28%. The approach as used by PwC and adopted in Seqwater's submission was to use June to June figures, so using the latest available data (from June 2004 to June 2014) the average growth rate is 2.45%.

Seqwater believes the original approach is correct and the escalation forecast should be updated to reflect the 2.45% figure as this provides a consistent analysis period (10 years) and is not selectively choosing a higher starting point so as to reduce the escalation rate. The table below displays the relevant calculations (digital file also supplied).

Note also that this is only one component (46% weighting) of an overall weighted index for this escalation forecast, hence the low impact to the overall rate.

The following table sets out the QCA advised escalators. Applying the methodology above results in escalation rates of 2.60% in 2014-15, 2.81% in 2015-16, 2.83% in 2016-17 and 2.83% in 2017-28. Seqwater recommends QCA adopts these escalation rates.

Table 45 Weighted escalation rates for contract services (%)

	2013-14	2014-15	2015-16	2016-17	2017-28
Seqwater submitted	3.46	3.46	3.38	3.38	3.38 per annum
CH2M HILL recommended	2.54	2.53	2.73	2.75	2.75 per annum

ABS 6427.0, June 2014, Table 17						
Index Number: 3020 Non-residential building construction Queensland						
Unit	Index Numbers					
Series Type	Original					
Data Type	INDEX					
Frequency	Quarter					
Series ID	A2333721X				***CH2M HILL Approach***	
Jun-2004	79.0	Sep-2009	98.6		**Sep-04**	80.3
Sep-2004	80.3	Dec-2009	98.8		**Jun-14**	100.6
Dec-2004	82.3	Mar-2010	98.7		**CAGR**	2.28%
Mar-2005	86.3	Jun-2010	97.8			
Jun-2005	88.9	Sep-2010	97.8		***PwC Approach***	
Sep-2005	91.4	Dec-2010	97.5		**Jun-04**	79.0
Dec-2005	93.2	Mar-2011	98.3		**Jun-14**	100.6
Mar-2006	95.1	Jun-2011	99.2		**CAGR**	2.45%
Jun-2006	96.6	Sep-2011	99.2			
Sep-2006	98.6	Dec-2011	100.2			
Dec-2006	99.7	Mar-2012	100.2			
Mar-2007	100.9	Jun-2012	100.4			
Jun-2007	101.9	Sep-2012	100.4			
Sep-2007	103.4	Dec-2012	98.5			
Dec-2007	104.0	Mar-2013	98.8			
Mar-2008	105.2	Jun-2013	99.1			
Jun-2008	107.1	Sep-2013	99.6			
Sep-2008	110.0	Dec-2013	99.7			
Dec-2008	109.4	Mar-2014	100.0			
Mar-2009	104.6	Jun-2014	100.6			
Jun-2009	102.1					