



Final Report

SEQ Grid Service Charges 2012-13

July 2012

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PREAMBLE

The Authority recommends the following Bulk Water Grid Service Charges (GSCs) for Seqwater and LinkWater for 2012-13.

2012-13 Recommended Grid Service Charges

| | <i>Total GSCs (\$m)</i> | <i>Volume (ML)</i> | <i>\$/ML</i> |
|--------------|-------------------------|--------------------|----------------|
| Seqwater | \$702.0 | 284,533 | \$2,468 |
| LinkWater | \$221.7 | 230,138 | \$963 |
| Total | \$923.7 | 284,533 | \$3,431 |

The total GSCs include variable costs based on volume forecasts from the November 2011 Annual Operations Plan. Variable charges should be applied on a \$/ML basis at each supply point to remove volume risk. Estimates of variable charges in this report exclude the cost of carbon which should be addressed as a cost pass-through.

The GSCs reflect the judgement of Seqwater and LinkWater about the appropriate risk/cost trade-off for water quality, and industry practice regarding asset reliability standards. Guidance on the appropriate standards from Government on these issues could reduce costs.

The recommended GSCs reflect the Authority's assessment of the prudence and efficiency of capital and operating costs. The Authority's analysis identified savings in 2012-13 capital expenditure of 13% for Seqwater and 1.4% for LinkWater.

The Authority recommends efficiency targets for fixed operating costs, based on evidence of prospective productivity gains and the targets applied by Australian regulators in recent decisions. On the basis that Seqwater has a larger, more diverse asset base than LinkWater and is yet to fully realise savings available from its merger with WaterSecure, the Authority proposes a higher target for Seqwater (2.5%) than for LinkWater (1.5%). These targets are in addition to some particular identified efficiency savings.

The recommended aggregate GSC of \$3,431/ML compares to the \$2,015/ML bulk water price charged to users in 2012-13. In other words, the South East Queensland Water Grid Manager is forecast to recover only 59% of bulk water costs.

GLOSSARY

| Term | Definition |
|---|---|
| Abu Dhabi Transmission and Despatch Company | Responsible for developing, operating and maintaining the high voltage power transmission and bulk water transmission networks within the Emirate of Abu Dhabi. |
| ACIL Tasman | Economic consultancy |
| ADWG | Australian Drinking Water Guidelines |
| AECOM | Provider of technical and management support services |
| AEMC | Australian Energy Market Commission |
| AEMO | Australian Energy Market Operator |
| AER | Australian Energy Regulator |
| Allconnex Water | Former DR responsible for the delivery of water and wastewater services in the Gold Coast, Logan and Redland districts |
| AMF | Asset Management Framework |
| AOP | Annual Operations Plan |
| Aquasure | Delivering the Victorian Desalination Project |
| Aqwest | Water retailer in Western Australia |
| Australian Laboratory Group Pty Ltd | Provider of laboratory and technical services |
| Atkins | Engineering consultants |
| AWTP | Advanced Water Treatment Plant |
| CAD | Computer Assisted Drawings |
| CAIT | Critical Asset Inspection Team |
| Capex | Capital Expenditure |
| Cardno | Engineering consultants |
| Cardo Australia | Engineering firm |
| CEFP | Clean Energy Future Plan |
| CNF | Competitive Neutrality Fee |
| CPI | Consumer Price Index |
| CRC | Capital Review Committee |
| CSO | Community Service Obligation |
| DERM | The former Department of Environment and Resource Management |
| DEWS | Department of Energy and Water Supply |

| | |
|-----------------------------|--|
| DR | Distributor-Retailer |
| DWQMP | Drinking Water Quality Management Plan |
| EBA | Enterprise Bargaining Agreement |
| Energex | Electricity distribution company |
| EPI | Eastern Pipeline Interconnector |
| ERA | Economic Regulatory Authority |
| ESC | Essential Services Commission |
| FAMP | Facilities Asset Management Plan |
| FRC Environmental | Offer water monitoring, testing and management solutions. |
| FTE | Full-time Equivalent |
| Gartner | Technology research company |
| GAWB | Gladstone Area Water Board |
| GCDP | Gold Coast Desalination Plant |
| GHD | Provider of engineering, architecture and environmental services |
| GIS | Geographic Information System |
| GL | Gigalitre (1,000 ML) |
| GSC | Grid Service Charge |
| GSP | Grid Service Provider |
| Halcrow | Provider of engineering services |
| HR | Human Resources |
| ICT | Information and communication technology |
| IPART | Independent Pricing and Regulatory Tribunal |
| IT | Information Technology |
| J & P Richardson Industries | Provider of electrical and mechanical contracting field services |
| John Holland | Deliver water and wastewater infrastructure |
| Knight Frank | Real estate company |
| KPMG | Accountancy and consultancy services firm |
| kWh | KiloWatt Hour |
| LGCs | Large-scale Generation Certificates |
| LinkWater | The Queensland Bulk Water Transport Authority |
| Market Rules | The South East Queensland Water Market Rules |

| | |
|------------------------------|--|
| MDMM | Mean Daily Maximum Month |
| Melbourne Water | Manages water supply catchments, treats and supplies water, removes and treats sewage and manages waterways and major drainage systems |
| Metaval Consolidated Pty Ltd | Provider of engineering services |
| ML | Megalitre (one million litres) |
| MWh | Megawatt hour |
| MWH | Specialises in water & wastewater treatment, environmental engineering, sustainable construction & construction management |
| NEM | National Electricity Market |
| NIP | Network Integration Pipeline |
| NPI – Stage 1 | Northern Pipeline Interconnector – Stage 1 |
| NPI – Stage 2 | Northern Pipeline Interconnector – Stage 2 |
| NPV | Net Present Value |
| NRW | (The former Queensland Department of) Natural Resources and Water |
| NWC | National Water Commission |
| O&M | Operations and Maintenance |
| Ofwat | Economic regulator of the water and sewerage sectors in England and Wales |
| OH&S | Occupational Health & Safety |
| OMD | Operation and maintenance deed |
| OMJV | Operations and Maintenance Joint Venture |
| Opex | Operating Expenditure |
| Origin Energy | Electricity and gas retailer; electricity generator and involved in gas exploration and production |
| PJR | Project Justification Report |
| PPI | Partial Performance Indicator |
| PricewaterhouseCoopers | Professional services firm |
| PRW | Purified recycled water |
| PS | Pump Station |
| QCA | Queensland Competition Authority |
| QTC | Queensland Treasury Corporation |
| QUU | Queensland Urban Utilities (Ipswich, Lockyer Valley, Scenic Rim and Somerset) |
| QWC | Queensland Water Commission |

| | |
|----------------------------|---|
| R&D | Research and Development |
| R&M | Repairs and Maintenance |
| RAB | Regulated Asset Base |
| RBA | Reserve Bank of Australia |
| RECs | Renewable Energy Certificates |
| RFT | Request for Tender |
| RO | Reverse osmosis |
| ROAM Consulting | Energy modellers |
| RWSP | Regional Water Security Program |
| SAP | Financial and resource planning software |
| SCA | Sydney Catchment Authority |
| SCADA | Supervisory Control And Data Acquisition |
| SEQ | South East Queensland |
| Seqwater | The Queensland Bulk Water Supply Authority |
| SEQwater | Trading name of the former South East Queensland Water Corporation Limited |
| SKM | Sinclair Knight Mertz – provider of services firm. |
| SMEC | Engineering consultants |
| SOP | SEQ System Operating Plan |
| SRWP | Southern Regional Water Pipeline |
| SunWater | Delivers bulk water infrastructure development and management |
| Sydney Catchment Authority | Manages and protects Sydney's drinking water catchments and catchment infrastructure, and supplies bulk water to its customers |
| Sydney Water Corporation | Supplies drinking water, wastewater services and some stormwater services |
| Third Horizon | Business consultants |
| Transfield Services | An operations, maintenance and construction services business, operating in the resources, energy, industrial, infrastructure, property and defence sectors |
| TRUenergy | Electricity and gas retailer |
| United Services | Occupational health and safety services firm |
| UnityWater | Distributor-retailer serving Moreton Bay and Sunshine Coast |
| Veolia | Provider of profession services to water and wastewater sectors |
| WACC | Weighted Average Cost of Capital |
| WAE | Water Access Entitlements |

| | |
|----------------|--|
| WaterSecure | The former Queensland Manufactured Water Authority, merged with Seqwater as of 1 July 2011 |
| WCRW | Western Corridor Recycled Water |
| WCRWS | Western Corridor Recycled Water Scheme |
| WGM | South East Queensland Water Grid Manager |
| WHS | Workplace health and safety |
| Wide Bay Water | Provides water and wastewater services to the Fraser Coast |
| Worley Parsons | Provider of services to energy and resource sector |
| WPI | Wage Price Index |
| WSSA | Water Services Association of Australia |
| WTP | Water Treatment Plant |

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EXECUTIVE SUMMARY

Direction Notice

Pursuant to a Direction Notice (see **Appendix A**) issued by the (then) Minister for Energy and Water Utilities (the Minister) on 20 October 2011, the Authority is required to:

- (a) investigate and recommend Grid Service Charges (GSCs) for the Grid Service Providers (GSPs) to apply in 2012-13;
- (b) conduct a detailed review of fixed and variable operating costs, including undertaking an appropriate benchmark review; and
- (c) develop a process, and appropriate Review Thresholds, for reviewing the 2012-13 Grid Service Charges.

Grid Service Providers (GSPs)

The GSPs are state-owned statutory authorities and comprise:

- (a) the Queensland Bulk Water Supply Authority (trading as Seqwater). Seqwater supplies treated water from dams and treatment plants as well as desalinated water from the Gold Coast Desalination Plant and purified recycled water from a network of advanced water treatment plants; and
- (b) the Queensland Bulk Water Transport Authority (trading as LinkWater). LinkWater provides water transport services to the SEQ Water Grid Manager (WGM) involving the transfer of water from Seqwater's assets through bulk pipeline networks to Council owned water distributor-retailers.

Limitations on the Authority's Discretion

The Direction Notice, issued by the Minister in accordance with his role as the Price Regulator, outlines key principles for risk allocation. These principles include the following:

- (a) GSPs are to be fully immunised from interest rate exposures, through recovery of the actual cost of debt;
- (b) GSPs are not to be subject to volume or source risk either in total or across production or dispatch points over the regulatory period; and
- (c) the 1 July 2011 regulated asset base (RAB) is to be as advised by the Price Regulator and not to be subject to optimisation. Expenditure on drought assets is to be incorporated in the RAB at project cost.

The Authority is also required to accept that:

- (a) the rate of return on drought assets is limited to the actual cost of debt provided by Queensland Treasury Corporation (QTC); and
- (b) the rate of return on non-drought assets must be set using parameters specified in the Direction Notice, with the risk-free rate and actual cost of debt advised by the QTC.

Under the Direction Notice, the Authority is also required to accept production forecasts consistent with the Grid Instructions forecast in the Operating Strategy (or any successor document) and any relevant information provided to the GSPs in accordance with the System Operating Plan.

However, detailed production forecasts were excluded from the sections of the November 2011 Annual Operations Plan (being the successor to the Operating Strategy) approved by the QWC. Further, the May 2012 AOP has yet to be approved. This means that there are no mandated or approved production forecasts and transfer volumes available to the Authority.

Consistent with QWC directions to the WGM, the Authority has sought to maintain the likely maximum capacity required of key assets in establishing the recommended GSCs. Where more recent production forecasts are available, or a reconfiguration of assets proposed, the extent of the adjustment to the GSC implied by the more recent information has also been identified.

The Authority has recommended variable operating charges on a \$/ML basis at each WTP or transfer point. This removes the need to rely on production forecasts for variable costs. For comparative purposes, the Authority has also estimated total variable operating costs which reflect production forecasts from each of the November 2011 and May 2012 AOPs.

Seqwater

The Price Regulator advised that Seqwater's opening RAB for 1 July 2011 was \$5.1 billion, comprising \$1.9 billion in non-drought assets and \$3.1 billion in drought assets.

A further \$875.5 million of capital expenditure was added to Seqwater's RAB in 2011-12, largely due to the commissioning of two major drought projects - Hinze Dam Raising and Wyaralong Dam. As required by the Direction Notice, drought assets are included in the RAB at project cost.

Of Seqwater's total proposed non-drought capital expenditure of \$32.2 million for 2011-12, SKM reviewed a sample of six non-drought capital expenditure projects (representing \$3.8 million), and considered that about \$0.8 million could not be considered prudent and/or efficient or for which there was insufficient information to fully justify their acceptance into the regulatory asset base.

In relation to 2012-13, Seqwater's drought capital expenditure program is now largely complete resulting in proposed drought capital expenditure now only totalling \$19.8 million. Of this amount, the Authority considered that \$0.8 million should be deferred until commissioning of the Wyaralong WTP.

Seqwater initially proposed total non-drought capital expenditure of \$62.6 million for 2012-13. Since the Draft Report, Seqwater withdrew one item (\$1 million) as a result of the Authority's Draft Report analysis, and added four items totalling \$3.9 million, revising total non-drought capital expenditure to \$65.5 million. The Authority reviewed a sample of 19 non-drought capital expenditure projects, and considered that about \$10.5 million could not be considered prudent and/or efficient or for which there was insufficient information to fully justify their acceptance into the regulatory asset base. If the May 2012 AOP is approved, there would be a further reduction of \$0.8 million.

The Authority considered whether the findings of its consultants, SKM give a clear indication of a systemic or widespread problem with Seqwater's capital expenditure planning and delivery processes that would justify extrapolation of the findings of SKM's sample to the broader un-sampled capital expenditure program. However, because such systemic issues could not be identified, the Authority did not apply a reduction factor to non-sampled capital expenditure for either 2011-12 or 2012-13.

In total, the Authority recommends an \$11.3 million or 13% reduction to Seqwater's forecast 2012-13 capital expenditure based on November 2011 production forecasts, or a \$12.1 million reduction if the May 2012 production forecasts are approved.

The Authority's comments on expenditure submitted prior to the Draft Report for commissioning beyond 2012-13 has been incorporated in **Appendix B**.

Seqwater's 2012-13 rate of return on non-drought assets, based on parameters provided in the Direction Notice, is 9.90% (pre-tax nominal). This compares with 9.83% in 2011-12 and 9.94% in 2010-11. Seqwater's drought assets earn a rate of return equal to the cost of debt which averages 6.4%.

Seqwater initially proposed a total fixed operating cost of \$235.6 million. Subsequently, this was increased to include decommissioning of water treatment plants, and to incorporate reduced fixed electricity costs, resulting in a revised total of \$237.5 million.

SKM reviewed 13 fixed operating cost items, including decommissioning costs, totalling \$35.9 million. After re-categorising sludge disposal costs as variable costs, the assessed net savings totalled \$320,000, or 0.1%.

As the cost savings could not be considered to reflect systemic issues, the Authority considered it inappropriate to extrapolate this saving across unsampled fixed operating costs. However, the Authority recommends that an overall efficiency target of 2.5% be applied to fixed operating costs (in addition to the savings already identified above) for Seqwater. This target lies within the range of such targets applied by Australian regulators in recent water regulatory decisions for operating expenditure.

SKM also undertook a more detailed review of non-direct costs (indirect and overhead costs) than possible in the time available for the Draft Report, and sought to identify in particular cost savings that could be achieved through the merger of Seqwater and WaterSecure and its contractors. However, the Authority has not recommended any specific cost savings arising from this merger given the nature of the contractual obligations and workplace arrangements in place.

The Authority has reviewed Seqwater's variable cost assumptions and concludes that Seqwater has overestimated certain variable costs such as electricity and chemicals. The Authority has reduced Seqwater's costs relating to these items but due to a reclassification of sludge costs variable costs are estimated to be higher.

Electricity costs were a particularly difficult issue. The Authority recommends that the carbon cost be excluded from the nominated variable charge, and from the constant load cost component of fixed charges and be passed through in the GSCs as incurred. These costs are difficult to estimate and are not controllable by the GSPs.

These cost reductions are offset by the Authority's recommendation that sludge disposal costs should be considered a variable cost rather than fixed. On this basis, the Authority has recommended a \$/ML variable charge for each of Seqwater's assets. When also taking into account water volumes forecast by the WGM in November 2011, the Authority's forecast variable charges of \$40.8 million are slightly higher those anticipated by Seqwater (\$39.3 million). Based on May 2012 production forecasts, the total variable costs are \$39.4 million.

In total, the Authority recommends GSCs for Seqwater in 2012-13 of \$702.0 million. This is slightly higher than actual 2011-12 (\$682.0 million), due to increases in capital charges resulting from the commissioning of Wyaralong Dam and Hinze Dam Raising in 2011-12, an increase in fixed operating costs, as well as increased variable operating charges due to increases in input prices. If the May 2012 production forecasts are adopted, the total GSC would be lower at \$700.6 million due to lower capital and variable operating costs.

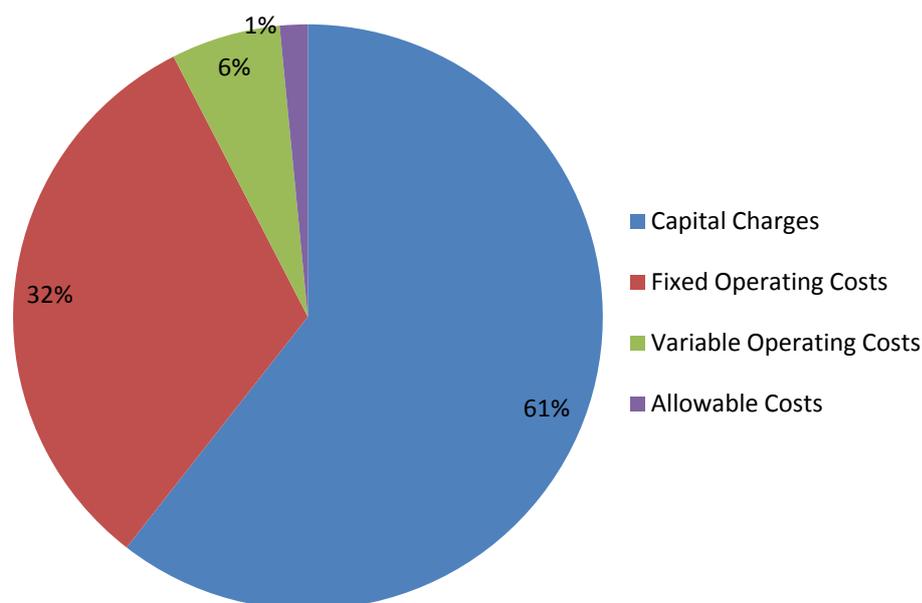
Capital charges comprise more than 60% of Seqwater's 2012-13 GSCs.

A summary of Seqwater's recommended GSC is provided in Table 1 below while Figure 1 shows the proportions of each component of the GSC.

Table 1: Seqwater's Recommended GSC (\$m)

| <i>Revenue Component</i> | <i>Approved 2010-11</i> | <i>Estimated Actual 2011-12</i> | <i>Seqwater Proposed 2012-13</i> | <i>QCA Recommended 2012-13</i> |
|--------------------------|-------------------------|---------------------------------|----------------------------------|--------------------------------|
| Capital Charges | 395.5 | 432.9 | N/A | 428.1 |
| Fixed Operating Costs | 221.7 | 220.8 | 235.6 | 227.1 |
| Variable Operating Costs | 45.8 | 25.8 | 39.3 | 40.8 [#] |
| Allowable Costs | 24.7 | 6.5 | 10.6 | 10.7 |
| Revenue Offset | - | -4.0 | -4.5 | -4.7 |
| Total GSC | 687.7 | 682.0 | N/A | 702.0 |

Note: these figures may not add due to rounding. 2010-11 GSCs include the former WaterSecure. #The increase is due to a reclassification of sludge costs from fixed operating costs to variable operating costs.

Figure 1: Seqwater's Recommended GSC for 2012-13

LinkWater

The Price Regulator advised that LinkWater's opening RAB for 1 July 2011 was \$2.04 billion, comprising \$1.46 billion in drought assets and \$0.58 billion in non-drought assets.

LinkWater's estimated 2011-12 capital expenditure totalled \$26.2 million, of which SKM reviewed a sample of four projects. SKM recommended reductions in 3 items, the changes being due to a deferral of expenditure to later years in one case; and errors in calculation of costs and data input for other items. As a consequence, the Authority recommends a reduction of \$0.64 million or 2.5% to LinkWater's 2011-12 non-drought capital expenditure.

LinkWater forecast a further \$21.8 million of capital expenditure in 2012-13. SKM reviewed a sample of five projects and recommended that one item was prudent but not efficient. The Authority recommends a \$0.3 million or 1.4% reduction to LinkWater's forecast 2012-13 capital expenditure.

The Authority considered whether the findings of its consultants, SKM, give a clear indication of a systemic problem with LinkWater's capital expenditure planning and delivery processes that would justify extrapolation of the findings of SKM's sample to the broader un-sampled capital expenditure program. However, because the savings were not considered to represent systemic issues, the Authority did not apply a reduction factor to un-sampled capex for either 2011-12 or 2012-13.

LinkWater's 2012-13 rate of return on non-drought assets, based on parameters provided in the Direction Notice, is 9.68% (pre-tax nominal). This compares with 9.87% in 2011-12 and 9.71% in 2010-11. LinkWater's drought assets earn a cost of debt rate of return which averages 6.5%.

SKM reviewed a sample of 11 of LinkWater's proposed fixed operating cost items and recommended that one had not been sufficiently justified to be considered efficient. The Authority recommends a cost reduction \$241,000 or 0.6% of LinkWater's proposed 2012-13 fixed operating costs. As the cost saving was due to insufficient information, and there was only one such item identified, the Authority considered it inappropriate to extrapolate this saving across unsampled fixed operating costs.

However, the Authority recommends that an overall efficiency target of 1.5% be applied to fixed operating costs (in addition to the savings already identified above) for LinkWater. This is considered appropriate given the available literature on prospective productivity gains, and lies within the range of such targets applied by Australian regulators in recent water regulatory decisions (see below).

SKM also reviewed one of LinkWater's proposed variable operating cost items, and recommended a small reduction of \$27,000, or 0.9% of total variable costs.

In regard to electricity costs, due to the difficulties involved in their estimation and that these costs are not controllable by LinkWater, the Authority recommends that the carbon cost be excluded from the nominated variable charge, and from the constant load cost component of fixed charges and be passed through as incurred. This results in a downward adjustment in electricity charges reported in the Authority's Draft Report of about \$0.4 million.

The Authority's GSC comprises a fixed charge (capital and fixed operating costs and allowable costs), as well as a variable charge determined at various system locations. The Authority also estimated a total GSC for indicative purposes based on the two available but unapproved demand forecasts.

In total, the Authority recommends a GSC for LinkWater in 2012-13 of \$221.7 million. The GSC based on May 2012 forecasts is about \$40,000 lower. The GSC is about 2.6% lower than LinkWater's proposed \$227.6 million.

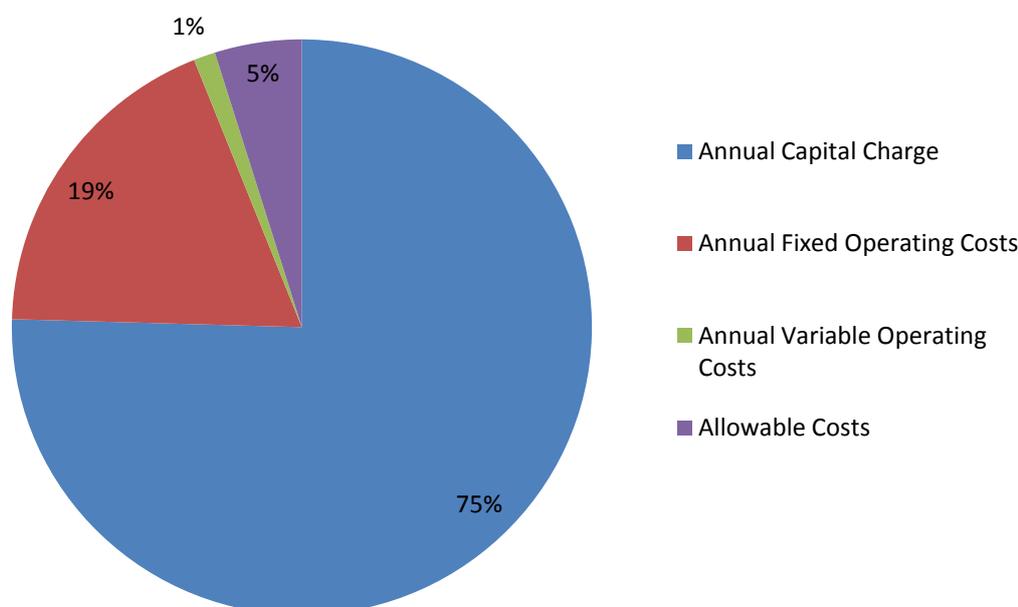
Capital charges account for 75% LinkWater's GSCs.

A summary of LinkWater's recommended GSC is provided in Table 2 and Figure 2 below. It is noted that for the rounded estimates provided below, the alternative production forecasts are not material.

Table 2: LinkWater's Recommended GSC (\$m)

| <i>Revenue Component</i> | <i>Approved 2010-11</i> | <i>Estimated Actual 2011-12</i> | <i>LinkWater Proposed 2012-13</i> | <i>QCA Recommended 2012-13</i> |
|--------------------------|-------------------------|---------------------------------|-----------------------------------|--------------------------------|
| Capital Charge | 139.4 | 144.5 | 170.7 | 165.5 |
| Fixed Operating Costs | 38.8 | 43.7 | 43.0 | 42.7 |
| Variable Operating Costs | 4.5 | 2.5 | 2.9 | 2.4 |
| Allowable Costs | 9.8 | 8.4 | 11.3 | 11.1 |
| Revenue Offset | - | - | - | 0.1 |
| Total GSC | 192.5 | 199.1 | 227.6 | 221.7 |

Note: these figures may not add due to rounding.

Figure 2: LinkWater's Recommended GSC for 2012-13

Productivity and Efficiency

In a review of recent regulatory decisions, the Authority found that economic regulators have in recent years applied efficiency targets to the total operating costs of bulk water entities of 0.3 to 3% per annum. Targets at the lower end of the range can arise where there have been demonstrable gains in efficiency over the previous regulatory period, that is, in mature regulatory environments. These findings served to inform the Authority in regard to the application of a general efficiency target for fixed operating costs.

The Authority also engaged Sinclair Knight Mertz (SKM) to benchmark Seqwater and LinkWater against comparable organisations.

SKM's benchmarking analysis was severely constrained by the lack of comparator organisations. Based on the limited data available, SKM identified that employee costs were potentially higher than

benchmark in both Seqwater and LinkWater (but following a correction of estimates the difference is lower than estimates for the purpose of the Draft Report).

The Authority undertook further analysis of operating cost benchmarks, focusing on two main comparators, Sydney Catchment Authority and Melbourne Water. While it is difficult to standardise comparative data, the Authority generally observed that the operating cost per ML of bulk water in South East Queensland lies above the range of very broadly estimated benchmark outcomes in Sydney and Melbourne.

Analysis by another of the Authority's consultants, Third Horizon, using a range of international comparators, further confirmed the possibility that Seqwater and LinkWater are not as efficient as other water utilities. The Authority notes that these benchmarking exercises must be interpreted cautiously, due to differences between comparators.

On the basis of the Authority's reviews, it considers that an additional generic efficiency target should be applied to operating costs, consistent with the approach adopted by other regulators.

In considering the magnitude of such a target, the Authority has taken into account that there is less flexibility in achieving a savings target in a one-year review period than over a five year regulatory period as has been applied by other regulators. The GSPs are better placed to identify efficiencies in their organisations than the Authority or SKM (information asymmetry) and therefore there is a case to apply efficiency incentives and targets (to promote) further innovation.

On the basis that Seqwater is a larger organisation, with more diverse assets, and is potentially yet to fully realise savings achieved from the merger with WaterSecure, the Authority proposes a higher target for Seqwater. The Authority also notes that only 14% of Seqwater's fixed opex was reviewed, compared to 38% for LinkWater, in the Authority's review of costs.

The Authority therefore proposes to apply a 2.5% efficiency target to Seqwater and 1.5% for LinkWater. When added to identified savings, the total efficiency gains would be 2.6% for Seqwater and 2.2% for LinkWater. Both these targets lie within the range applied by Australian regulators in recent water regulatory decisions.

Summary of GSCs

A summary of the GSCs for the GSPs for 2012-13 is provided in Table 3.

On the basis of the 2012-13 volume forecast provided by the WGM (November 2011) the total GSCs across both GSPs average \$3,431/ML. This compares to an approved forecast of \$3,299/ML in 2011-12.

Table 3: 2012-13 Grid Service Charges per ML

| | <i>GSCs (\$m)</i> | <i>Volume (ML)</i> | <i>\$/ML</i> |
|--------------|-------------------|--------------------|----------------|
| Seqwater | \$702.0 | 284,533 | \$2,468 |
| LinkWater | \$221.7 | 230,138 | \$963 |
| Total | \$923.7 | 284,533 | \$3,431 |

Note: Total volume excludes LinkWater's transport volumes as they do not add to total water supplied

At \$3,431/ML, the GSCs compare to the 2012-13 bulk water price charged by the WGM to Distributor/Retailers which has a weighted average of \$2,015/ML. In other words, in respect of bulk

water sold to Distributor/Retailers, the WGM is forecast to recover only 59% of the GSCs cost of \$3,431/ML.

Water Quality

Following publication of the draft GSC report, Seqwater informed the Authority that it is required to meet the quality parameters set out in the Grid Contract which also requires compliance with the Australian Drinking Water Guidelines (ADWG) and water quality requirements set out in legislation.

The ADWG set out the maximum levels of pollutants allowable in water, but also require water suppliers to adopt a risk-based approach to water quality management.

Under the Public Health Act 2005 a water service provider would be liable if it provided drinking water that it knew, or reasonably ought to have known, was unsafe – even if it complies with the water quality parameters specified in the Grid Contract.

The Authority has therefore accepted the judgement of the GSPs for the purpose of recommending GSCs as to do otherwise would expose service providers to an unacceptable level of risk on a matter of substantive health and safety. Nevertheless, the Authority notes that some guidance (or standards) from Government as to the appropriate risk/cost trade-off could reduce costs.

Asset Reliability

The Authority notes that the Grid Contracts contain some requirements regarding asset reliability but are not specified by asset. Individual asset reliability standards would provide the GSPs with clarity (and potentially reduce costs) regarding the services required of each of their assets, or at each demand zone.

In the absence of clearly defined individual asset reliability standards, the Authority has assessed each submission on its merits and relied on the advice of its external consultants where possible using general ‘industry standards’.

Review Thresholds

The Direction Notice also instructed the Authority to develop a process, and appropriate Review Thresholds, for reviewing the 2012-13 GSCs. Table 4 below summarises the Review Thresholds proposed by the Authority. The Authority is confident that these thresholds can be adopted without compromising GSPs’ financial integrity and stability.

Table 4: 2012-13 Proposed Review Thresholds

| <i>Review Event</i> | <i>Review Threshold for end-of-period review</i> | <i>Review Threshold for within-period review</i> |
|---|--|--|
| Change in law or Government policy | Zero | 5% of total GSCs |
| Emergency event | Zero | 5% of total GSCs |
| Feedwater quality event | Zero | 5% of total GSCs |
| Change in demand or source | Zero | 5% of total GSCs |
| Change in cost of debt | Zero | 5% of total GSCs |
| Under- or over-spend of capital expenditure | Zero | 5% of total GSCs |

Consistent with the requirements of the Direction Notice for the Authority to provide incentives for the entities to invest, innovate and pursue efficiency improvements, the Authority recommends that an incentive structure be implemented to encourage GSPs to achieve efficiency gains.

Under such an arrangement, GSPs will be permitted to retain in 2013-14 50% of any efficiency gains achieved in 2012-13 in GSCs. However, the efficiency gains must be the result of specific initiatives put in place by the GSPs, and should be submitted for consideration as part of the next GSCs review.

1. MINISTER'S DIRECTION

1.1 South East Queensland (SEQ) Water Market Rules

Pursuant to section 10(m) of the *Queensland Competition Authority Act 1997* (the QCA Act), the Authority can be required to perform functions provided to the Authority under an (other) Act or to exercise a power delegated to it under an (other) Act.

The SEQ Water Market Rules (Market Rules) require the Authority to investigate and recommend Grid Service Charges (GSCs) to be paid to the Grid Service Providers (GSPs) in 2012-13 and to provide a report to the Price Regulator setting out its recommendations. The Price Regulator is the State of Queensland or its nominated agent, in this case, the Minister for Energy and Water Supply (the Minister).

The GSCs are charges paid by the SEQ Water Grid Manager (WGM) to GSPs for the provision of water services declared by the Minister under the *Water Act 2000* (Declared Water Services).

1.2 Direction Notice

The Authority received a Direction Notice from the Price Regulator dated 20 October 2011. A copy forms **Appendix A**. The Direction Notice requires the Authority to:

- (a) investigate and recommend GSCs for 2012-13;
- (b) conduct a detailed review of fixed and variable operating costs, including undertaking an appropriate benchmarking review to provide advice on potential efficiency improvements and business savings based on good industry practice;
- (c) assess the prudence and efficiency of capital expenditure and operating cost estimates;
- (d) develop a process and appropriate Review Thresholds for reviewing the 2012-13 GSCs; and
- (e) provide a report to the Price Regulator setting out recommendations for the GSCs for 2012-13, including identifying opportunities for efficiency improvements in capital and operating costs.

1.3 Conduct of the Investigation

Consistent with the Direction Notice, the Authority has consulted with relevant parties and considered all submissions within the applicable timetable for the investigation. The Authority provided a Draft Report setting out its recommendations to the Price Regulator on 30 April 2012 and stakeholders for comment.

Since the Draft Report, the Authority has considered all submissions, undertaken additional investigations, and consulted further with stakeholders. Under the Direction Notice the Authority is required to provide a Final Report by 30 June 2012.

2. BACKGROUND

2.1 The SEQ Water Grid

Since 2008, the SEQ urban water and wastewater sector has undergone extensive reform which has involved, among other things, the establishment of the SEQ Water Grid. The Water Grid integrates the water sources, storages and treatment plants across the SEQ region (from Noosa to Coolangatta and out to the Lockyer Valley) with new climate resilient water supplies, such as desalination and purified recycled water.

In addition, 22 separate entities were amalgamated to establish the WGM, two state-owned GSPs (Seqwater and LinkWater) and three council-owned distributor-retailers entities (DRs) (UnityWater, Queensland Urban Utilities and Allconnex Water).

2.1.1 Grid Operation and Planning

The Government sets the water security objectives for SEQ and the infrastructure and demand management programs to achieve those objectives in the Regional Water Security Program (RWSP). The Level of Service objectives in the RWSP describe the desired frequency, severity and duration of water restrictions.

The Queensland Water Commission (QWC) develops the SEQ System Operating Plan (SOP), which implements the RWSP. The SOP contains a series of rules and requirements that affect the operation of the SEQ Water Grid to achieve the desired Level of Service objectives.

To date, drought response has been directed by the *Water Regulation 2002* (Qld) and the SEQ RWSP, (DERM 2010) which have mandated the construction or upgrade of bulk water assets such as the Gold Coast Desalination Plant (GCDP) and the Western Corridor Recycled Water Scheme (WCRWS). With the completion of Wyaralong Dam and the Northern Pipeline Interconnector Stage 2, the infrastructure mandated by the Government is now largely complete. The QWC's SEQ Water Strategy (QWC 2011) describes the likely next regionally significant sources of water supply.

The WGM holds contracts to provide potable and purified recycled water to the DRs and power stations. To meet its customers' demand for water, the WGM contracts the water services of the GSPs. The prices that the WGM pays for these services are the GSCs.

Subject to the approval of the AOP as outlined by the SOP, the WGM issues Grid Instructions to direct what services it requires from the GSPs to meet the demands forecast by the DRs. In this way, the WGM directs the short term operation of the SEQ Water Grid. The WGM's Grid Instructions must be consistent with the approved Annual Operations Plan prepared by the WGM in accordance with the SOP, or as directed by the QWC. The Annual Operations Plan describes how the WGM intends to meet the forecast water demands of its customers.

The WGM is also required to provide advice to responsible Ministers in regard to new and replacement capital expenditure on infrastructure or information technology projects of \$2 million or more. The WGM is to advise whether there is a clear and appropriate need for the proposed expenditure and that a full range of options has been considered including alternative ways of operating the SEQ Water Grid and utilising existing infrastructure.

Capital expenditure projects are also subject to guidance through processes administered by the Department of Energy and Water Supply (previously the Department of Environment and Resource Management (DERM)), including Strategic Asset Management Plans

(SAMPs), Dam Safety Guidelines and Drinking Water Quality Management Plans (DWQMPs).

2.1.2 Seqwater

The Queensland Bulk Water Supply Authority (trading as Seqwater) was established in November 2007 under the *South East Queensland Water (Restructuring) Act 2007* and reports to two Ministers, the Treasurer and the Minister for Energy and Water Supply. Seqwater is considered a GSP under the *Water Act 2000*.

Seqwater is responsible for the provision of bulk water services in SEQ, and owns a number of assets that provide Declared Water Services. Seqwater's major assets include dams, weirs and water treatment plants (WTPs) and include bulk supply assets transferred from local governments and public water boards under the *South East Queensland Water (Restructuring) Act 2007* and recently constructed drought assets (see Section 2.2), such as Wyaralong Dam.

Seqwater provides potable water by treating the water captured in its water storages and operates assets that are connected to the SEQ Water Grid as well as stand-alone water supply schemes in SEQ. Seqwater is also responsible for management of a substantial catchment area and natural assets. Seqwater holds only very minor water allocations itself. The majority of water allocations for SEQ are held by the WGM.

Seqwater was merged with WaterSecure, the former Manufactured Water Supplier, on 1 July 2011. As a result, Seqwater is also responsible for two recently constructed drought assets that manufacture water in SEQ. The GCDP produces drinking water from seawater, while the WCRWS Scheme is a network of advanced water treatment plants (AWTPs) that produce purified recycled water (PRW) from treated wastewater produced from assets owned by the DRs. An existing Project Alliance Agreement is in place with Veolia Water and John Holland to operate and maintain the Gold Coast Desalination Plant and an Operations and Maintenance Agreement is in place between Seqwater and Veolia Water (the operator) on the WCRW scheme.

2.1.3 LinkWater

LinkWater owns and operates the bulk transport assets that transport potable water around the SEQ Water Grid. LinkWater's assets comprise bulk pipelines, pumping stations and reservoirs, including assets constructed as drought projects such as the Southern Regional Water Pipeline (SRWP) and assets transferred from local governments and public water boards under the *South East Queensland Water (Restructuring) Act 2007*. LinkWater is considered a GSP under the *Water Act 2000*.

LinkWater Projects is a government-owned and incorporated company established as a Special Purpose Vehicle in January 2006 for the design and construction of bulk water pipelines in SEQ. While LinkWater and LinkWater Projects are separate businesses, they are governed by the same Board and Chief Executive Officer.

2.1.4 Bulk Entity Amalgamation

The Queensland Government has released a Four Point Plan to reduce water prices, which includes amalgamation of the bulk water entities. At the time of writing, the details and timing of any proposed amalgamation is unknown.

2.2 Drought Assets

Drought assets are regionally significant capital investments determined by the Queensland Government for the purposes of regional water security and constructed under the *Water Regulation 2002* (Qld), as amended by Part 8 of the *Water Amendment Regulation (No 6) 2006* (Qld), and Table 1 of the RWSP (DERM 2010).

As directed by the Market Rules (s 8.11) and the Direction Notice, the Authority must include all drought assets in the regulated asset base (RAB) at their project construction cost including any capitalised amounts and allow them to earn a rate of return equal to the cost of debt.

2.3 Bulk Water Prices

The GSCs are distinct from the Bulk Water Prices, which have been set by the Queensland Government until 2017-18 and are paid to the WGM by the DRs.

The 10-year Bulk Water Price Path prevents retail water bills from immediately reflecting the entire cost of the Government's \$7 billion of investment in bulk water infrastructure. The WGM's 2010-11 Annual Report (WGM 2011) shows that the revenue shortfall between GSCs paid and Bulk Water Prices received has been largely capitalised as debt.

The Bulk Water Price Path is not reviewed by the Authority. However, the GSCs are an important input into determining the level of debt held by the WGM.

3. FRAMEWORK FOR THE INVESTIGATION

3.1 Changes in Scope since 2011-12

Compared to the 2011-12 GSC investigation, for 2012-13:

- (a) there are now two GSPs rather than three;
- (b) the Authority is required to undertake a detailed benchmarking review of fixed and variable operating costs to provide advice on potential efficiency improvements and business savings based on good industry practice; and
- (c) the Authority is to consider any adjustments required due to any under- or over-recovery of GSCs in 2011-12, consistent with the Review Thresholds approach previously established by the Authority.

3.2 Regulatory Objectives

The Market Rules and the Direction Notice provide guidance as to the key objectives in recommending GSCs for 2012-13. The GSCs should:

- (a) establish an environment which fosters prudent and efficient operating and maintenance practices and utilisation of infrastructure;
- (b) allow the GSPs to recover a sustainable revenue stream from the provision of Declared Water Services determined on the basis of efficient and prudent expenditure forecasts, recognising that the time horizon may extend beyond a single regulatory period; and
- (c) provide appropriate incentives for GSPs to invest, innovate and pursue efficiency improvements consistent with their roles and responsibilities.

In conducting its investigation, the Authority must:

- (a) recognise the need to minimise the economic cost of regulatory actions and uncertainty;
- (b) to the extent practicable, ensure that:
 - (i) the costs to Grid Participants of regulation do not exceed the benefits of such regulation;
 - (ii) information requests issued to Grid Participants and procedural requirements which apply to Grid Participants are efficient and effective and that a reasonable time period in which to comply is afforded to Grid Participants; and
 - (iii) Grid Participants are afforded a reasonable opportunity to participate; and
- (c) take into account the systems, information and organisational capacity of Grid Participants.

The Market Rules and the Direction Notice also set out a range of policy objectives which must be met within the broader regulatory framework in setting GSCs for 2012-13. These are identified in the following sections.

3.3 Grid Service Charges

Under the Market Rules (s 8.8), the components of the GSCs are:

- (a) Capital Charges (return of and return on capital);
- (b) Fixed Operating Charges;
- (c) Variable Operating Charges; and
- (d) Allowable Costs.

The Direction Notice also provides key principles for risk allocation. These principles include the following:

- (a) GSPs are not required to bear volume or source risk, either in total or across production or dispatch points, over the regulatory period;
- (b) the opening RAB and asset lives as at 1 July 2011 are not to be reviewed by the Authority or subject to optimisation;
- (c) expenditure on capital projects approved by the Price Regulator prior to 1 July 2011 should be recognised as prudent;
- (d) in order to fully immunise GSPs from interest rate exposures, the rate of return earned by GSPs for 2012-13 is to be based on the actual cost of debt;
- (e) major capital investment for grid capacity augmentation is to be included in the relevant entity's RAB at the project cost; and
- (f) drought assets constructed under the *Water Regulation 2002* (Qld) and the RWSP (DERM 2010) should earn a rate of return equal to the actual cost of debt.

The Direction Notice requires the Authority to assess the prudence and efficiency of capital expenditure and operating costs. Further, the Market Rules require the Price Regulator to take account of (only) 'prudent and efficient capital expenditure' (s 8.11(e)), and to permit GSPs to recover (only) 'prudent and efficient operation and maintenance costs (s 8.12(a)), 'efficient corporate costs' (s 8.12(b)) and 'efficient variable operating costs' (s 8.13).

Under the Market Rules (s 8.7), the Price Regulator may direct the Authority to review GSCs. GSPs may also submit an application for a review of the GSCs (s 8.15). The Direction Notice requires the Authority to develop a process, and appropriate Review Thresholds, for reviewing the 2012-13 GSCs. The Authority's analysis and recommendations in regard to Review Thresholds are outlined in Chapter 7.

The Authority is also required to consider any adjustments required due to an over- or under-recovery of GSCs in 2011-12, as described in the Authority's Review Thresholds chapter.

3.3.1 Volume and Source Risk 2012-13

Under the Direction Notice, the Authority is to adopt production forecasts consistent with the grid instructions forecast in the Operating Strategy (or successor document), and any relevant information provided to the GSPs in accordance with the System Operating Plan (SOP).

Production forecasts are relevant to assessing the Capital Charge and the Variable Operating Charge.

Draft Report

In the Draft Report, the Authority recommended charges based primarily on the WGM's November 2011 Annual Operations Plan (AOP), a successor document to the Operating Strategy.

For particular dispatch points, the WGM proposed in March 2012 submission production forecasts that were different from those in the November 2011 AOP. On the basis that this represented more recent information, the Authority adopted these later forecasts when considering capital expenditure need and, as a result, excluded capital expenditure relating to WTPs which the WGM advised were not required to meet the water security risk criteria mandated in the SOP.

Submissions in Response to the Draft Report

QWC

The QWC (2012) advised that the November 2011 AOP had not been approved. In particular, the QWC indicated that the section of the WGM's November 2011 AOP (Attachment 7) relating to total production forecasts and certain production or dispatch points were specifically excluded from approval.

Furthermore, QWC advised that it had directed the WGM, in accordance with the SOP, to issue Grid Instructions on the basis of only certain sections of the November 2011 AOP (sections 5.1 and 5.5 and Attachments 1, 2, 3 and 4) – and that this remained the approved operating mode for the grid and that the WGM's submission on this matter should not be taken to account.

WGM

The WGM (2012b) provided the Authority with the May 2012 AOP, which was not completed at the time of the Draft Report. The WGM noted that the May 2012 AOP was being assessed by the QWC. The May 2012 AOP contains water production forecasts and transfer volumes that are consistent with the WGM's submission in February 2012.

Seqwater

Seqwater (2012b) maintained its proposals for capital expenditure at WTPs that the WGM submitted are no longer required. Seqwater noted that the May 2012 AOP stated that certain WTPs were not required only for an interim period, pending discussion with Unitywater. On this basis, Seqwater submitted that it is still possible that supply from these WTPs may be required should some adverse event occur, in which case the renewals works are required.

Subsequently, Seqwater advised that expenditure on some WTPs (Woodford and Caboolture) planned for 2012-13 is now no longer required in view of the proposed operating framework detailed in the WGM's May 2012 AOP.

Authority's Analysis

For the Draft Report, the Authority was not aware the November 2011 AOP had not been approved in full.

In this regard, the Authority notes that Section 5.5 and Attachments 1 to 4 of the November 2011 AOP refer to operating modes and maximum available capacities which explicitly require operation and available capacity of some WTPs that the WGM subsequently submitted are not required. For the purposes of recommending GSCs, the Authority must accept the legislative framework in place and therefore maintain the QWC approved service capacity of certain infrastructure.

At the same time, the Authority notes that the May 2012 AOP (yet to be approved), is consistent with the WGM's submission in March 2012 and identifies changed expectations of total production forecasts and in some instances a reconfiguration of assets considered necessary to achieve expected production forecasts resulting in changes in forecast volumes at certain WTPs and dispatch points.

Given the changing production forecasts and potential efficiencies identified by the WGM, the Authority proposes to take these into account provided they are not inconsistent with the QWC approved Grid Instructions.

Where the WGM May 2012 AOP is inconsistent with the QWC approved Grid Instructions, but is considered to represent potentially prudent and efficient costs, the Authority has estimated the change to the GSC that the Government may wish to take account of, particularly if the May 2012 AOP is approved.

Consistent with the GSPs submissions, the Authority has recommended variable operating charges on a \$/ML basis at each WTP or transfer point. This removes the need to rely on production forecasts for variable costs. For comparative purposes, the Authority has also estimated total variable operating costs which reflect production forecasts from each of the November 2011 and May 2012 AOPs.

3.4 Capital Charges

3.4.1 Opening RAB

The opening RAB of the GSPs includes former local government, SunWater and water board assets – these assets were transferred to GSPs under the *South East Queensland Water (Restructuring) Act 2007(Qld)* and included in the GSPs' RAB on the transfer date (mostly 1 July 2008). The value and life of assets transferred to the GSPs from local governments were determined by the Queensland Government.

Under the Direction Notice, the Authority is required to accept the opening values and asset lives as at 1 July 2011 provided by the Price Regulator.

On 17 February 2012, the Price Regulator provided a 1 July 2011 opening RAB to the Authority. This RAB represents an update on the 1 July 2011 RAB provided to the Authority by the QWC during the 2011-12 investigation. The Authority has accepted this new RAB, and has adjusted its recommended 2012-13 GSCs to take account of any under- or over-recovery in 2011-12 as a result of the updated RAB.

As for 2011-12, for the 2012-13 review, the Authority has:

- (a) identified that land assets have been included in the RAB. Where possible to do so, these have been identified separately, to avoid depreciating them. If land assets have been inadvertently depreciated in previous periods, the Authority has ceased depreciation and retained the land in the RAB at the value as provided by QWC; and

- (b) found that adjustments to asset values, although insignificant, were included in the RAB. The Authority proposes to net these from higher value related assets with a similar life. This will leave the overall RAB unchanged but does affect the balance between drought and non-drought assets (only for LinkWater and such an adjustment was accepted by the Minister for the 2011-12 GSCs).

As recommended in the 2011-12 Final Report (QCA 2011) the 1 July 2011 RAB provided by the Price Regulator has been rolled forward to 1 July 2012 by:

- (a) adding prudent and efficient capital expenditure that was commissioned in 2011-12;
- (b) subtracting straight-line depreciation incurred in 2011-12; and
- (c) adding asset appreciation of 2.5% in 2011-12.

The 1 July 2012 RAB is the opening RAB for the 2012-13 regulatory period.

3.4.2 Capital Expenditure

The Market Rules requires the Authority to take account of:

- (a) any capital expenditure required to be undertaken to comply with legislative requirements; and
- (b) capital costs for assets constructed under Part 8 of the *Water Regulation 2002* (Qld), including:
 - (i) commissioning costs;
 - (ii) capitalised corporate costs; and
 - (iii) capitalised interest incurred from commencement of construction to certification of constructed assets.

The Direction Notice requires that the Authority accept that:

- (a) expenditure on capital projects approved by the Price Regulator prior to 1 July 2011 should be recognised as being prudent; and
- (b) regionally significant capital investment for grid capacity augmentation determined by the Government as part of the SEQ Water Strategy and RWSP (DERM 2010) is to be rolled into the relevant entity's RAB at project cost.

Prudency and Efficiency

As indicated above, the Authority is required to assess the prudency and efficiency of new, non-drought capital expenditure. The Authority proposes to continue to apply the definitions of prudency and efficiency adopted in its 2011-12 GSC investigation, with minor variations.

Capital expenditure is prudent if there is a demonstrated need for the expenditure, for example:

- (a) it is required as a result of a legal obligation, growth in demand or renewal of existing infrastructure that is currently used and useful; or

- (b) it achieves an increase in the reliability or the quality of supply that is explicitly endorsed or desired by customers or required by a relevant regulatory agency.

Capital expenditure is efficient if it is cost effective when considered against the scope and standard of works required, and assessed against market benchmarks. In particular:

- (a) the scope of the works is appropriate having regard to the desired outcomes and the options available, including the substitution possibilities between capital expenditure and operating expenditure and non-network alternatives such as demand management;
- (b) the standard of the works conforms with technical, design and construction requirements in legislation, industry and other standards, codes and manuals. Compatibility with existing and adjacent infrastructure is relevant as is consideration of modern engineering equivalents and technologies; and
- (c) the cost of the defined scope and standard of works is consistent with conditions prevailing in the markets for engineering, equipment supply and construction.

Draft Report

The Authority engaged SKM to assist with reviewing the prudence and efficiency of capital expenditure. Having regard to the costs and time involved, a sampling approach was adopted to assess the prudence and efficiency of capital expenditure.

To assist with assessing capital expenditure, the GSPs have provided details of forecast capital expenditure against the following investment drivers:

- (a) Service – capital expenditure associated with upgrading service outcomes to meet customer desired standards. These can take the form of improved reliability;
- (b) Compliance – capital expenditure associated with the replacement and/or enhancement of an asset to prevent non-compliance with legislative requirements such as the *Water Act 2000* (Qld), Water Market Rules, Grid Services Contract, Water Quality Guidelines and Occupational Health and Safety (OH&S);
- (c) Renewal – capital expenditure associated with the replacement and/or enhancement of an asset that is currently compliant with service performance standards and legislative requirements but faces an unacceptable risk of future non compliance. The renewal will maintain existing levels of service over the life cycle of the asset;
- (d) Business efficiency – capital expenditure designed to improve operational efficiency and reduce ongoing costs; and
- (e) Growth – capital expenditure designed to provide an increase in the capacity or capability of an asset in response to increased demand, growth or variations required by a customer.

In the Draft Report, LinkWater (2012a) raised concerns about the interaction between the Authority's review and the development of a Water Supply Asset Plan under the SOP (QWC 2011). LinkWater submitted that any endorsement from the QWC of LinkWater's Water Supply Asset Plan is effectively an endorsement of the prudence of LinkWater's demand driven (growth) Capital Works Program as presented in that Plan. The program of work in the Water Supply Asset Plan will also form a large part of the Capital Works Program and maintenance costs for future submissions to the Authority.

LinkWater considered that the consequence of having two separate assessments is that there is the potential for inconsistency between the respective endorsed programs of work. LinkWater considered that this is particularly the case given that the SOP process will be undertaken annually while the long-term regulatory arrangements will cover multiple years.

LinkWater questioned how, in the event that the QWC issues an endorsement of a program of work after the Authority finalised its assessment, any differences will be treated from a regulatory perspective and which endorsement carries precedence.

The Authority was advised by the QWC that the Authority's regulatory process is intended to be the final discipline in terms of prudence and efficiency of proposed capital expenditure. This is not inconsistent with either the SOP (QWC 2011) or the Direction Notice. The Authority considered LinkWater should liaise with the QWC to resolve any remaining uncertainty in this regard.

The Authority, however, considered that the Water Supply Asset Planning process under the SOP (QWC 2011) will form an important input into any future regulatory reviews of GSPs' capital expenditure programs.

Submissions in Response to the Draft Report

The WGM (2012b) noted that the Authority's Draft Report identified a number of sampled items for which insufficient information was available to assess prudence and efficiency. The WGM submitted that these findings may reflect systemic issues, which apply equally to the proposed capex that has not been reviewed by the Authority. The WGM recommended that the Authority not endorse proposed capex to be commissioned, or commenced in 2012-13 unless and until it has been specifically assessed for prudence and efficiency.

Authority's Analysis

The Authority considers that the WGM's proposed suggestion to exclude all items until reviewed is not appropriate as it imposes unreasonable additional risks on the entities.

3.4.3 2011-12 Capital Expenditure

The 2011-12 Review Thresholds proposed to take account of any variation between prudent and efficient actual 2011-12 capital expenditure and the forecast of capital expenditure incorporated in the 2011-12 GSCs. The Authority has adjusted the 2012-13 GSCs to account for any under- or over-recovery of 2011-12 capital charges as a result of variation in prudent and efficient 2011-12 capital expenditure.

3.4.4 New Multi-Period Capital Expenditure

Draft Report

The Authority's role under the Market Rules only applies to the 2012-13 regulatory period, limiting the ability of the Authority to provide any undertakings or assurances about the future treatment of capital expenditure commencing in the 2012-13 year but to be completed in later years.

This presents some risk to the GSPs, as any assessment by the Authority that capital expenditure was imprudent could occur after several years of capital expenditure. GSPs were invited to identify such projects in their submissions to the Authority.

Stakeholder Submissions

Seqwater (2012a) submitted that a review of multi-period capital expenditure projects only in the year of completion gives rise to significant regulatory risk. Seqwater considered that the more substantial and financially significant a capital project is, the more likely it is that its construction will occur over multiple years, and the more unmanageable these regulatory risks will become.

Seqwater submitted that its regulatory risk goes beyond that of other regulated businesses, due to the annual regulatory cycle that applies to the GSPs. Seqwater considered that a longer regulatory period would allow for review of at least the prudence of all proposed capital expenditure.

Seqwater proposed that it should be provided with the same level of regulatory guidance afforded to regulated businesses under other, more standardised, regulatory regimes. Specifically, Seqwater requested the Authority's review of a number of multi-period capital expenditure projects.

Authority's Analysis

The Authority agreed that a one-year period represents a regulatory risk to GSPs regarding multi-period capital expenditure. At the same time, the Authority noted that there are mitigating factors that will reduce the risk to the GSPs. For example, GSPs capital expenditure projects are generally required by regulation or service standards, and therefore prudence should be easily assessed by the GSP.

Capital expenditure that is most at risk is large, non-drought, multi-year renewal capital expenditure that is expected to commence in 2012-13.

As the capital expenditure will not be rolled into the RAB until it is commissioned, the Authority's assessment of the prudence of multi-period projects may not be relevant in the event that the Authority is not involved in future recommendations of GSCs. To assist, the Authority nevertheless provided an assessment of the proposed capital expenditure (wherever possible), and will be bound by its own findings (if it is involved in future reviews), subject to an ex post assessment of the actual expenditure incurred.

While the Authority has not been provided the time to review each of Seqwater's multi-period capital expenditure items, a number of items were reviewed in Chapter 4 below.

Submissions in Response to the Draft Report

Seqwater

Seqwater (2012b) submitted that the Authority's Draft Report used a different method of categorising capital projects compared to that used in the 2011-12 review.

Seqwater noted that, in the previous review, projects were categorised according to the financial year in which the expenditure was incurred, focusing on the review year. In this review, the Authority has categorised projects according to the year in which the project is due to be completed (the anticipated date of commissioning).

Seqwater therefore grouped projects according to those commissioned in 2011-12, those commissioned in 2012-13, and those commissioned in later years from 2013-14 to 2016-17. Seqwater noted that, for the first time, the Authority has drawn conclusions about projects proposed to be commissioned in a year other than that in question. Seqwater acknowledged

that this is partially due to Seqwater seeking a review of multi-year projects to minimise its regulatory risks.

Seqwater considered that it would be helpful for the Authority to publish statements to note that:

- (a) due to the regulatory process governing the review, findings that relate to capex in forward years (after the financial year being reviewed) do not have any financial impact on Seqwater; and
- (b) for all projects, particularly multi-year projects, the review is not final and there will be further reviews, including an ex post review once the project is completed.

Seqwater noted that the Authority applied a value of zero to projects where efficiency is not yet proven. Seqwater suggested that the Authority should consider making a finding as to how much of the project would be considered efficient, rather than apply a zero value.

WGM

The WGM suggested that the Authority could consider the timeframe within which any prudent expenditure is undertaken. The WGM considered there is an opportunity to stage some of these works, taking into account surplus capacity within the system and the small number of recent incidents. The benefits of staged delivery of prudent capex include a reduced need for project delivery staff and time for long term demand trends to be understood, reducing the risk of over-sized infrastructure.

Authority's Analysis

The Authority has consistently only included items in the asset base once commissioned. Hence, items that were commissioned in 2011-12 may be subject to sampling for ex post review, and items expected to be commissioned in 2012-13 have also been sampled for review with potential implications for 2012-13 GSCs.

There has not been any change to the treatment of capex items that would have any implications for the method of determining the GSCs.

In the Draft Report, the Authority reviewed 10 Seqwater capex items expected to be commissioned after 2012-13, and conducted a less detailed review of a further 7 items that were identified in submissions, particularly by the WGM. The conclusions in relation to these items had no bearing on the 2012-13 GSCs. No post-2012-13 items for LinkWater were reviewed as none were proposed.

Given the limited time available to complete the review, and because there are no implications for 2012-13 GSCs, the Authority has only reported further stakeholder comments and provided comments where new information was provided.

For the Final Report, the Authority has separated the analysis of post 2012-13 items from the process of estimating GSCs by including them as **Appendix B** to the Report.

3.4.5 Capitalisation of Interest

Seqwater (2012a) submitted that the Authority should continue to capitalise interest costs incurred during construction of multi-period capital expenditure projects. Seqwater considered it appropriate to estimate interest costs by reference to the allowed rate of return, or regulatory weighted average cost of capital (WACC), as project financing is likely to reflect the business gearing.

The Authority noted that the Market Rules (s 8.11) (Queensland Government 2010) require the Authority to allow capitalised interest costs on drought capital expenditure. The Authority considered that a consistent approach is appropriate for non-drought multi-period capital expenditure, and therefore accepts Seqwater's submission in principle. For drought projects, the Authority believed that the appropriate interest rate is the cost of debt. For non-drought projects, the appropriate interest rate is the WACC recommended by the Authority.

3.4.6 Excess Water Treatment Capacity

Draft Report

The WGM (2012a) provided a submission to the Authority relating to capital expenditure proposed by the GSPs. The WGM submitted that the Water Grid currently has a large amount of surplus capacity, due to dams being near full and customer demand remaining relatively low. The WGM noted that current demand is about 276,000 ML per annum, compared with the system yield of about 485,000 ML and the installed water treatment capacity of about 750,000 ML. That is, the WGM estimates that current demand is equal to about 57% of the system yield and about 37% of the installed water treatment capacity.

Given these circumstances, the WGM submitted that it is proposing changes to the operation of the system to reduce costs. The WGM stated that it is seeking to consolidate the treatment of water, avoiding the need to take water from some WTPs that are expensive to operate and for which new capital expenditure is proposed. The WGM stated that it will primarily source water from seven WTPs, with five additional WTPs available to provide supplementary supplies in response to peak demands, or supply interruptions to other assets.

The WGM stated that service will not be required from 11 WTPs for at least five years, and most likely more than 15 years. The Authority has considered the implications of the WGM's submission in its review of Seqwater's capital and operating expenditure (Chapter 4).

Submissions in Response to the Draft Report

The WGM (2012b) advised that an updated version of the AOP will be submitted to the QWC in May 2012 for approval. The proposed plan reflects their previous submission (WGM, 2012a), in that no supply will be required from the Caboolture, Woodford and South Maclean WTPs in 2012-13. No supply will be required from the Banksia Beach WTP in normal operations, but may be required to provide supplies in response to emergency situations or customer requests.

Authority's Analysis

The May 2012 AOP has now been provided to the Authority. The Authority has taken account of all additional information in regard to WTPs in its Chapter 4 analysis of Seqwater's GSCs.

3.4.7 Water Quality

Submissions in response to the Draft Report

Seqwater

Subsequent to the Draft Report, Seqwater (2012b) submitted that water quality requirements are contained in a number of documents, including:

- (a) the *Water Supply (Safety & Reliability) Act 2008*;

- (b) the Grid Contract;
- (c) the Australian Drinking Water Guidelines; and
- (d) the *Public Health Act 2005*.

Seqwater submitted that its Drinking Water Quality Management Plan prepared under the *Water Supply (Safety and Reliability) Act* identifies potential hazards and provides an assessment of the relevant risks and demonstrates how Seqwater addresses those risks, including through monitoring and verification programs and the water quality parameters to be used for indicating compliance.

Seqwater submitted that the water it provides must be of a standard higher than that set out in the Grid Contract for some parameters. Seqwater submitted that some final water quality outcomes were a consequence of the requirements of mid-treatment processes. Seqwater provided the example of turbidity, which normally is substantially lower than the aesthetic requirements in the Grid Contract due to the need to ensure that the water filtering process removes pathogens such as protozoa, cryptosporidium and giardia.

Further, Seqwater submitted that, were it to provide water which meets the specified quality standards as set out in the Grid Contract, but remained unsafe, it may be liable for legal action against it. For this reason, Seqwater conducts its own risk analysis to determine the level of treatment required, rather than relying explicitly on the specified quality parameters in the Grid Contract.

WGM

The WGM (2012b) submitted that the project specifications for new water treatment plants are more stringent than set out in the Grid Contracts.

Authority's Analysis

The Authority notes that Seqwater must use its best endeavours to meet the quality parameters set out in the Grid Contract, which specifies maximum concentration levels for various contaminants such as aluminium and manganese and other quality standards relating to items such as water temperature and turbidity.

At the same time, the Authority notes that the Grid Contract also requires compliance with the Australian Drinking Water Guidelines. The ADWG set out guideline values for maximum levels of pollutants which should occur in water, but also set out the need for water suppliers to adopt a risk-based approach to water quality management. Where a water supplier has undertaken such an approach, and its assessment of risk leads it to conclude that the safety levels it must meet should exceed the guidelines, the ADWG recommends that it must meet these higher safety guidelines.

The Authority understands that Seqwater would be liable under the *Public Health Act 2005* and the Grid Contract if it provided drinking water that it knew, or reasonably ought to have known, was unsafe (likely to cause physical harm to a person who might later consume it). The Authority understands that this liability exists even if Seqwater achieves compliance with the water quality parameters specified in the Grid Contract.

Indeed, as noted in the WGM's May 2012 AOP:

Health related issues are treated as an absolute constraint on the system. That is, if a particular operational response needs to be taken to ensure water deliver to customers meets the health

requirements set out in the Australian Drinking Water Guidelines 2011, then those operational responses are undertaken regardless of cost.

The Authority therefore agrees that Seqwater has an obligation to manage water quality risk in a manner that may differ from the water quality parameters explicitly listed in the Grid Contract and, as a result, may warrant higher levels of expenditure than would be implied by the Grid Contract alone.

Without explicit direction from Government on the appropriate level of risk/cost trade-off, Seqwater (and LinkWater) have the incentive to minimise risk to the greatest extent possible (which in turn implies higher levels of expenditure).

With a view to minimising the incurrance of unnecessary costs, the Authority considers that there could be merit in the Government, on behalf of water users, reviewing the level of guidance provided to GSPs to establish the appropriate level of water quality risk at an appropriate level of cost. To this end, the Authority notes that ADWG recommends that, when translating the guidelines into standards, operators and regulators should consider costs and benefits.

The Authority has accepted the judgement of the GSPs for the purpose of recommending Grid Service Charges – to do otherwise would require the Authority to establish the appropriate quality/risk standard and expose the service providers to an unacceptable level of risk on a matter of substantive health and safety. This is considered a matter more appropriately determined by Government. The Authority could assist in the future by identifying the various risk/quality cost options or the process that should be adopted for this purpose.

3.4.8 Asset Reliability and Performance

Submissions in Response to the Draft Report

The WGM (2012b) submitted that it has concerns in relation to the level of [asset] reliability required, especially given the surplus water treatment capacity currently available in the system.

Authority's Analysis

The Authority notes that the Grid Contracts contain some requirements regarding asset reliability. GSPs are required to provide 60 days notice of scheduled maintenance that may affect their contractual service obligations. Furthermore, GSPs are permitted service interruptions in the event of, for example:

- (a) emergency events;
- (b) avoidance of imminent injury or harm;
- (c) prevention of damage to property; and
- (d) compliance with legislative requirements.

The Authority also notes that these provisions of the Grid Contract apply broadly, and are not specified by asset. In contrast, the Authority notes that the WGM's submission made prior to the Draft Report categorised WTPs that it will rely on for base load and WTPs that will provide supplementary supply. The Authority considers that this categorisation reflects an implicit individual asset reliability requirement, and that a lower level of asset reliability is appropriate for supplementary WTPs relative to base load WTPs.

The Authority further notes some government policy decisions, such as the Hot Standby mode at the GCDP, provide guidance on individual asset reliability, but only in a partial manner. The Levels of Service contained in the SOP provide service standards for the Grid as a whole, but do not extend to asset reliability or performance.

The Authority notes that asset performance standards are directly relevant to a number of proposed capital expenditure projects considered in this Final Report, including those relating to raw water quality such as sludge handling upgrades at WTPs.

The Authority recommends that individual asset reliability standards would provide the GSPs with clarity regarding the service required of each of their assets, or at each demand zone. Examples of asset reliability standards include:

- (a) notification periods for planned outages;
- (b) duration of unplanned outages;
- (c) number of unplanned outages per period;
- (d) number of asset failures per KM/ML etc;
- (e) notification periods for output ramp-up for supplementary supplies; and
- (f) leakage, losses, and evaporation.

Quantified asset reliability standards would enable a much more rigorous appraisal of GSPs' proposed capital expenditure (and to a lesser extent, operating costs) against service requirements. For example, sludge handling upgrades could potentially be avoided at WTPs with low asset reliability requirements if the WTP could go out of service during poor raw water quality events and avoid the need to handle above average amounts of sludge.

In the absence of clearly defined individual asset reliability standards, the Authority has assessed each submission on its merits and relied on the advice of its external consultants where possible using general industry standards.

3.4.9 Other Capital Expenditure Issues

In the process of the investigation, a number of issues relating to capital expenditure warranted further attention:

- (a) GSPs lost assets in the January 2011 floods, which are to be replaced during 2012-13. Any relevant capital expenditure has been incorporated into the RAB at its estimated efficient cost. Any revenues received from insurance companies and disaster relief are expected to be available and deducted from the RAB for the purpose of determining GSCs by the time of the Final Report. The existing asset remains in the RAB; and
- (b) the Floods Commission of Inquiry made a number of interim recommendations which may require a capital expenditure response from Seqwater. The Queensland Government accepted all the interim recommendations of the Commission of Inquiry. Accordingly, the Authority accepts the prudence of all capital expenditure recommended by or as a direct result of recommendations of the Commission of Inquiry.

3.4.10 Return on Capital

The Direction Notice requires that:

- (a) for drought assets constructed under the *Water Regulation 2002* (Qld) (amended 2006) and Table 1 of the RWSP (DERM 2010), the rate of return should be the actual cost of debt inclusive of administration and capital markets charges, but exclusive of a Competitive Neutrality Fee (CNF) as advised by Queensland Treasury Corporation (QTC);
- (b) for non-drought assets and post-commissioning expenditure on drought assets, a rate of return equal to the WACC, calculated on a pre-tax nominal basis, is to be achieved. The cost of debt component of the WACC is to be equal to each GSP's forecast cost of debt including administration, capital market charges and CNF, as advised by QTC; and
- (c) in order to fully immunise GSPs from interest rate exposures, the rate of return earned by GSPs for 2012-13 is to be based on the actual cost of debt.

Each GSP will have a slightly different WACC applying to non-drought assets and different costs of debt applying to drought assets, reflecting differences in the underlying debt pools managed by QTC that are applicable to their assets.

The Authority has made adjustments to the 2012-13 GSCs to account for any variance between forecast and actual cost of debt during the 2011-12 year to date.

The Authority considers that, at the end of the 2012-13 period, the Price Regulator will need to adjust the returns to ensure that the returns equal the actual cost of debt as provided by QTC. The process for these adjustments is considered in Chapter 7.

3.4.11 Return of Capital

The form of return of capital is not specified in the Market Rules (Queensland Government 2010) or the Direction Notice although the Authority is required to accept the asset lives associated with the RAB at 1 July 2011.

In previous periods, return of capital was calculated on a straight line depreciation basis over the estimated asset useful life. The Authority proposes to continue this approach.

Where possible, the Authority will separately identify land assets, and remove them from the calculation of return of capital.

For assets constructed after 1 July 2011, the Authority has reviewed the asset lives proposed by GSPs for consistency with the asset lives for similar assets in the RAB, and with asset lives used in other regulatory reviews.

3.4.12 Indexation

The Market Rules and the Direction Notice are silent in regard to the method of indexation of asset values throughout the regulatory period.

The Authority recommended a 2.5% annual indexation rate to all assets for the purposes of asset appreciation and for determining the closing RAB in its investigation of 2011-12 GSCs, consistent with the QWC approach in 2010-11.

The Authority has in recent investigations (e.g. SunWater, Gladstone Area Water Board (GAWB), QR Network) also applied a 2.5% indexation factor on the basis that this represents the mid-point of the Reserve Bank of Australia's (RBA's) target inflation band and that there is a reasonable expectation that the RBA will be able to maintain inflation within this band over time.

The Authority therefore recommends an annual indexation rate of 2.5% to apply for 2012-13.

3.4.13 Working Capital Allowance

The Market Rules and Direction Notice do not contain any provision regarding working capital.

In 2011-12, the Price Regulator directed the Authority to recommend a working capital allowance as an Allowable Cost based on the following formula:

$$(\text{Annual Accounts Receivable} \times \text{Average Debtor days}/365 - \text{Annual Accounts Payable} \times \text{Average Creditor days}/365) \times \text{WACC};$$

Following a review of the GSPs' invoicing history, the Authority recommended that a benchmark average of 30 creditor days and 45 debtor days apply to each GSP for 2011-12.

The Authority considers that this approach remains appropriate for 2012-13.

The 2012-13 Direction Notice defines Allowable Costs, with the exception of the QWC levy, as once-off costs which cannot reasonably be foreseen, rather than costs that will be incurred on a recurring basis.

On this basis, Seqwater (2012a) proposed to include the working capital allowance as a component of the Capital Charge, rather than an Allowable Cost. The Authority accepts this proposal.

3.4.14 Capital Charge Structure

Seqwater (2012a) submitted that it supported the continuation of the structure of the Capital Charge that applied in 2011-12, of a single annual amount which is not disaggregated by asset or service type. The Authority accepts this approach, and recommends a single annual Capital Charge for each GSP, paid monthly.

3.4.15 Modelling the Capital Charge

For simplicity, the Authority models prices and charges on an end-of-year basis, with pre-tax nominal rates of return and a full year's depreciation applied to opening asset values. In effect, this assumes the Capital Charges will be received at the end of the year rather than at the end of each month when the Capital Charges are actually received.

Under this approach, the net present value of revenues actually recovered over the course of a year would exceed that of the maximum Capital Charges recommended by the Authority as they are collected monthly.

To address this issue, the Authority discounts the Capital Charge to a mid-year value, to give an approximate estimate of the revenue required assuming a constant income stream over the course of a year.

In the 2011-12 Grid Service Charges, the Authority used the actual rate of return advised by the QTC and applied to each asset (the WACC for non-drought assets, and the costs of debt for each of the drought assets) to discount the Capital Charge to a mid-year value.

Draft Report

In the 2012-13 Grid Service Charges Draft Report, the Authority sought to estimate the mid-year value on the basis of CPI (rather than WACC adjustment used for the 2011-12 Final Report) to maintain the GSC in real terms.

This revised approach was applied retrospectively to 2011-12 Grid Service Charges, resulting in a draft recommendation of a \$15 million payment (\$11.3 million to Seqwater, \$3.7 million to LinkWater) in the Authority's 2012-13 Draft Report due to what was considered an under-recovery of the Capital Charge in 2011-12 (the CPI being lower than the WACC).

LinkWater's Submission

LinkWater (2012b) sought further clarification in relation to the Authority's modelling and whether the Authority has accounted for timing differences in the receipt of revenues.

Authority's Analysis

Subsequent to the Draft Report and following further internal review and discussion with GSPs, the Authority notes that the key issue is that, under the Grid Contract approach of monthly invoicing in arrears, GSPs receive Capital Charges on a monthly basis.

Having regard to this concern, discounting by the relevant rate of return is indeed a more accurate approach to ensuring that an appropriate amount of return is received by the entities on an NPV basis. That is, the CPI does not appropriately reflect the time value of money gained by GSPs earning revenue in advance of incurring costs.

The Authority therefore recommends that the relevant rate of return be adopted to discount the Capital Charge to a mid-year value, consistent with the approach adopted in the 2011-12 Grid Service Charges. The Authority notes a concern (July 2012) by Seqwater that the cost of debt would be more suitable as a measure of the opportunity cost of capital as Seqwater would use the cash inflow to reduce debt. However, the Authority notes the cash flow could also be used to fund working capital or new capital expenditure.

For clarification, the Authority does not apply any mid-year discounting to the GSPs' operating costs, as these are typically estimated on the basis that they are incurred and paid on a monthly basis. The monthly timing of accounts receivable and payable is separately addressed by a working capital allowance.

3.5 Fixed Operating Charge

The Market Rules (s. 8.12) requires the Price Regulator to permit GSPs to recover:

- (a) prudent and efficient costs of, and incidental to, the operation and maintenance of the assets required to provide Declared Water Services (Relevant Assets) apportioned on an appropriate basis between the provision of Declared Water Services and other services; and
- (b) efficient corporate and related expenses.

The Direction Notice requires the Authority to accept that the current scope of recreation and catchment management activities is prudent.

3.5.1 Prudency and Efficiency

The Authority proposes to retain the tests of prudency and efficiency that were adopted in its recommendation of 2011-12 GSCs.

Under these tests, operating expenditure is prudent if it is required to meet the GSP's relevant requirements relating arising from:

- (a) its Grid Contract;
- (b) the SOP (QWC 2011);
- (c) the forecast required supply consistent with the grid instructions forecast in the WGM's Annual Operations Plan and any relevant information provided to the GSPs in accordance with the SOP (QWC 2011); and
- (d) its standard of service.

Operating expenditure is efficient if it is undertaken in a least-cost manner over the life of the relevant assets and is consistent with relevant benchmarks. In assessing efficiency, it is necessary to take account of the conditions prevailing in relevant markets, historical trends in operating expenditure and the potential for efficiency gains or economies of scale.

3.5.2 2011-12 Fixed Operating Charges

The 2011-12 Review Thresholds provided GSPs an efficiency incentive to make efficiency savings in their fixed operating costs. This incentive enabled GSPs to retain 100% of their saving in the year it was achieved and 50% in the following year if achieved as a result of specific initiatives put in place by GSPs. The Authority has reviewed 2011-12 efficiency saving initiatives submitted by the GSPs and incorporated an incentive payment in the recommended 2012-13 GSCs where warranted.

Seqwater (2012a) submitted that there is no need to change the structure of the Fixed Operating Charge applied in 2011-12, of a single annual sum, paid monthly. The Authority accepts this approach.

3.5.3 QCA Levy

The QCA levy was considered an Allowable Cost during the 2011-12 investigation. However, the Price Regulator's 2012-13 Direction Notice defines Allowable Costs, with the exception of the QWC levy, as once-off costs which cannot reasonably be foreseen, rather than costs that will be incurred on a recurring basis. The QCA levy, which is both foreseeable and recurring, does not fit the description of an Allowable Cost.

While LinkWater's submission included the QCA levy as an Allowable Cost, consistent with 2011-12, Seqwater proposed that the 2012-13 QCA levy be included as a component of the Fixed Operating Charge. For consistency with the Direction Notice the Authority accepts Seqwater's proposal.

The QCA 2012-13 levy of \$2.05 million excluding GST is allocated according to the effort expected by the Authority in reviewing the GSPs. Currently, as a separate exercise is required to review each of the previous Seqwater and WaterSecure costs, and LinkWater costs, the QCA levy is allocated 2/3 to the new Seqwater and 1/3 to LinkWater (as for 2011-12).

3.6 Variable Operating Charge

The Market Rules (s 8.13) require the Price Regulator to permit GSPs to recover efficient variable operating costs relating to assets required to provide Declared Water Services (Relevant Assets) apportioned on an appropriate basis between the provision of Declared Water Services and other services.

The Direction Notice requires the Authority to accept that production forecasts for the regulatory period are to be consistent with the Grid Instructions forecast in the WGM's Operating Strategy (WGM 2011) (or any successor document) and any relevant information provided to the GSPs in accordance with the System Operating Plan (QWC 2011).

3.6.1 Prudence and Efficiency

The Authority proposes to retain the tests of prudence and efficiency that were adopted in its recommendation of 2011-12 GSCs.

Under these tests, operating expenditure is prudent if it is required to meet the GSP's relevant requirements arising from:

- (a) its Grid Contract;
- (b) the SOP (QWC 2011);
- (c) the forecast required supply consistent with the Grid Instructions forecast in the WGM's AOP and any relevant information provided to the GSPs in accordance with the SOP (QWC 2011); and
- (d) its standard of service.

Operating expenditure is efficient if it is undertaken in a least-cost manner over the life of the relevant assets and is consistent with relevant benchmarks. In assessing efficiency, it is necessary to take account of the conditions prevailing in relevant markets, historical trends in operating expenditure and the potential for efficiency gains or economies of scale.

3.6.2 2011-12 Variable Operating Charges

In 2011-12, the Authority recommended that Variable Operating Charges be invoiced to the WGM based on actual volumes and the recommended \$/ML unit rates. The use of actual volumes in invoicing ensured that GSPs were not exposed to volume or source risk.

The 2011-12 Review Thresholds also allowed for an assessment of the recommended \$/ML unit rates at the end of the period. The Authority has conducted an assessment of 2011-12 \$/ML variable operating cost unit rates, where submitted by the GSPs. The Authority has made adjustments to the 2012-13 GSCs to account for any variance between forecast and actual prudent and efficient variable operating costs during the 2011-12 year to date.

Draft Report

Submissions

LinkWater (2012a) submitted that it is responsible to reflect as far as practicable the short-term cost drivers of the business from both a location and usage perspective.

For this reason, LinkWater proposed the following tariffs:

- (a) a two-part tariff for each pump station based on the fixed and variable energy costs incurred for the use of each pumping station levied on a \$/ML basis;
- (b) a charge for treated water at each water quality facility to reflect the \$/ML cost of different water treatment requirements; and
- (c) all remaining costs recovered via a fixed monthly tariff.

Authority's Analysis

The Authority considered that the Variable Operating Charge should be expressed as a \$/ML amount at relevant supply and distribution points, with the charges determined on monthly volumes in arrears. Effectively, the Fixed Operating Charge and Variable Operating Charge form a two-part tariff. The Authority therefore accepted LinkWater's proposed variable tariff structure. This tariff structure is also consistent with the structure of the information provided by Seqwater.

The Authority proposed to recommend volumetric (\$/ML) charges for the GSPs' nominated supply and distribution points. For reporting purposes, the Authority also recommended a forecast Variable Operating Charge for 2012-13 based on the WGM's production forecasts for the full year.

Submissions in Response to the Draft Report

Seqwater (2012b) submitted that, in determining GSCs for 2011-12, when the Price Regulator applied the Authority's recommendations, Seqwater was issued with invoicing instructions that had the effect of applying a cap on the total variable operating charge that Seqwater could recover in 2011-12. This will have no impact in 2011-12, as actual demand is likely to be lower than forecast. However, the issue may have financial implications in future years if demand is higher than forecast.

Authority's Analysis

In 2011-12 GSCs, the Authority's intent was for each GSP to apply the variable operating charge to actual volumes recorded at each bulk supply point. The Authority understands that such an approach was adopted by LinkWater in its invoicing to minimise the size of any end-of-period adjustment.

While the Authority published a total variable operating charge, this was for illustrative purposes only and based on forecast demand. The Authority's actual 2011-12 recommendations were \$/ML charges to apply at each supply or transport asset.

As noted above, the Authority has also recommended 2012-13 variable charges on a per ML basis to be used as the basis for invoicing. The total GSC is only an indicative forecast based on expected volumes.

3.7 Allowable Costs

Under the Market Rules, the Price Regulator may permit the GSPs to recover other prudent and efficient costs incurred to provide Declared Water Services which are not recoverable as Capital Charges, Fixed Operating Charges or Variable Charges. This includes the levy payable by the GSPs to the QWC under section 360F of the *Water Act 2000* (Qld).

The Direction Notice requires the Authority to recognise that Allowable Costs, with the exception of the QWC Levy, are once-off costs which cannot be reasonably foreseen, rather than costs that will be incurred on a recurring basis.

Stakeholder Submissions

Seqwater (2012a) submitted that the relationship between Allowable Costs and Review Thresholds needs to be made clear so there is certainty about what events qualify under each regime.

Authority's Analysis

QWC Levy

The QWC has advised that the 2011-12 QWC levy of \$20.658 million should be adjusted to account for the 2010-11 financial year where QWC incurred less than the estimated user charges. The extent of this reduction is shown in Table 3.1.

Table 3.1: 2011-12 QWC Levy (\$ Million)

| | <i>Seqwater</i> | <i>LinkWater</i> | <i>Total</i> |
|-----------------------|-----------------|------------------|--------------|
| Original 2011-12 Levy | 10.329 | 10.329 | 20.658 |
| 2010-11 Adjustment | -3.816 | -1.908 | -5.724 |
| Net 2011-12 Levy | 6.513 | 8.421 | 14.934 |

In the Draft Report, the Authority reduced its recommended 2012-13 GSCs to take into account the \$5.7 million downward adjustment to the 2010-11 QWC levy.

Subsequent to the Draft Report, Seqwater submitted that it had already accounted for this difference in its invoicing of the WGM within 2011-12, and that there is no need for any additional deduction. LinkWater's GSC was also adjusted.

On this basis, the Authority removed its adjustment to account for an over recovery of 2011-12 Allowable Costs for both GSPs, that is, the full 2012-13 amount is included in GSCs.

In relation to 2012-13, the QWC has not finalised its budgeting process, and therefore could not provide a final 2012-13 levy at the time of the Authority's Final Report. In the interim, the Authority has adopted a 2012-13 QWC levy estimate of \$10.59 million excluding GST for each GSP. This represents a 2.5% increase on the 2011-12 levy, and is consistent with assumptions made by the GSPs in their submissions.

However, the Authority notes that it is possible that this cost will vary, dependent on the Government's decisions relating to the QWC.

QCA Levy

The QCA levy was considered an Allowable Cost during the 2011-12 investigation but has been included in the Fixed Operating Charge for the 2012-13 GSCs. See section 3.5 above.

Relationship to Review Thresholds

In response to Seqwater's submission, the Authority considers that the purpose of the Allowable Costs category is to provide a mechanism for GSPs to recover unforeseen and once-off costs, without the need for them to be included in other charges. From the Authority's point of view, this has the benefit of providing a consistent basis for estimating

operating and capital charges from year to year. That is, in forming a view of the GSPs' costs over time, the Authority considers it useful to exclude Allowable Costs.

In this regard, the Authority recommends that Review Thresholds are the primary mechanism for reducing GSPs' financial risks by allowing for adjustment to GSCs both within and at the end of regulatory periods. The Authority considers that some Review Events (see Chapter 7) are likely to result in Allowable Costs, such as changes in law or emergency events. However, the eligibility of Allowable Costs for an ex-post adjustment will continue to be recommended by the Authority on a case by case basis.

3.8 Other Services

In recommending the Capital Charge to apply to GSPs, the Market Rules (s. 8.11) require the Authority to take into account an appropriate apportionment of the RAB between the provision of Declared Water Services and other services.

The Direction Notice requires the Authority to accept that expenses and revenues associated with Seqwater's irrigation schemes must be taken into account.

3.8.1 Irrigation Services

In the 2011-12 GSC investigation, the Authority was required to continue the 2010-11 regulatory approach of passing through irrigation revenues and costs in GSCs. As a consequence, all operating costs of the assets servicing irrigators (whether the same assets provide a service to the WGM or not) were included in GSCs, while all irrigation revenues (excluding renewals annuity revenue) were applied as a revenue offset.

Capital expenditure on assets that served both the WGM (by providing water for urban and industrial use in SEQ) and irrigators was included in GSCs, while capital expenditure relating to assets that only served an irrigation purpose was excluded.

Renewals annuity revenue (collected for the purpose of renewing assets that provide irrigation services), was held in escrow by Seqwater to be considered as part of a more detailed review of SEQ irrigation charges.

Stakeholder Submissions

Seqwater (2012a) submitted that there should be no change to the approach adopted for the 2011-12 GSCs. Seqwater submitted that the cost allocation to other services is a relatively minor issue for GSCs, as irrigation revenues comprise only around 0.5% of total GSCs. Seqwater considered that a comprehensive review of operating and capital expenditure allocation should occur through the Authority's review of irrigation charges, with the outcomes of that review applied for future years commencing with the GSCs in 2013-14.

Authority's Analysis

Pending a more detailed review, the Authority proposes to continue the regulatory treatment of Seqwater's irrigation schemes adopted in previous years. That is, operating expenditure related to the irrigation schemes should be passed through to the GSCs, while any irrigation revenue (excluding renewals annuity) should be offset against GSCs.

Renewals annuity revenue is considered to be revenue reserved on behalf of irrigators to cover the costs of future asset refurbishment and replacement. As a consequence, renewals annuity revenue should be held in escrow and capital expenditure directly attributed or allocated to irrigation services should be excluded from the RAB for the GSCs.

The Authority accepts Seqwater's proposal that a more detailed cost allocation method is preferable to passing all costs and revenues through to GSCs. The Authority considers it appropriate to include this as part of the forthcoming review of SEQ irrigation charges, rather than the current GSC investigation.

3.8.2 Non-Grid Revenues

Draft Report

In relation to other non-grid activities, the Authority identified the following potential non-regulated revenues:

- (a) mini-hydro generators at Wivenhoe and Somerset Dams. In previous years, the Price Regulator treated the mini-hydro assets as non-regulated non-Grid assets, and excluded all direct operating costs and revenues from the determination of GSCs. Seqwater previously submitted that the revenue earned from non-regulated assets is minor. In 2011-12, the Authority recommended that the QWC's approach be continued for the interim regulatory period.

As the quantum is relatively minor (\$360,000), the Authority did not consider it necessary to assess whether the returns to Seqwater for this purpose are above those necessary to reward Seqwater for the costs (including risks) involved. Nevertheless, as the water users are incurring the capital costs of the hydro-plant and the non-direct costs involved, there is a case for some revenue from the sale of power to be returned to water customers. The Authority noted that to offset the total revenue from hydro against water revenue would remove the incentive for Seqwater to undertake mini-hydro electricity supply and incur the necessary costs involved. For simplicity, 50% of the revenue (net of direct operating costs) was recommended to be offset against water charges while the remaining 50% should be allocated to Seqwater to provide the incentive to utilise assets; and

- (b) revenue earned from the leasing of water assets such as reservoirs for placement of third-party telecommunication equipment. The Authority did not recognise revenue from telecommunications facilities in its 2010-11 SEQ Interim Price Monitoring Report (QCA 2010), on the basis that this was non-regulated revenue and that revenues were not significant.

However, the Authority noted that this revenue represents low risk returns to GSPs and no costs (other than the opportunity cost of the land – which is very low) and therefore should at least in part provide some revenue offset to water users. For simplicity, the Authority proposed that 50% of the revenue (\$77,347) should be offset against water charges while 50% should be allocated to Seqwater to provide the incentive to utilise assets.

Submissions in Response to the Draft Report

Seqwater (2012b) agreed that water grid customers should receive some compensation for the use of water grid assets for hydro or other non-regulated purposes. However, Seqwater submitted that it needs appropriate incentives to encourage use of water grid assets by other parties. Seqwater further noted that there are a number of issues that have been subject to interim arrangements pending detailed review and that, in this context, treatment of non-regulated services has been considered in isolation and prematurely by the Authority.

Seqwater therefore proposed that the interim arrangements [that Seqwater retains 100% of revenues] should be continued in 2012-13 and that treatment of non-regulated revenues be

considered in full once the longer term regulatory regime is in place. Seqwater noted that the impacts are negligible – at around 0.04% of GSCs.

Authority's Analysis

The Authority considers that a sharing arrangement for these net revenues would still allow Seqwater and LinkWater to earn revenues in excess of costs and therefore provide sufficient incentive to seek revenue contributions from third parties wishing to access grid infrastructure for non-regulated activities, while also providing benefits for water users.

3.9 Efficiency Incentives

Draft Report

In the 2011-12 investigation, consistent with the requirements of the Direction Notice to provide incentives for the entities to invest, innovate and pursue efficiency improvements, the Authority recommended that an incentive structure be implemented to encourage GSPs to achieve efficiency gains. This enabled GSPs to keep any cost savings achieved as a result of specific efficiency initiatives in 2011-12 and retain 50% of the saving in the next year's GSC.

In the Draft Report, the Authority proposed to continue these efficiency incentive arrangements for 2012-13. GSPs will be permitted to retain all cost savings achieved in 2012-13 relative to recommended GSCs. In addition, the GSP will receive a further 50% of any efficiency gains achieved in 2012-13 in the GSCs for 2013-14.

For the Draft Report, the Authority indicated that it will consider efficiency gains affecting any component of the GSCs. However, the efficiency gains must be the result of specific initiatives implemented by the GSPs, and should be submitted for consideration as part of the review of GSCs for 2013-14.

The Authority acknowledged that the WGM's operation of the SEQ Water Grid may have cost impacts for the GSPs. The Authority recommended that cost savings achieved by GSPs as a result of WGM decisions regarding grid operation and planning should not be retained by the GSPs.

Final Report

Given the limited response to adopting such efficiency gains, the Authority has also considered extrapolating identifiable systemic savings to unsampled proposed capital, fixed and variable expenditures.

However, after reviewing proposed costs, the Authority has found it inappropriate to do so for the purpose of the current review. Details of the sampling analysis for Seqwater and LinkWater are provided in Chapters 4 and 5.

In addition to the incentive mechanism that was applied in 2011-12, the Authority now recommends that an efficiency target be applied to the fixed operating costs of each GSP. The analysis of the efficiency targets is provided in Chapter 6.

3.10 Review Process

In undertaking its investigation, the Authority invited submissions, prepared a Draft Report for consultation and liaised extensively with stakeholders. Stakeholders have also had an opportunity to view and comment on the Final Report before its finalisation.

The Authority notes concerns of some stakeholders that the limited time frame for the review had a material impact on the ability of some stakeholders to provide relevant information for the purpose of the Draft Report.

In this regard, the Authority particularly notes the short timeframe available for the preparation of the Final Report after issuance of the Draft Report and receipt of subsequent submissions. As a result, there has been limited consultation on the Final Report, including the proposal to apply efficiency targets. Nevertheless the Authority, as the Investigating Authority under the Market Rules, has to make the final recommendation that it considers most appropriate having regard to all the information before it within the time available for this purpose.

4. SEQWATER

4.1 Background

Seqwater is responsible for storing, treating and manufacturing water for supply to the SEQ Water Grid.

Seqwater owns and manages a range of water storage assets, manufactured water assets and WTPs and groundwater assets. These include:

- (a) 26 dams and weirs across SEQ, including Wivenhoe, Somerset and North Pine Dams, Hinze Dam on the Gold Coast and Baroon Pocket Dam on the Sunshine Coast. Seqwater also owns the land inundated by the dams up to the flood margin, although at some storages such as Wivenhoe and Somerset Dams, it owns land beyond the flood margin;
- (b) 46 operational WTPs, the largest of which are Mt Crosby, Molendinar, Mudgeeraba, North Pine and Landers Shute. Of these, eight are interconnected to the Grid's bulk transport pipelines, while another 31 provide water directly to the distribution network, including standalone WTPs serving regional towns. Seqwater also owns seven minor treatment plants at recreation areas, 46 pump stations and 26 associated pipelines;
- (c) a reverse osmosis desalination plant at the Gold Coast;
- (d) three Advanced Water Treatment Plants (AWTPs) located at Bundamba, Luggage Point and Gibson Island;
- (e) more than 200 kilometres of large-diameter underground pipeline; and
- (f) six bores and bore fields, most of which were constructed in response to the drought and transferred to Seqwater.

On 1 July 2011, Seqwater was merged with the former manufactured water provider, WaterSecure.

Purified recycled water from the AWTPs supplies water to the Tarong and Swanbank power stations. The WGM plans to expand the supply of purified recycled water to other industrial and agricultural users, and purified recycled water is identified as a backup mechanism for SEQ's dams should they fall below a combined capacity of 40% under the SOP (QWC 2011).

The Gold Coast Desalination Plant (GCDP) feeds directly into the SEQ Water Grid. The Queensland Government announced in December 2010 that the desalination plant would operate on a "hot standby" mode. This entails production being scaled back to the minimum level required to ensure the plant could come on line at 100% capacity within 72 hours and 33% within 24 hours. This mode of operation allows the WGM to have water capacity on standby to react to water quality incidents, grid asset failures, or planned maintenance.

Seqwater outsources the operation of both the WCRWS and the GCDP. Veolia Water Australia is the appointed operator for the WCRWS, while the GCDP is operated by an alliance consisted of Veolia Water Australia, John Holland Australia, and the owner Seqwater.

4.2 Capital Charge

4.2.1 Opening RAB

Under the Direction Notice, the Authority is required to accept the opening RAB for Seqwater as at 1 July 2011, as provided by the Price Regulator. The Price Regulator has determined a 1 July 2011 RAB of \$5.1 billion, comprising \$1.9 billion in non-drought assets and \$3.1 billion in drought assets.

Seqwater's 1 July 2011 RAB values and asset lives are provided in Table 4.1 below.

Table 4.1: Seqwater RAB as at 1 July 2011

| <i>Category</i> | <i>Asset</i> | <i>Value (\$'000)</i> | <i>Remaining Life (years)</i> |
|--------------------|---|---------------------------|-----------------------------------|
| Non-Drought | Local Government Assets | 1,059,995 | 60.0 |
| | SEQWater assets | 487,998 | 59.6 |
| | Aquagen Assets | 123,015 | 59.7 |
| | Lake Manchester | 82,349 | 47.6 |
| | SunWater/NRW Assets | 79,941 | 60.0 |
| | Actual CAPEX 2008/09 | 38,740 | 14.5 |
| | Actual CAPEX - ongoing 2009-10 | 37,128 | 21.0 |
| | Ongoing 2010-11 CAPEX forecast | 18,683 | 18.7 |
| | Sth Maclean WTP transfer | 2,412 | 29.1 |
| | IT Equipment | 823 | 4.5 |
| | Office Furniture & Fittings | 747 | 4.0 |
| | Redlands transfers | 535 | 60.4 |
| | Ewen Maddock WTP Upgrades (CAPEX post completion) | 250 | 28.5 |
| | Plant and equipment | 31 | 4.4 |
| | <i>Sub-total</i> | <i>1,932,649</i> | <i>57.2</i> |
| Drought | Gold Coast desalination plant (IOP) | 813,584 | 23.2 |
| | Gold Coast desalination plant (Final Assets) | 149,763 | 34.0 |
| | Land for GCDP | 3,496 | - |
| | WCRW - Bundamba-Caboonbah Pipeline (Western Pipeline) | 365,025 | 62.4 |
| | WCRW - Eastern Pipeline 1A & 1B | 311,552 | 54.5 |
| | WCRW - Gibson Island AWTP | 289,163 | 24.0 |
| | WCRW - Bundamba 1A AWTP | 220,929 | 25.0 |
| | WCRW - Luggage Point AWTP | 212,609 | 21.2 |
| | WCRW - Bundamba 1B AWTP | 198,682 | 23.2 |
| | WCRW - Eastern Pipeline 2A | 126,855 | 64.3 |
| | Land PRW - WCRW | 53,092 | - |
| | WCRW - PRW Wivenhoe Release | 35,296 | 68.8 |
| | WCRW - Eastern Pipeline 2B (Kuraby PS) | 31,413 | 30.8 |
| | WCRW - Eastern Pipeline 2B (LPPS) | 28,269 | 59.5 |
| | WCRW - SRWP | 23,262 | 59.7 |
| | WCRW - Eastern Pipeline 1B (Wacol) | 22,734 | 34.9 |
| | WCRW - Luggage Point - Effluent Div Pump Stn | 16,314 | 45.4 |

| | | |
|--|------------------|-------------|
| Land Allocation Cost WCRW -SRWP | 7,746 | - |
| Coominya pipeline transfer from WCRW | 6,721 | 68.2 |
| Esk-Wivenhoe pipeline transfer from WCRW | 6,654 | 68.6 |
| WCRW - Scheme Wide Telemetry | 5,695 | 18.3 |
| WCRW - SBS Dosing | 1,068 | 25.4 |
| Land Allocation Cost - WCRW PRW Wivenhoe Release | 297 | - |
| Brisbane Aquifer Project | 48,528 | 17.2 |
| Bromelton Offstream Storage | 45,879 | 28.0 |
| Ewen Maddock WTP Upgrades | 42,992 | 27.9 |
| Bribie Island Groundwater | 39,971 | 17.3 |
| Cedar Grove Weir | 26,110 | 98.0 |
| Enoggera Dam WTP Upgrades | 11,635 | 28.5 |
| Enoggera Project pain/gain liability | 249 | 28.9 |
| <i>Sub-total</i> | <i>3,145,583</i> | <i>34.8</i> |
| Total | 5,078,232 | 43.3 |

Note: Includes former WaterSecure assets. Totals may not add due to rounding. Remaining life totals are weighted averages.

The opening RAB includes non-drought capital expenditure from 2009-10 and 2010-11, reflecting QWC's approach of adding actual non-drought expenditure into the RAB as it is incurred rather than at the commissioning of the capital expenditure. In contrast, the Authority proposes to continue the approach that it was required to accept in the 2011-12 investigation, of including capital expenditure in the RAB as at the commissioning date.

Any multi-period capital expenditure projects that commenced prior to 1 July 2011 and were partially included by the QWC in the 1 July 2011 RAB will be added to the RAB as at the commissioning date. On such projects, only expenditure incurred post 1 July 2011 has been reviewed by the Authority and added to the RAB.

4.2.2 2011-12 Capital Expenditure

The Direction Notice requires the Authority to consider any adjustments required due to an over- or under-recovery of GSCs in 2011-12. The Authority's 2011-12 Review Thresholds committed to allowing GSPs to recover actual (rather than forecast) 2011-12 capital expenditure that was prudent and efficient. The Authority therefore requested Seqwater to provide details of estimated actual 2011-12 capital expenditure¹.

Seqwater's estimated actual capital expenditure commissioned in 2011-12, compared to the forecast approved by the Price Regulator, is summarised in Table 4.2 below.

¹ Seqwater's submission date of 29 February 2012 means it could not possibly provide actual capital expenditure for 2011-12. Instead, Seqwater's submission represents estimated actuals. The Authority proposed a further adjustment for actual 2011-12 capital expenditure as part of a subsequent review.

Table 4.2: Seqwater's Proposed 2011-12 Capital Expenditure (\$ million)

| <i>Category</i> | <i>Type</i> | <i>Approved Forecast</i> | <i>Estimated Actual</i> |
|-----------------|--------------------|--------------------------|-------------------------|
| Drought | Infrastructure | 404.2 | 844.1 |
| Non-Drought | Infrastructure | 40.2 | 22.9 |
| | Non-infrastructure | 7.8 | 9.4 |
| Total | | 452.3 | 876.4 |

Note: Totals may not add due to rounding. Estimated actual exclude capital expenditure incurred but not commissioned in 2011-12.

2011-12 Drought Capital Expenditure

Hinze Dam

The much greater than forecast level of drought expenditure is almost entirely due to the deferral of the completion date of the Hinze Dam Raising project from 2010-11 to 2011-12. The expected commissioning of Hinze Dam capital expenditure in 2011-12 is offset by a corresponding decrease in the 1 July 2011 RAB. Table 4.3 shows that the net effect is a slight decline in the expected total cost of the Hinze Dam Raising project.

Table 4.3: Hinze Dam Raising cost forecasts (\$ million)

| | <i>2011-12 GSC investigation</i> | <i>2012-13 GSC investigation</i> |
|-----------------------------|----------------------------------|----------------------------------|
| 1 July 2011 RAB | 433.8 | - |
| 2011-12 capital expenditure | 11.3 | 443.4 |
| 2011-12 land acquisition | 9.0 | 9.0 |
| 2011-12 defects liability | 10.0 | 10.0 |
| Total | 464.1 | 462.4 |

Note: Totals may not add due to rounding.

Wyaralong Dam

Seqwater (2012a) submitted that additional information regarding the components of Wyaralong Dam expenditure has become available since the 2011-12 investigation. Table 4.4 refers.

Table 4.4: Wyaralong Dam construction costs (\$ million)

| | <i>2011-12 GSC investigation</i> | <i>2012-13 GSC investigation</i> |
|-------------------|----------------------------------|----------------------------------|
| Dam Construction | 373.4 | 281.6 |
| Land Acquisition | - | 45.1 |
| Road Construction | - | 46.7 |
| Total | 373.4 | 373.4 |

Note: Totals may not add due to rounding.

Seqwater submitted that the road component of construction attracted a separate cost of debt (see section 4.2.6 below), while the new information regarding the land component will affect Seqwater's depreciation revenue (as land does not depreciate).

Gibson Island AWTP

Seqwater (2012a) submitted that the revised 1 July 2011 RAB now only includes capital expenditure incurred during 2010-11. As a consequence, 2011-12 works on Gibson Island AWTP have been excluded from the 1 July 2011 RAB and therefore need to be included as 2011-12 capital expenditure. Table 4.5 refers.

Table 4.5: Gibson Island AWTP cost forecasts (\$ million)

| | <i>2011-12 GSC investigation</i> | <i>2012-13 GSC investigation</i> |
|--|----------------------------------|----------------------------------|
| 1 July 2011 RAB | 284.8 | 289.2 |
| 2011-12 Change Request capital expenditure | - | 1.3 |
| 2011-12 Practical Completion capital expenditure | - | 6.1 |
| Total | 284.8 | 296.5 |

Note: Totals may not add due to rounding.

As required by the Direction Notice, the Authority has included the full project cost of Seqwater's 2011-12 drought capital expenditure in the RAB. As noted above, the Authority included the capital expenditure from the date of commissioning.

2011-12 Non-Drought Capital Expenditure

Seqwater's submission

Seqwater (2012a) submitted that the lower than forecast non-drought capital expenditure in 2011-12 was largely due to the deferral of commissioning of a large number of approved capital expenditure projects.

Table 4.6: Seqwater's proposed 2011-12 Non-Drought Capital Expenditure (\$ million)

| <i>Type</i> | <i>Approved Forecast</i> | <i>Estimated Actual</i> | <i>Difference</i> |
|------------------------------------|--------------------------|-------------------------|-------------------|
| Approved infrastructure capex | 22.3 | 20.1 | -2.2 |
| Approved non-infrastructure capex | 7.8 | 9.4 | 1.5 |
| Un-forecast capex | - | 2.8 | 2.8 |
| <i>Sub-total</i> | <i>30.2</i> | <i>32.2</i> | <i>2.1</i> |
| Capex deferred to 2012-13 | 16.6 | - | -16.6 |
| Capex not proceeding | 1.1 | - | -1.1 |
| Irrigation capex included in error | 0.2 | - | -0.2 |
| Total | 48.1 | 32.2 | -15.8 |

Note: Totals may not add due to rounding.

Seqwater submitted that it expected approved capital expenditure projects that will be commissioned in 2011-12 to be underspent by \$0.7 million, but has included an additional \$2.8 million of capital expenditure that was not forecast at the time of the 2011-12 GSC investigation. The net difference is \$2.1 million. Table 4.7 has more detail on a project level.

Table 4.7: Seqwater's 2011-12 Proposed Non-Drought Capital Expenditure (\$'000)

| <i>Capital Expenditure Project</i> | <i>Approved Forecast</i> | <i>Estimated Actual</i> | <i>Difference</i> |
|---|--------------------------|-------------------------|-------------------|
| Landers Shute Stage 2 Trunk Main | - | 1,120 | 1,120 |
| ICT Merger Related ICT Costs | - | 970 | 970 |
| North Pine Dam Gates Upgrade | - | 873 | 873 |
| Mt Crosby Eastbank Renewals | 670 | 1,049 | 379 |
| Mt Crosby Westbank Renewals | 384 | 814 | 430 |
| Power Supply Review | 4,080 | 4,410 | 330 |
| Bundamba SCADA & Control Systems | 1,500 | 1,814 | 314 |
| Access to Critical infrastructure Review (Road and Alternative Access to Sites) | 923 | 509 | -414 |
| Treated Water Storage | 1,760 | 100 | -1,660 |
| Mt Crosby Eastbank WTP - Raw Water Infrastructure upgrade | 2,420 | 420 | -2,000 |
| Other (137) | 18,419 | 20,142 | 1,724 |
| Total | 30,155 | 32,222 | 2,066 |

Note: Totals may not add due to rounding.

Prudency and Efficiency Review

The Authority engaged SKM to review a sample of Seqwater's 2011-12 capital expenditure for prudency and efficiency. Due to the fact that the Authority reviewed 2011-12 forecast capital expenditure as part of the 2011-12 investigation, the Authority focussed its review on capital expenditure that differed from forecast. This included capital expenditure that was not previously forecast, and estimated actual capital expenditure that varied from forecast by more than 30%.

In total, SKM reviewed six 2011-12 capital expenditure projects for prudency and efficiency, comprising 12% of Seqwater's total submitted 2011-12 capital expenditure.

Item 1: North Pine Dam Gates Upgrade

Seqwater's Submission

Seqwater expended \$873,000 on the North Pine Dam Gates Upgrade project in 2011-12, which involved the installation of a new emergency backup system to operate the five radial gates at North Pine Dam. The new backup system will be the second backup operating system for the radial gates.

Seqwater submitted that the new emergency backup system is urgently required to guarantee the operation of the radial gates and the safety of the dam. Seqwater noted that the most recent major dam safety inspection found that the redundancy of the current backup system was such that it was not satisfactory to guarantee the safety of the dam in a flood event.

SKM's Review

SKM noted this project was not submitted as part of last year's review and an assessment of prudence had not been previously completed.

SKM reported that, during the January 2011 floods, floodwaters passed around the dam gates and flowed over areas that are used to operate the gates. Discrepancies were also identified between rainfall quantities and intensities and previous flood studies. Following the floods the Dam Safety Regulator required Seqwater to undertake a review of the flood. The review found that there were four key issues identified that required upgrading at North Pine Dam.

Upon review of these findings SKM noted the need to implement upgrades to the gate operating system to allow the gates to be operated under extreme flood conditions.

SKM also noted that Seqwater discussed the works with the Dam Safety Regulator who agreed this was a satisfactory and necessary method of providing an acceptable flood passing capacity for the dam as required as part of the licence conditions of the dam.

Seqwater identified three options for guaranteeing the operation of the radial gates and the safety of the dam in a major flood event, and chose the option "Design and Install new second backup system". SKM found this to be the only viable option, as the backup system was required to be in place prior to the next wet season.

Based on the above SKM found the project to be prudent. The driver of compliance was demonstrated and an acceptable decision making process had been used. While the normal procedures were not followed, waivers were sought and received from these procedures and this was considered to be appropriate considering the urgency of the project due to significant risk to life and property.

SKM reviewed the scope of works undertaken by Seqwater and found it to be appropriate for the project. SKM noted that the standards of works adopted for this project have not been specified in documentation received to date.

SKM noted that a sole sourced tender approach was adopted to ensure that the completion date could be met. Waivers were sought and received, and SKM considered this to be acceptable due to the risks involved with delaying the project. SKM also found that, as sole tenders were sought consecutively from separate tenderers, de facto testing of the prevailing market conditions had been conducted.

With regards to timing and deliverability, SKM found that based on the available information the project should have been completed and handed over. Whilst no update on the current progress of the project was provided, it was understood that the system is operating. SKM also found the project management costs and supervision costs to be at the upper end of the typical range.

SKM assessed the project as efficient as the scope was appropriate, and the costs were reasonable and were de facto market tested.

Authority's Analysis

The Authority accepted SKM's finding that the North Pine Dam Gates Upgrade is prudent and efficient.

No submissions were received in response to the Draft Report in relation to this item.

Item 2: Mt Crosby Eastbank Renewals

Draft Report

Seqwater's Submission

This project is concerned with the renewal of existing assets at Mount Crosby Eastbank WTP.

The Works comprise 11 components being:

- (a) Pump Station Crane renewals;
- (b) Camerons Hill flow meter delivered water pipeline outlet;
- (c) Asbestos removal;
- (d) Sludge pipeline;
- (e) Renewals project management;
- (f) Flow control valve;
- (g) Raw water pump 12;
- (h) Backwash pipe work;
- (i) Filter bank stage 2;
- (j) Pump priming system; and
- (k) Switchboards.

Seqwater estimated the cost of this project at \$1,049,000, to be completed in 2012-13. This represented a 57% increase on the total project amount of \$670,000 during the 2011-12 review.

SKM's Review

SKM's analysis focussed on the change in expenditure incurred during 2011-12.

Of the 11 components comprising this project, eight components were submitted during the 2011-12 investigation. As such these components did not require a prudency assessment.

SKM noted that the three other components related to "a change in scope of one project, one new project, and one project being brought forwards from 2012-13".

SKM's review of the scope of the works found them to be appropriate but noted that no information was provided on the following components:

- (a) Cameron's Hill Flow Meter;
- (b) Renewals Project Management; and
- (c) Pump Priming System.

In reviewing the project costs, SKM noted that budget estimates within the documents received for each subproject were not consistent with the information provided in response to its request for information. The variances are shown in Table 4.8 below.

Table 4.8: Project Cost Variances

| <i>Project</i> | <i>Budget (project specific documents)</i> | <i>Revised Budget</i> | <i>% Difference</i> |
|---|--|-----------------------|---------------------|
| Pump Station Crane Renewals | - | \$65,000 | - |
| Cameron's Hill Flow Meter Delivered Pipeline Outlet | - | \$50,000 | - |
| Asbestos Removal | \$171,500 | \$150,000 | -13% |
| Sludge Pipeline | \$62,500 | \$220,000 | 252% |
| Renewals Project Management | - | \$1,094 | - |
| Flow Control Valve | \$131,000 | \$151,000 | 15% |
| Raw Water Pump 12 | \$200,000 | \$94,380 | -53% |
| Backwash Pipe Work | \$60,000 | \$56,500 | -6% |
| Filter Bank Stage 2 | \$61,500 | \$61,500 | 0% |
| Pump Priming System | - | \$50,000 | - |
| Switchboards | \$102,000 | \$150,000 | 47% |
| Total | \$954,594¹ | \$1,049,474 | 10% |

*Note*¹ where no budget was obtained from project specific documents, the revised budget was used. Source: SKM (2012)

Seqwater provided SKM with a justification of these variances and SKM found this to be supported by the scope of works for the various components.

SKM concluded that notwithstanding that insufficient evidence was provided, particularly for the three sub-projects; sludge pipe work, the asbestos removal and the switchboard replacement, the brief scope of works for these three sub-projects was acceptable. SKM therefore assessed the project to be both prudent and efficient.

However, SKM also noted the need to develop a comprehensive audit document trail for this project. For this to occur SKM recommended the following items be provided:

- (a) a breakdown of costs by sub-project including project management, design and contingencies;
- (b) standards of works;
- (c) evidence of procedures used; and
- (d) project plan.

Authority's Analysis

In the Draft Report, the Authority noted SKM's finding as to the prudence and efficiency of this project. However, the Authority noted the substantial information inadequacies identified by SKM, and considered that this was not acceptable for a project largely completed in 2011-12, for which information should be readily to hand. The Authority therefore excluded three sub-projects totalling \$520,000 from recommended GSCs pending the provision of more information.

Seqwater's Submission on the Draft Report

Seqwater (2012b) provided further documentation relating to the three sub-projects in question. Seqwater submitted that the three projects have been completed during the year at a lower than forecast cost. The rationale for the capital expenditure and the breakdown of the cost were provided, along with reasons for variations from the original forecasts. In addition, Seqwater detailed the standard of works and procedures adopted in order to manage risks.

On this basis, Seqwater sought approval for additional expenditure of \$435,135 associated with these three sub-projects of the Mt Crosby Eastbank Renewals Projects, comprising:

- (a) \$219,925 associated with the Sludge Pipeline;
- (b) \$118,862 associated with Asbestos removal; and
- (c) \$96,348 associated with the switchboard replacement.

SKM's Review

SKM reviewed the additional information provided by Seqwater and found that the additional information provided that the total cost of the project was now forecast to be \$859,118 which is 18.5% lower than previously submitted (Table 4.9)

Table 4.9: Project Cost Variances

| <i>Project</i> | <i>Draft Report Budget</i> | <i>Revised Seqwater Budget</i> | <i>% Difference</i> |
|---|----------------------------|--------------------------------|---------------------|
| Pump Station Crane Renewals | 65,000 | 65,000 | - |
| Cameron's Hill Flow Meter Delivered Pipeline Outlet | 50,000 | 2,000 | -96% |
| Asbestos Removal | 150,000 | 118,862 | -21% |
| Sludge Pipeline | 220,000 | 219,925 | - |
| Renewals Project Management | 1,094 | 1,094 | - |
| Flow Control Valve | 151,000 | 104,135 | -31% |
| Raw Water Pump 12 | 94,380 | 194,700 | 106% |
| Backwash Pipe Work | 56,500 | 0 | -100% |
| Filter Bank Stage 2 | 61,500 | 52,054 | -15% |
| Pump Priming System | 50,000 | 5,000 | -0.9 |
| Switchboards | 150,000 | 96,348 | -36% |
| Total | 1,049,474 | 859,118 | -18% |

Source: SKM (2012)

SKM reviewed the information provided by Seqwater with regards to the three projects found to have insufficient documentation in the Draft Report. SKM found that:

- (a) the asbestos removal sub-project was efficient;
- (b) the sludge pipe replacement sub-project was efficient. However, the procurement of the sub-project which was a valued in excess of \$100,000 was found to be non-compliant with Seqwater's Procurement Handbook and Procurement Supply Procedures, as the third quote was verbal; and
- (c) the switchboard upgrade works sub-project was efficient.

SKM noted that the non-compliance with procurement policies of the sludge pipe replacement sub-project does not in itself mean that the project is not efficient. Notwithstanding this, SKM found that non-compliance with Procurement Policies is not acceptable and should not occur.

SKM confirmed that the revised total expenditure of \$859,118 was prudent and efficient.

Authority's Analysis

The Authority notes that the estimated actual cost and approved cost for this project was incorrectly listed in the Draft Report as a 2012-13 project. Seqwater also submitted a revised budget.

After considering SKM's analysis of Seqwater's additional information, the Authority has accepted SKM's finding that the revised expenditure of \$859,118 is prudent and efficient.

Item 3: Mt Crosby Westbank Renewals

Draft Report

Seqwater's Submission

The original scope of the Mt Crosby Westbank WTP renewals made allowance for \$383,500 of work to be undertaken that included new valves and pipework at the Mt Crosby Westbank WTP. Subsequent to the Authority's 2011-12 Final Report, Seqwater (2012a) identified additional components that required renewal or replacement. The components identified by Seqwater were two Clearwater pumps (12 and 13) which have been identified as requiring refurbishment as they have been in operation for 25 years with no major overhaul, and the refurbishment of Raw Water Pump 5.

In addition, Seqwater indicated that the raw water isolation valves will have to be replaced before work on Raw Water Pump 5 can commence and therefore the refurbishment of Raw Water Pump 5 is on hold and was now not expected to be completed within 2011-12.

Seqwater estimated the cost of this project at \$814,000 for 2011-12, \$430,000 (or 112%) higher than that submitted to the Authority in its 2011-12 review.

SKM's Review

As this project was submitted and reviewed as part of last year's review an assessment of prudence was not required.

Seqwater submitted to SKM that components 5, 6 and 7 in Table 4.10 below are a result of asset failures and were not included in the original budget submitted to the Authority as part of the 2011-12 Grid Service Charges Review.

SKM found that the cost of the original projects had decreased by \$55,667. However this was more than offset by the addition of components 5, 6 and 7 at a cost of \$485,800. Seqwater subsequently advised that component 7 was on hold and was not expected to be completed within the 2011-12 and that it was likely to be included in future years' programs.

Table 4.10: Mt Crosby Westbank Renewals Project

| <i>ID</i> | <i>Component</i> | <i>Original estimated cost (\$)</i> | <i>Estimated actual cost (\$)</i> | <i>Component status</i> |
|-----------|---|---|---------------------------------------|-------------------------|
| 1 | TWB Ren: Pure Water Pump Check Valves | 153,370 | 126,793 | |
| 2 | DAF Recycle Pumps Discharge Pipe Work Replacement | 59,630 | 51,240 | |
| 3 | Basin Inlet Valves | 26,000 | 30,000 | |
| 4 | Filter Rate Control Valves | 144,500 | 120,000 | |
| | <i>Subtotal A</i> | <i>383,500</i> | <i>328,033</i> | |
| 5 | Clearwater Pump 12 | New component | 85,800 | Under construction |
| 6 | Clearwater Pump 13 | New component | 100,000 | With procurement |
| 7 | Raw Water Pump 5 | New component | 300,000 | On hold |
| | <i>Subtotal B</i> | | <i>485,800</i> | |
| | Total (Subtotal A + Subtotal B) | 383,500 | 813,833 | |

Source: SKM (2012)

In its review of the scope of the proposed works SKM found that the refurbishment of the Clearwater Pumps (components 5 and 6) was initially to be funded from operating expenditures. SKM considered that these components were capital expenditure rather than operational expenditure.

SKM reviewed the costs submitted for the Clearwater Pumps (components 5 and 6) and found them to be efficient. SKM also noted that the project costs for Clearwater Pump 13 included a contingency of only 5% which it considered to be low and not sufficient to allow for any unplanned incidents. SKM concluded that expenditure on the Clearwater Pumps (components 5 and 6) was efficient.

With regards to the Raw Water Pump 5 (component 7), Seqwater did not provide SKM with sufficient information to determine the scope of works for this component. As the refurbishment of Raw Water Pump 5 was on hold, SKM recommended its removal from 2011-12 costs.

SKM found the total prudent and efficient expenditure in 2011-12 to be \$514,000.

Authority's Analysis

In the Draft Report, the Authority accepted SKM's findings on the prudence and efficiency of this project, and removed the cost of component 7 (\$300,000) from the prudent and efficient amount.

Further, the Authority noted SKM's finding that components 5 and 6 were to be initially funded from operating expenditure. As the Authority's 2011-12 recommended GSCs included an allowance for operating expenditure, which has not been reviewed in this report, the Authority considered there is a strong likelihood that Seqwater has recovered these components through operating expenditure. Seqwater should not recover the costs of these

components twice. As a consequence, the Authority also removed components 5 and 6 (\$185,800 in total).

In summary, the Authority recommended inclusion of 2011-12 expenditure totalling \$328,033 for this item.

Seqwater's Submission on the Draft Report

In its submission Seqwater (2012b) confirmed that the expenditure on components 5 and 6 were coded and incurred as capital expenditure not operating expenditure. Therefore, Seqwater seeks the Authority's approval for the additional expenditure of \$185,800 associated with these items. With regards to component 7 Seqwater has confirmed that this sub-project has been placed on hold and is not expected to be completed before 30 June 2012.

Authority's Analysis

The Authority has accepted Seqwater's submission that expenditure on components 5 and 6 of this project were not coded as operational expenditure. For the Draft Report, SKM reviewed the expenditure on these items and found it to be prudent and efficient. The Authority accepts SKM's recommendation.

With regards to component 7 the Authority continues to exclude all expenditure (\$300,000) related to this item.

In summary, the Authority recommends inclusion of 2011-12 expenditure totalling \$514,000 for this item.

Item 4: Asset Management System: P&C - Intranet Stage 2 & 3

Seqwater's Submission

This project is comprised of the two phases of the delivery of a new intranet system for Seqwater.

Seqwater (2012a) estimated the cost of this project at \$400,000 for 2011-12, \$280,000 (or 233%) higher than the cost submitted to the Authority in its 2011-12 review.

SKM's Review

As this project was submitted and reviewed as part of last year's review an assessment of prudence was not required.

SKM found that Seqwater had prepared a detailed scope of works for the project within the *Intranet Master List of Requirements No 12*. This document detailed the 62 components that made up the project and tracked their progress. SKM found the scope of the works to be appropriate.

SKM reviewed the cost of the projects and the factors identified by Seqwater as having led to the increase in costs including:

- (a) the project commenced late causing implementation costs to spill over into the 2011-12 financial year (budgeting was completed assuming full implementation of stage one of the project on the 2010-11 financial year (\$150,000 or greater than 50% of the variance);
- (b) the project budget figure was set before the actual costs of the delivery of the business requirements was known; and

- (c) the project budget figure did not allow for some known, or any evolving, business requirements.

SKM found that based on the information provided, the project was efficient and that the basis of the increase was that the original 2011-12 budget was estimated in 2009-10.

Authority's Analysis

The Authority has accepted SKM's finding that the project is prudent and efficient.

No submissions were received in response to the Draft Report in relation to this item.

Item 5: Caboolture WTP Renewals

Seqwater's Submission

This project at the Caboolture WTP consists of two components - the replacement of the main switchboard and the installation of a motorised trolley for the chlorine gas hoist.

Seqwater (2012a) estimated the cost of this project at \$378,000 for 2011-12, \$235,000 (or 164%) higher than the cost submitted to the Authority in its 2011-12 review.

The original budget for the project made allowance for costs of \$143,000. Seqwater indicated that the original budget was underestimated and did not allow for all the cost components.

SKM's Review

As this project was submitted and reviewed as part of last year's review an assessment of prudence was not required.

SKM found the scope and standard of the works to be appropriate noting that the current switchboard posed an increased risk of failure and was a safety hazard to operations and maintenance staff.

Seqwater advised SKM that the cost estimates provided to the 2011-12 review were developed at a very early stage in scoping the necessary work, which underestimated the likely costs. The current estimate took account of a more thorough scoping, project management cost, necessary inspections and internal costs during commissioning, as well as contingency, all of which were not adequately represented in the initial forecast. The revised costs are detailed in Table 4.11 below.

Table 4.11: Revised Project Costs (\$)

| <i>Description</i> | <i>Cost</i> |
|-----------------------------|----------------|
| Design scope | 7,500 |
| Detail design contract | 70,000 |
| Supply and install contract | 215,000 |
| Internal costs | 25,000 |
| <i>Subtotal</i> | <i>317,500</i> |
| Project management | 25,000 |
| Contingency (8%) | 27,500 |
| Total | 370,000 |

Source: SKM (2012)

SKM found the costs to be reasonable and the revised main switchboard replacement cost submitted to the Authority to be more in line with market conditions and realistic overall project costs. SKM also noted that the 8% contingency was below the industry standard contingency of 10% to 15%.

SKM concluded that the project is prudent and efficient.

[Authority's Analysis](#)

The Authority accepts SKM's finding that the Caboolture WTP Renewals project is prudent and efficient.

No submissions were received in response to the Draft Report in relation to this item.

[Item 6: Esk WTP Renewals](#)

[Draft Report](#)

[Seqwater's Submission](#)

This project involves a series of works to be carried out at the Esk WTP including;

- (a) raw water pump renewal;
- (b) replace main switch board;
- (c) replace roof Clearwater tank;
- (d) replace screen hoist; and
- (e) construct chemical unloading bund.

The first three components were not included in the previous review of the 2011-12 budget.

A component relating to an office for the operations manager has been removed from the scope of the project since the previous review of the 2011-12 budget.

Seqwater (2012a) estimated the cost of this project at \$289,000 for 2011-12, \$204,000 (or 340%) higher than the cost submitted to the Authority in its 2011-12 review.

[SKM's Review](#)

In its review of the project costs SKM found that for the components that were previously reviewed Seqwater did not provide an explanation of why one component had been excluded from the project's current scope.

With respect to the two remaining components, SKM noted that Seqwater did not provide an explanation of why there was a variance between the approved and actual cost.

SKM noted that the cost of replacing the screen hoist was about 8% less than the approved cost and hence was assessed as efficient. The cost of constructing the chemical unloading bund had increased by about 20%. No explanation was provided although it should be noted that the increase was a minor value (i.e. \$5,000).

With respect to the three additional components, Seqwater did not provide SKM an explanation as to why the components have been included in the budget nor as to how the cost was calculated. Without additional details, SKM found that the project cost cannot be assessed as efficient.

SKM concluded that the lack of an explanation as to why the project cost had changed prevented the project being assessed as efficient.

SKM found \$49,000 to be prudent and efficient in 2011-12.

For the other expenditure to be found to be efficient SKM noted that the following information was required:

- (a) the project's programme;
- (b) a cost breakdown for each component i.e. provide relevant quotes/ tenders;
- (c) an explanation as to why one previously approved component (the office for operation manager renewals) had been excluded; and
- (d) an explanation as to why three additional components were included.

[Authority's Analysis](#)

In the Draft Report, the Authority accepted SKM's finding that \$49,000 of expenditure in 2011-12 was prudent and efficient, and all other expenditure was excluded.

[Seqwater's Submission on the Draft Report](#)

Seqwater (2012b) provided to the Authority a summary of the six items which comprise the Esk WTP Renewals and the reasons for the variation from original 2011-12 approved forecasts. The variances include the following:

- (a) three items (raw water pump station, clearwater tank roof replacement and main switchboard replacement) were previously approved in 2010-11, but not completed during that year. These projects were subsequently carried forward to 2011-12, with two items experiencing relatively large cost increases compared with their initial estimates (reflecting a more representative scope of work);
- (b) a minor increase in the cost of the site road;

- (c) a minor decrease in the cost of the raw water intake screen; and
- (d) the inclusion of costs associated with an office for the operations manager. These costs were included in the original 2011-12 approved value, but mistakenly omitted from Seqwater's 2011-12 forecast provided as part of the 2012-13 submission. More detailed scoping of the project resulted in an increase in costs from the original estimate. Seqwater confirms that the project is a capital project and thus should remain in the capital budget.

Seqwater also submitted that three of the original sub-projects are not expected to be delivered during 2011-12 and are likely to be deferred to 2012-13. Seqwater adjusted its 2011-12 cost estimates accordingly.

Seqwater has sought approval for additional capital expenditure of \$247,330 (over the \$84,500 previously approved) consisting of:

- (a) \$182,000 associated with the clearwater Tank;
- (b) \$38,142 associated with the raw water pump; and
- (c) \$111,688 associated with the office for the operations manager.

SKM's Review

SKM reviewed the additional information provided by Seqwater and noted that the sub-project expenditures put forward its 2012-13 submission differ substantially from those provided as part of the 2011-12 review (see Table 4.12 below.)

Table 4.12: Esk WTP Renewals Sub-projects Budgets (\$)

| <i>Sub-project</i> | <i>2011-12 Approved Value</i> | <i>2011-12 Expenditure</i> |
|---|-------------------------------|----------------------------|
| 1. Raw Water Pump Station | - | 38,142 |
| 2. Main Switch Board | - | - |
| 3. Clearwater Tank | - | 182,000 |
| 4. Raw Water intake Screen | 19,500 | - |
| 5. Site Road (chemical unloading bund) | 26,000 | - |
| 6. Office for operations manager renewals | 39,000 | 111,688 |
| Total | 84,500 | 331,830 |

Source: SKM (2012)

SKM considered that the scope of the raw water pump and clearwater tank sub-project were appropriate while the scope of the office for the Operations Manager was inadequate as it is not specific enough.

With respect to the raw water pump replacement sub-project SKM noted that Seqwater provided a quote from Cardo Australia. The quote from Cardo Australia was the "successful quote" implying that others were sought. However, without evidence of this or evidence that Cardo Australia has been appointed to the Tiered Panel or Standard Panel or is on a contract

arrangement found that it cannot be ascertained that Seqwater's procurement procedures have been applied. As such the tender cannot be assessed as fair market value.

Furthermore, SKM found that the cost increase relating to the raw water pump replacement and Clearwater Tank roof replacement sub-projects raises concerns regarding Seqwater's cost estimating. SKM found that the details provided do not justify scope changes of a magnitude relative to the cost increase.

In its assessment of the efficiency of the Clearwater Tank roof replacement SKM could not substantiate the efficiency of this project. It noted that additional information was required including details of the procurement of the works, including tender review, tender cost breakdown and final cost breakdown indicating Seqwater's costs, contingencies and any other relevant items should be provided.

SKM found that insufficient details have been provided that allows an assessment of whether or not the office for Operations Manager sub-project has followed Seqwater's procurement procedures. Therefore SKM conclude that the related expenditure cannot be substantiated as efficient.

Authority's Analysis

The Authority has accepted SKM's finding that all capital expenditure for 2011-12 related to this project be excluded.

Summary of Prudency and Efficiency Review

As noted in Chapter 3, the Authority has considered whether the findings of its consultants, SKM, give a clear indication of a systematic or widespread problem with Seqwater's capital expenditure planning and delivery processes that would justify extrapolation of the findings of SKM's sample to the broader un-sampled capital expenditure program.

SKM sampled six 2011-12 capital expenditure projects. Reductions in proposed costs of \$0.779 million or 20% have been accepted by the Authority.

Of the reviewed projects, three were found to be prudent and efficient, one was re-scoped by Seqwater, one component of one project was delayed (at SKM's suggestion) and there was insufficient information to accept another project as prudent and efficient.

The Authority does not consider that these adjustments are of a nature that should be extrapolated across other proposed capital expenditures. Moreover, the Authority notes the small sample size of 12% of capital expenditure.

Table 4.13: Reviewed 2011-12 Non-Drought Capital Expenditure (\$'000)

| <i>No</i> | <i>Project Title</i> | <i>Forecast Cost</i> | <i>Estimated Actual Cost</i> | <i>Final Prudence</i> | <i>Final Efficiency</i> | <i>Draft Recommendation</i> | <i>Final Recommendation</i> |
|---------------------------------|---------------------------------|----------------------|------------------------------|--------------------------------|--|-----------------------------|-----------------------------|
| 1 | North Pine Dam Gates Upgrade | - | 873 | Prudent | Efficient | 873 | 873 |
| 2 | Mt Crosby Eastbank Renewals | 670 | 1,049* | Prudent | Seqwater's revised estimate considered efficient | 914* | 859 |
| 3 | Mt Crosby Westbank Renewals | 384 | 814 | Prudent, one component removed | Efficient, one component removed | 328 | 514 |
| 4 | AMS: P&C - Intranet Stage 2 & 3 | 120 | 400 | Prudent | Efficient | 400 | 400 |
| 5 | Caboolture WTP Renewals | 143 | 378 | Prudent | Efficient | 378 | 378 |
| 6 | Esk WTP Renewals | 85 | 289 | Insufficient information | Insufficient information | 49* | 0 |
| Total Sample | | 1,402 | 3,803 | | | 2,942 | 3,024 |
| Total Non-Drought Capex | | | 32,222 | | | 31,361 | 31,443 |
| Total Sample/Total Capex | | | 12% | | | | |

*Note: *The estimated actual cost for the recommended component of this project was incorrectly stated in the Draft Report*

4.2.3 2012-13 Forecast Capital Expenditure

Seqwater (2012a) initially submitted capital expenditure, to be commissioned in 2012-13, of \$82.4 million.

Table 4.14: Seqwater's 2012-13 Capital Expenditure

| <i>Capital Expenditure</i> | <i>Cost</i> <i>(\$'000)</i> | <i>Asset Life</i> <i>(years)</i> |
|----------------------------|--------------------------------|-------------------------------------|
| Drought | 19,800 | 77 |
| Non-Drought | 62,607 | 26 |
| Total | 82,407 | 39 |

Note: Totals may not add due to rounding. Asset lives are weighted averages.

2012-13 Drought Capital Expenditure

The majority of capital expenditure projects required under the *Water Regulation 2002* or the RWSP (DERM 2010) have now been completed, so the Authority expects the proportion of drought capital expenditure to fall in 2012-13 and subsequent years.

Seqwater's 2012-13 forecast drought capital expenditure is summarised below in Table 4.15.

Table 4.15: Seqwater's Proposed 2012-13 Drought Capital Expenditure

| <i>Capital Expenditure Project</i> | <i>Asset</i> | <i>Cost</i> <i>(\$'000)</i> | <i>Asset Life</i> <i>(years)</i> |
|------------------------------------|-----------------------------------|--------------------------------|-------------------------------------|
| Land Costs and Legal Costs | Wyaralong WTP | 800 | - |
| Easement Compensation Payments | Western Corridor Pipeline Network | 19,000 | 80 |
| Total | | 19,800 | |

Note: Totals may not add due to rounding.

As required by the Direction Notice, the Authority accepts Seqwater's 2012-13 drought capital expenditure values.

However, the Authority has not included costs relating to the Wyaralong WTP in the RAB. The Authority recommends that costs relating to the Wyaralong WTP should be included in the RAB at the commissioning date of the WTP. This is consistent with the Authority's recommendations regarding land acquisition costs and design work at Wyaralong WTP in

2011-12, and mirrors the approach adopted for other drought assets. It also reflects the fact that the 1 July 2011 RAB provided by the Price Regulator does not include any value relating to the Wyaralong WTP, despite Seqwater incurring expenditure during 2010-11.

Any interest incurred on expenditure to date should be capitalised at the cost of debt that applied to Wyaralong WTP.

2012-13 Non-Drought Capital Expenditure

Capital Expenditure Forecasting

Draft Report

Some of Seqwater's forecast capital expenditure projects were submitted to the Authority prior to the finalisation of a corresponding planning study. The WGM brought this to the Authority's attention, particularly in relation to the Scenic Rim Regional Planning Study, which involved several participants and was shortly due for completion.

Seqwater submitted that its approach to forecasting capital expenditure is to only include projects that, on the balance of probabilities, it considers are likely to proceed. As such, it considered it was appropriate to include capital expenditure that met this test even if the planning study had not been completed. On the other hand, the WGM considered that proposed expenditure should not include such projects as it effectively sought the Authority's endorsement of a project before the final option (potentially a do-nothing option) had been determined.

Ultimately, only capital expenditure which is prudent (necessary) and efficient (cost effective) will be included in the asset base (see Chapter 3). This cannot be determined with certainty until after the expenditure has been incurred (and any relevant planning studies have been completed). However, as the GSC being assessed is for the year ahead (2012-13 in this case), the Authority cannot wait until expenditure has been incurred before it calculates the GSC if the GSC is to provide the best estimate of the costs of providing services in the relevant year. This militates towards the Seqwater approach and the inclusion of expenditure prior to the completion of a corresponding planning study if it was reasonably likely (i.e. on the balance of probabilities) that the expenditure was prudent and efficient.

At the same time, consideration of proposed capital expenditure before the completion of a corresponding study makes it more difficult to assess the prudence and efficiency of such expenditure. Failure to include proposed capital expenditure in the calculation of GSCs in a particular year does not prevent its inclusion in a subsequent year, even if it is incurred in an earlier year. However, it is more difficult to address the issue of expenditure previously deemed to be prudent and efficient (without the assistance of a corresponding planning study) which is subsequently found not to be so as it could well be argued that the expenditure was incurred in reliance of the assessment of it as being prudent and efficient. This militates against the Seqwater approach and towards the WGM approach.

On balance, the WGM's approach was considered less risky and, therefore, unless there is other compelling information, the absence of a relevant planning study and options analysis will normally exclude the proposal from inclusion in GSCs in the relevant year, with consideration delayed until such information is available. In assessing whether there are any such compelling reasons otherwise, the Authority would have regard for the views of all stakeholders and the expert technical consultants employed by the Authority to assist it with the assessment of project prudence and efficiency.

While Seqwater's capital expenditure forecasts, which were presented to the Authority in February 2012, should be well-informed regarding expenditure for the 2012-13 period, the Authority noted that relevant planning studies and options analyses are not always available for the Authority's review. As indicated above, this makes the Authority's assessment task more difficult and problematic.

Moreover, it was not appropriate for the Authority to recommend that two competing proposals to address the same service requirement should be included in GSCs. In this regard, the Authority noted that, in the instance of Image Flat, Seqwater and LinkWater have

each submitted capital expenditure projects that are effectively mutually exclusive. In addition, it is also possible that on occasions DR entities could submit solutions to service requirements that compete with GSPs' proposals.

To address this issue, the Authority recommended that an attempt should be made between the relevant parties to resolve such competing proposals. Where agreement cannot be reached, the Authority would need to rely on its own analysis.

Submissions in Response to the Draft Report

The WGM (2012b) submitted that it endorsed the position of the Authority that, unless there was other compelling information, the absence of a relevant planning study and options analysis would normally exclude the project from inclusion in GSCs in the relevant year.

Seqwater (2012b) submitted that in providing its proposed capex programme, its regulatory budget should closely align to its financial budget. Seqwater therefore considered it appropriate to include capex that met the test of budget alignment, even where it remained conditional on regional planning studies or government decisions.

Seqwater indicated that it faced a difficult choice in these matters – either it must continue to budget for conditional projects that it considered likely to eventuate, and risk the potential reputational harm that comes from the QCA withholding a finding of prudence, or it must remove such items from its regulatory budget, creating discrepancies between its regulatory and financial accounts.

Seqwater suggested that the Authority could qualify its conclusions by noting that:

- (a) there will be projects in Seqwater's capex programme where approval will be automatically withheld by the Authority, given the early stages of those projects;
- (b) in these circumstances, this is not the same as a rejection or negative finding as to the suitability or necessity of the project: and
- (c) for all projects, particularly multi-period projects, the review is not final and there will be further reviews relating to the project, including an ex post review once the project is completed.

Seqwater suggested that the issue for budgeting for capital projects in the early stages of development, including conditional projects, should be further considered by all stakeholders prior to the next review process.

Authority's Analysis

In seeking to assess whether a particular capital expenditure proposal should be admitted into the asset base for the purpose of establishing future charges, a judgement is required as to:

- (a) whether sufficient certainty exists about whether a particular proposed capital expenditure item is prudent (needed) and efficient (least cost). A proposed capital expenditure in its early stages, for which planning studies have not been completed, is not necessarily automatically rejected – this will depend on the availability of other relevant information. As noted above, in assessing whether there is any such compelling justification for an item, the Authority will have regard for the views of all stakeholders and the expert technical consultants employed by the Authority to assist it with the assessment of project prudence and efficiency;
- (b) whether sufficient certainty exists that the project will be commissioned within the relevant regulatory period. Previously a requirement of the Manual attached to the

2011-12 Direction Notice, this represents a generally accepted regulatory requirement reflecting the need for the expenditure to provide benefits in the period in which charges apply;

- (c) whether its exclusion imposes unnecessary planning (regulatory risk) risks to the service provider. It is accepted that an ex post review may lead to a different conclusion than implied by an entity's budget. In the current review, the Authority has reviewed a sample of 2011-12 capex items, including some that were not forecast at the time of the review of 2011-12 GSCs, and others where costs varied from forecast.

The approach taken by the Authority may mean that the financial budget may not align with the regulatory outcomes. The Authority considers that Seqwater should bear the risk that a capex project is found in an ex post review to be either not prudent or not efficient as this provides an incentive to ensure that only demonstrably prudent and efficient capital expenditure is incurred; and

- (d) the nature of the regulatory framework (for example, whether suitable review thresholds are in place to address risks not capable of being managed). The Authority's proposed Review Thresholds provide for a within (the 12 month) period review of the GSPs' over (or under) spend of capital expenditure. As the GSCs are only set for one year, and given the Review Thresholds proposed, the risks associated with exclusion of a project which should go ahead but for which the case only becomes more certain during the regulatory period are quite limited.

Exclusion of a project by the Authority therefore:

- (a) is not the same as a rejection or negative finding as to the suitability or necessity of the project but rather can reflect a different judgement about the need to include it after considering the matters identified in (a) to (d). Such a difference in judgement can be expected where different GSPs provide different proposals to address the same identified need; circumstances have changed between the time of budget preparation and regulatory review; or, the nature of the information used to form the judgements has changed; and
- (b) for all projects, particularly multi-period projects, the review is not final and there will be further reviews relating to the project, including an ex post review once the project is completed. Given the time constraints for the review, the Authority has not sought to derive conclusions on these multi-period projects but rather provided further information relevant to the assessment that could be required in future regulatory periods.

Review Timing and Future Reviews

Submissions in Response to the Draft Report

Seqwater submitted that the findings of insufficient information in the Authority's Draft Report for a number of items were at least partially a function of the short timeframes for the review. Seqwater indicated that it co-operated fully in the investigation process providing over 300 documents in response to information requests. Seqwater submitted that even a small amount of additional time would have allowed investigators (SKM) more time to identify the information needed and more time for Seqwater to compile it.

Authority's Analysis

The Authority agrees that the timeframe for the current review may have constrained the ability to collate all necessary information in the form necessary for its consultants to form

relevant judgements. Where such a finding may still be derived, a further opportunity remains for outstanding matters to be considered in any ex post review.

Prudency and Efficiency Review – Sampled Items

The Authority has conducted a review of prudency and efficiency of Seqwater’s proposed 2012-13 capital expenditure. As noted in its 2011-12 Final Report, the Authority has not re-assessed the prudency of projects that were previously reviewed and found prudent by the Authority.

The Authority engaged SKM to review a sample of Seqwater’s 2012-13 capital expenditure for prudency and efficiency.

In total, SKM reviewed sixteen 2012-13 capital expenditure projects for prudency and efficiency (Items 1-16 below), comprising 41% of Seqwater’s total submitted 2012-13 capital expenditure.

Item 1: Mt Crosby WTP Water Quality Improvement

Seqwater’s Submission

The Mt Crosby WTP Water Quality Improvement project involves the upgrading of a number of chemical systems to enable the plants to better manage dirty water events including turbidity and manganese events.

Seqwater’s (2012a) submitted cost and timing of this project have changed substantially relative to the 2011-12 investigation. Table 4.16 refers.

Table 4.16: Mt Crosby WTP Water Quality Improvement (\$)

| <i>Submission</i> | <i>2010-11</i> | <i>2011-12</i> | <i>2012-13</i> | <i>Total</i> |
|--------------------|----------------|----------------|----------------|------------------|
| 2011-12 Submission | 1,086,278 | 1,000,000 | 0 | 2,086,278 |
| 2012-13 Submission | Not Provided | 3,769,000 | 24,000 | 3,793,000 |

SKM’s Review

SKM noted that, as the prudency of the project was established during the 2011-12 investigation, a re-assessment of prudency was not required.

SKM noted that alternative options were examined, including a do nothing approach. Based on the provided information SKM concluded that the scope presented by Seqwater was the best means of achieving the desired outcomes. SKM found that Seqwater followed its procurement policies and procedures.

The forecast costs for this project provided by Seqwater to SKM are detailed in Table 4.17.

Table 4.17: Mt Crosby WTP Water Quality Improvement

| | <i>Cost (\$)</i> | <i>Calculation</i> |
|---|------------------|---------------------|
| Contract sum | 3,300,000 | |
| Contract contingency | 495,000 | 15% of contract sum |
| <i>Contract Total</i> | <i>3,795,000</i> | |
| Project Contingency | 210,000 | 6% of contract sum |
| Project management | 495,000 | 15% of contract sum |
| <i>Original Total</i> | <i>4,500,000</i> | |
| Pre-coagulation caustic dosing system replacement | 416,076 | |
| Total | 4,916,076 | |

Source: SKM (2012)

SKM found that the contract contingency (\$495,000) and project contingency (\$210,000) were considered to be for the same purpose. This in effect is a 21% contingency, which is beyond industry standards. However, it noted that as the actual expenditure is entered into the RAB, the overly generous allocation of contingency should not carry through.

Seqwater submitted that there was an opportunity to achieve a significant cost saving, approximately 50%, by adding the Mt Crosby Eastbank Caustic Dosing System Replacement (at a cost of \$416,076) to package the works already awarded to a contractor for the Mt Crosby Chemical Dosing System Upgrade. SKM found that a benefit realisation plan should be implemented to measure the achievement of the efficiencies.

SKM concluded that the project was efficient as the scope was appropriate, the standards of works were consistent with industry practice and the costs were consistent with prevailing market conditions.

Authority's Analysis

The Authority notes SKM's finding that this project is efficient. The Authority notes a disparity between the amount reviewed by SKM and that provided to the Authority. On the basis that Seqwater's submitted amount is lower than that deemed efficient by SKM, even when accounting for a duplication of contingencies, the Authority has accepted Seqwater's submission and included a total of \$3,793,000 in its recommended GSCs.

No submissions were received in response to this item.

Item 2: Various WTP Chemical Dosing Improvements

Draft Report

Seqwater's Submission

This project involves various improvements to the chemical dosing plants to enable Seqwater to meet the regulatory requirement of fluoridating public water supplies servicing a population of over 1,000 people.

Seqwater (2012a) estimated the cost of this project at \$1,462,000 to be completed in 2012-13. Seqwater had previously expected this project to be completed in 2011-12, and had submitted an amount of \$750,000 during the 2011-12 review.

[SKM's Review](#)

As this project was submitted and reviewed as part of last year's review an assessment of prudence was not required.

SKM reviewed the Project Management Plan and found the work method to be an appropriate method to ensure a more reliable fluoridation rate, noting that Seqwater identified a total of 112 fluoride improvement items as of 28 November 2011.

SKM found that the standards of works adopted for this project was that all work must meet the following legislative requirements:

- (a) the *Water Fluoridation Act 2008* (Qld); and
- (b) the *Queensland Water Fluoridation Regulation 2008* (Qld).

SKM noted that the Project Management Plan stated that due to this being a program of works a range of procurement delivery alternatives would be implemented. SKM found that the overarching procurement implementation method in the Project Management Plan conformed to industry practice and ensured that all work undertaken was market tested. However, sufficient information was not provided to determine whether Seqwater followed its procurement procedures in tendering and awarding the works for the various projects.

Seqwater did not provide documentation showing the procurement method implemented for the various projects and consequently it was not possible for SKM to determine whether Seqwater followed the overarching procurement method.

SKM concluded that it did not receive sufficient information to assess whether the cost increase for the various WTP chemical dosing improvement projects undertaken were efficient. The value of expenditure considered efficient by SKM was the \$750,000 amount submitted in 2011-12.

[Authority's Analysis](#)

In the Draft Report, the Authority accepted SKM's finding that there was insufficient information to assess the expenditure as efficient. As such the Authority did not include expenditure on this project in the RAB above the \$750,000 included in 2011-12.

The Authority noted that the provision of additional documentation may demonstrate the efficiency of this expenditure. This documentation includes:

- (a) a list of projects showing the cost breakdown of the original budget of \$750,000 and the actual estimated expenditure;
- (b) documentation demonstrating the various procurement methods implemented for the various projects;
- (c) documentation demonstrating the method of identifying the various projects;
- (d) documentation in regard to the status of the various improvement projects; and
- (e) documentation showing how corporate costs have been allocated to the various improvement projects.

[Seqwater's Submission on the Draft Report](#)

Seqwater (2012b) submitted that its original forecast for 2011-12 costs was determined before the scope of the works had been formulated and as such were preliminary, later proved to be inadequate. Twenty-five projects were prioritised by Seqwater to be delivered in 2011-12. The cost estimate for these works was \$1,131,766, which accounted for approximately 3.8% of total expenditure associated with the Fluoridation Stage 1 and 2 projects.

Seqwater provided the Authority with a breakdown of the revised forecast figure of \$1,132,000, along with documentation as to how projects were prioritised.

Seqwater submitted that all except two of the 25 projects are expected to be completed by 30 June 2012. The Hopper Humidity Control and the Stage 2 Parcel 2 High Level Safe Access will both be undertaken in 2012-13, with some of the cost savings from other projects distributed across both.

[SKM's Review](#)

SKM reviewed the additional information provided by Seqwater and noted that the additional information allowed a greater understanding of the program to be gained. The additional information indicated that the two projects are not programmed to be completed in the 2011-12 financial year (Hopper Humidity Control and Parcel 2 Safe High Level Access). SKM recommended that the expenditure on these projects should not be added into the RAB until the projects are complete. Furthermore, SKM found that of the sample of projects selected for further review, including the two above, sufficient information to finalise the efficiency assessment was still not available.

Consequently SKM found that there is no acceptable substantiating reason to increase the budget from the previous 2011-12 budget of \$750,000. SKM recommended that after conclusion of the 23 projects, an ex-post review be completed.

SKM noted that as none of the four sub-projects have been assessed as efficient, no budget can be approved until sufficient documentation is provided and reviewed.

[Authority's Analysis](#)

The Authority has accepted SKM's finding that the expenditure for this project is not prudent or efficient.

[Item 3: Mt Crosby Eastbank WTP High Voltage Renewals](#)

[Draft Report](#)

[Seqwater's Submission](#)

The Mt Crosby high voltage upgrade project consists of replacing areas of the high voltage electrical installation to improve reliability, serviceability and safety for electrical operations.

Seqwater submitted that the estimated actual 2011-12 expenditure was \$1,374,000, an increase of 99% over the costs submitted to the Authority in 2011-12. Seqwater's 2012-13 submission included an additional expenditure of \$60,000 in 2012-13 for a total project cost of \$1,434,000.

[SKM's Review](#)

As this project was submitted and reviewed as part of last year's review an assessment of prudence was not required. However, SKM noted that the information provided supported renewal as the cost driver for the project and that a criticality and condition assessment was conducted in order to determine the works required.

Seqwater noted in its sourcing strategy documentation May 2011 that the project budget will be updated after tenders are received and evaluated. SKM noted that the Mt Crosby High Voltage Upgrade Project Sourcing Strategy states that Seqwater will seek tender offers from the market through a 'design and construct' contract. However, the tender review report was not provided to SKM.

SKM considered that the increase in costs above those approved by the Authority was most likely justified as a result of an underestimate of the original cost estimate relative to high tender prices within the market. However, another possible explanation for the large variance in budget costs could be due to a change in scope.

SKM concluded that sufficient information was not available to determine whether a change in scope contributed to the increase in expenditure. Nonetheless, SKM found that the project was able to be delivered within the 2011-12 financial year and that the overheads applied to this project were reasonable.

SKM found that an assessment of the efficiency of the project could not be completed until additional information regarding the post contract scope is provided. As such, SKM recommended that there be no increase to the value approved by the Authority in its 2011-12 review (SKM 2011).

Authority's Analysis

In the Draft Report, the Authority accepted SKM's finding that there was insufficient information to assess the expenditure as efficient. As such the Authority did not include expenditure on this project in the RAB above the \$690,000 approved in 2011-12.

The Authority noted that the provision of additional documentation may demonstrate the efficiency of this expenditure. This documentation includes:

- (a) the pre-contract scope of works;
- (b) the tender reviews; and
- (c) the post contract scope of work.

Seqwater's Submission on the Draft Report

Seqwater submitted that its original forecast for the project was developed prior to the release of tenders. Seqwater received tender bids from four companies, all each of which were above the original forecast costs.

Seqwater therefore submitted that the difference between the original Authority approved value and the Seqwater cost estimates is substantially explained by the initial underestimation of project costs. In addition, the original contingency was subsequently increased to reflect the increase in total project costs. Seqwater provided a detailed explanation of the project scope and tender applications and, on the basis of the additional information, sought approval for the additional expenditure of \$684,000 associated with Mt Crosby Eastbank High Voltage renewals project.

SKM's Review

SKM reviewed the additional information provided by Seqwater including the tender Evaluation Report and Recommendation. SKM compared the 2010 Project Management Plan and the Mt Crosby HV Upgrade Project Sourcing Strategy, (Seqwater, May 2011) and found that the scope of the project had not changed and that the increase in costs is most likely a result of an underestimate of the original cost estimate relative to high tender prices within the market.

The project was assessed by SKM as efficient as the scope is appropriate, the standards of works appear to be consistent with industry practice and the costs are consistent with prevailing market conditions.

Authority's Analysis

The Authority has accepted SKM's finding that the revised expenditure is prudent and efficient.

Item 4: North Pine WTP Fluoride Dosing Point Relocation

Seqwater's Submission

The North Pine WTP Fluoride Dosing Point Relocation project involves the relocation of the fluoride dosing point between the filters and the treated water storages, and to retain the existing lime dosing system (also downstream of the filters).

Seqwater (2012a) estimated the cost of this project at \$1,048,000 for 2011-12, \$613,000 (or 141%) above the costs submitted to the Authority in 2011-12.

SKM's Review

As this project was submitted and reviewed as part of last year's review an assessment of prudence is not required.

SKM found that the project design will comply with the Fluoride Code of Practice, relevant Australian Standards and WSAA Standards.

With regards to project costs, SKM noted that Seqwater did advise the reason for the \$613,000 variance to date and that Seqwater has forecast capital costs of \$55,000 for the 2012-13 financial year.

SKM found that the construction cost estimate from the Design Report was \$831,922. SKM noted that the estimate was produced with an accuracy of $\pm 25\%$ and was inclusive of a 20% contingency.

Considering the costing accuracy, SKM found the project could cost up to \$1,039,000 (1.25 x \$831,922) and that the cost was comparable to the expenditure of \$1,048,000 detailed in the Seqwater 2012-13 Information Return.

SKM also found that Seqwater followed its procurement procedures in tendering the works for this project but no information was provided for the project; consequently an assessment of deliverability was not possible.

SKM concluded that the price submitted for the expenditure in 2011-12 was assessed to be efficient as it was comparable to the estimate on the Design Report. The scope was considered to be appropriate and the standard of works was consistent with industry practice.

Authority's Analysis

The Authority accepts SKM's finding that the WTP Fluoride Dosing Point Relocation is prudent and efficient.

Item 5: North Pine WTP Filter upgrade

Draft Report

Seqwater's Submission

The North Pine WTP filtration system is to be upgraded to address the decreasing reliability of the existing assets at the North Pine WTP. Seqwater (2012a) estimated the cost of this project at \$4,551,000 to be completed in 2012-13, 98% higher than the \$2,297,157 value submitted to the Authority during the 2011-12 review.

SKM's Review

SKM's assessment focussed on the expenditure incurred during the 2011-12 year, of \$2,551,000.

As this project was submitted and reviewed as part of last year's review an assessment of prudence was not required.

SKM found that insufficient information was provided to allow an assessment of efficiency, and that no information was provided to explain the cost increase above those reviewed in 2011-12. Additionally no details were received confirming the delivery method, the tender process, the current status of the project's program or the standards of work.

Authority's Analysis

In the Draft Report, the Authority accepted SKM's finding that there was insufficient information to assess the expenditure as efficient. As such the Authority did not include expenditure in 2012-13 on this project in the RAB beyond the \$2,297,157 value submitted in 2011-12.

The Authority noted that the provision of additional documentation may demonstrate the efficiency of this expenditure. This documentation includes:

- (a) an explanation of the cost increase;
- (b) the project Cost Plan;
- (c) tender process and review;
- (d) the project program; and
- (e) confirmation of the standard of works.

Seqwater's Submission on the Draft Report

In response to the Authority's findings Seqwater (2012b) provided the requested information. Seqwater noted that the latest estimated actual spend for 2011-12 is \$258,000 due to the delays involved with this project. Seqwater submitted that the cost plan which forecast total costs in 2011-12 of \$2,551,000 is therefore superseded and the actual expenditure in 2011-12 to date is \$129,000.

Seqwater has submitted that this cost variance reflects delays in project delivery and Seqwater's estimation of the most likely timing of contingency payments, to reflect the timing of the riskier elements of the project. The overall budget for the project has not changed since the business case was developed in September 2010.

[SKM's Review](#)

SKM reviewed the additional information provided by Seqwater and noted that while the decision to bring forward a number of high risk activities could justifiably result in the increase of \$751,000 the figure of \$2,551,000 cannot be approved as the latest estimated actual spend for 2011-12 is \$258,000.

SKM also noted that the project was put to tender and that the results were unsatisfactory and at present the tenderer's pricing is being independently reviewed and that, furthermore, the business case for the project is under review. This approach was considered by SKM to be appropriate in light of the results of the tender review process outlined in the Evaluation Report. SKM found that as the project is undergoing reassessment, the timing and the deliverability of the project cannot be commented on in this review and hence it cannot be confirmed as efficient.

Based on the updated information, SKM concluded that the initially proposed increase to \$2.55 million cannot be justified. SKM noted that recent advice from Seqwater indicates that only \$255,000 of the approved 2011-12 expenditure of \$1.8 million is likely to be spent in the 2011-12 financial year. SKM considered this project should be considered for review in the future.

[Authority's Analysis](#)

The Authority notes Seqwater expects to only spend \$255,000 in 2011-12 and that the project is under review following unsatisfactory tenders. The Authority notes that it considered this project prudent and efficient at an expected value of \$1.8m during its review of the 2011-12 Grid Service Charges, and that Seqwater has proceeded on this basis. The Authority therefore accepts that the project is prudent, and that expenditure incurred to date in investigating delivery options for this project is efficient.

However, given the considerable uncertainty regarding the likely project cost, the Authority does not consider that the project, in total, can be considered efficient. The Authority has not included any further expenditure for 2012-13.

[Item 6: Gold Coast Desalination Plant Autoflush](#)

[Draft Report](#)

[Seqwater's Submission](#)

Seqwater (2012a) proposed to undertake upgrades of the GCDP to enable autoflush of SAF pumps and headers, at a cost of \$1.975 million in 2012-13.

[WGM's Submission](#)

The WGM noted that the desalination facility is required to continue operations in stand-by mode. The WGM considered that, while maintaining availability, expenditure on upgrades should be minimised.

[Seqwater's Response to the WGM's Submission](#)

Seqwater submitted that the autoflush proposal is not driven by capacity, but rather potential efficiency and workplace health and safety (WHS) compliance. Seqwater noted that, had it been known that the GCDP would be operating on hot standby (or at 33% utilisation) when it was constructed, these works would have been incorporated in the original design.

[SKM's Review](#)

In its initial assessment of costs, SKM noted that the information provided in the preliminary business case was not consistent with the costs within Seqwater's submission to the

Authority. SKM was advised by Seqwater that of the total \$1.975 million cost of the project, approximately \$400,000 was to be funded by the Construction Alliance.

Seqwater nominated renewals as the cost driver for this project. However, Seqwater indicated to SKM that the decision to automate the flushing system was multi-factorial with consideration given to efficiency improvement, safety and reduced pipework deterioration. Based on this, SKM found that that business efficiency and service were more appropriate cost drivers for the project.

SKM found the options analysis undertaken by Seqwater included three options including a "do nothing" option. SKM considered this appropriate.

SKM concluded that the project was prudent and that the primary cost driver should be amended to business efficiency.

SKM reviewed documentation including the *Preliminary Business Case for Super Duplex Pump and Header Draining and Flushing at the Gold Coast Desalination Plant*. Based on the information provided, SKM found the scope of works to be appropriate.

The Business Case reviewed by SKM contained the budget estimate for the project. SKM noted that this estimate included a contingency of $\pm 15\%$ for executing the works under the Veolia Water Alliance. It also listed the cost of the manual flushing system to be funded by the Construction Alliance at \$431,000. The difference between the submission and the preliminary Business Case was not established.

Whilst SKM found that the preliminary Business Case required updating, it assessed the project as prudent as the primary driver of business efficiency had been demonstrated, a subordinate driver of service was also relevant and an appropriate decision making process was followed.

SKM assessed the project as efficient as the scope (which required further refinement) was acceptable, the standards of works were expected to be consistent with industry practice and the amended costs appeared reasonable.

[Authority's Analysis](#)

In the Draft Report, the Authority accepted SKM's finding that this project is both prudent and efficient, with the exception of \$431,000 of costs to be funded by the Construction Alliance.

[Seqwater's Submission on the Draft Report](#)

Seqwater (2012b) has confirmed the cost of the manual flushing system is to be funded by the Construction Alliance, and does not contest the findings of the Authority's Draft Report.

[Authority's Analysis](#)

The Authority notes Seqwater's submission and confirms that it has excluded the \$431,000 of costs to be funded by the Construction Alliance.

[Item 7: Business Driven Projects from ICT Operations Plan - Plant and Equipment](#)

[Seqwater's Submission](#)

Seqwater (2012a) proposed \$1.7 million of expenditure in 2012-13 for seven projects which form part of the ongoing ICT Ops Plan Plant and Equipment program. The seven projects and their 2012-13 costs are outlined in Table 4.18 below.

Table 4.18: 2012-13 ICT Ops Plan Plant and Equipment Programme Expenditure (\$)

| <i>Project</i> | <i>Cost 2012-13</i> |
|---|---------------------|
| Website Redevelopment Project | 100,000 |
| Facilities and Property Management | 100,000 |
| Water Quality Management System | 300,000 |
| Citrix Review Architecture Strategy | 500,000 |
| Enterprise Compliance and Risk Management | 400,000 |
| Seismic Network consolidation | 150,000 |
| Water Billing and Trading Solution | 150,000 |
| Total | 1,700,000 |

Source: SKM (2012).

SKM's Review

SKM found that the drivers of the seven projects ranged from improvement, though renewal to compliance. Improvement comprised the largest value. SKM also reviewed the status of the individual projects and found that the decision making process was appropriate.

SKM concluded that the project was prudent, the primary driver of improvement was demonstrated and an appropriate decision making process was documented.

SKM found for all projects the scope of works to be appropriate for their respective current state and that the standard of works was consistent with industry practice.

In its review of the individual project costs SKM found that most were based on the industry knowledge of the Project Manager and subsequently reviewed by the Project Director. If necessary an informal peer review by industry participants (Gartner) was completed. SKM found this to be an appropriate process.

In its review SKM found that the 2012-13 project (program) expenditure was efficient as the scope was appropriate, the standards of works were expected to be consistent with industry practice and the preliminary costs were reasonable.

However, SKM noted that this was a program of projects and only project schedules for capitalisation in 2012-13 were reviewed. It did not conduct an assessment of the prudence and efficiency of later projects to be completed. Consequently, these amounts cannot be determined as prudent or efficient.

SKM recommended that this budget be reviewed in future years when information is available. In addition, SKM noted that the quantum of increase in 2013-14 expenditure is too large (+ 188%) to allow approval by projection.

Authority's Analysis

The Authority has accepted SKM's finding that the 2012-13 projects of the ICT Ops Plan Plant and Equipment programme are prudent and efficient. The Authority notes SKM's concerns regarding expenditure beyond 2012-13, and recommends that Seqwater address these issues in submissions to future regulatory investigations.

No submissions on this item were received in response to the Draft Report.

Item 8: Gold Coast Desalination Plant Repairs and Maintenance Asset Replacement

Seqwater's Submission

Seqwater (2012a) proposed \$3.81 million of expenditure for the supply and installation of new reverse osmosis (RO) membranes and cartridge filters at the GCDP to continue to meet its contractual water quality requirements.

SKM's Review

SKM noted that membranes and filter cartridges by their nature are required to be replaced on a periodic basis, due to deterioration of the filtering material with the consequent increase in consumables and reduction in the quality of water being produced.

The business case for the replacement of the membranes and filter cartridges is currently being developed by Seqwater and was not provided to SKM.

SKM noted that the project included the replacement of 30% of membranes and first pass RO filter cartridges and 2% of second pass RO filter cartridges. SKM received no documentation of the decision making process followed.

However, SKM noted that the level of operation of the plant was significantly less than the design and expected operation. As such no replacement of membranes and cartridges occurred since the plant began operation in 2009. SKM found that an allowance of 5% per annum for the replacement of membranes and cartridges was included in the plant's budget, and on this basis project was found to be prudent.

Based on the available information, SKM found the replacement of 30% of membranes and first pass RO filter cartridges and 2% of second pass RO filter cartridges to be an appropriate scope of works for the project.

SKM found that that the preliminary cost estimate for the project was developed from the RO membranes purchase order from the supplier, dated July 2010. SKM considered that this was an appropriate method to calculate the cost estimate given the project's phase of development.

SKM therefore found the project to be efficient as the scope was appropriate, the standards of works were expected to be consistent with industry practice and the preliminary costs were defensible. It is noted that the cost estimate was based on preliminary estimates only (which should be subject to ex post review once incurred).

Authority's Analysis

The Authority has accepted SKM's finding that this project is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 9: Holts Hill Chlorine Control Building Foundation Repairs

Seqwater's Submission

Seqwater (2012a) proposed \$2.26 million of expenditure for the Holts Hill Chlorine Control Building Foundation Repairs project commencing in 2011-12, but commissioned in 2012-13. This project includes the construction of a new prefabricated building sited over the existing chemical bund on a suspended concrete deck at road level. The building would house all electrical and control components apart from a new pole-mounted transformer and a skid-

mounted generator. The existing building would be demolished and reforming earthworks undertaken.

SKM's Review

The cost driver nominated by Seqwater for this project was service. SKM found that multiple investigations were conducted over a period of years (Brisbane City Council in 2002, GHD in 2009 and Worley Parsons in 2010) with the consistent recommendation that the chemical building should either be relocated to a safer site at Holts Hill or retained with stabilisation and remediation of the slope and building. SKM concluded that service was an acceptable cost driver for this project.

SKM also found that an acceptable decision making process was documented for the project. Therefore SKM concluded that the project was prudent.

In its review of the scope of the project SKM found that scope of works for the project was considered appropriate.

The 2012-13 project budget was assessed by SKM as efficient as the scope was appropriate, the proposed standards of works were consistent with industry practice and the costs will be market tested by the tender process.

Authority's Analysis

The Authority accepts SKM's finding that this project is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 10: Woodford WTP Upgrade

Draft Report

Seqwater Submission

Seqwater has proposed a number of minor works to upgrade the Woodford WTP, at an estimated cost of \$274,000, to be commissioned in 2012-13.

Table 4.19: Woodford WTP Proposed Capital 2012-13 Expenditure (\$'000)

| <i>Project Description</i> | <i>Cost</i> |
|----------------------------------|-------------|
| Old Plant - Filters - Filter 1 | 140 |
| Chemical delivery Bund | 65 |
| Turbidity (Post Primary Filter) | 10 |
| Raw Water pH | 8 |
| pH - Post Primary Filtered Water | 8 |
| Raw Water Turbidity | 13 |
| Old Plant - Backwash Pump | 30 |
| Total | 274 |

Note: Totals may not add due to rounding.

WGM's Submission

The WGM (2012a) submitted that supply from the Woodford WTP was not required.

The WGM noted that the Woodford demand zone was currently being supplied from the Northern Pipeline Interconnector via Elimbah Reservoir. The WGM submitted that this mode of operation was reflected in the current Grid Instructions.

The WGM considered that, given that no supply was required, the Woodford WTP could be decommissioned, avoiding the need for any future capital expenditure. The WGM submitted that a decision to decommission the Woodford WTP would have no material impact on water security over the short or long term, as the entitlement from this source was 1,250 ML, compared to current Grid-wide demand of about 290,000 ML per annum.

Seqwater's Response to the WGM's Submission

Seqwater submitted that the proposed capital expenditure for the Woodford WTP in 2012-13 was primarily related to renewal works rather than upgrades. Seqwater submitted that some of this renewals work may still be required irrespective of whether supply is delivered by the plant, in order to maintain compliance with other legislative obligations.

Seqwater noted that, if it was decided that supply was not required from Woodford WTP, there would be a need for operating expenditure associated with the decommissioning works.

Authority's Analysis

In the Draft Report, the Authority noted that the Direction Notice requires it to accept production forecasts that are consistent with Grid Instructions forecast in the WGM's Annual Operations Plan (WGM 2011) and any relevant information provided to GSPs in accordance with the SOP (QWC 2011). The Annual Operations Plan (WGM 2011) forecasts supply from the Woodford WTP in 2012-13, in contradiction to the WGM's submission (WGM 2012) that supply is not required. However, the Authority noted that the Annual Operations Plan (WGM 2011) pre-dates the WGM's submission (WGM 2012). Furthermore, the Authority considered that the WGM's submission to the Authority constitutes relevant information provided to Seqwater in accordance with the SOP (QWC 2011).

The Authority noted that Seqwater has considered that some capital expenditure may still be required, but has not provided further justification.

On this basis, the Authority accepted the WGM's submission that supply from the Woodford WTP was not required to meet its obligations under the System Operating Plan (QWC 2011). The Authority therefore recommended that all proposed capital expenditure on the Woodford WTP is not prudent and excluded \$274,000 of capital expenditure in 2012-13.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that at the time of its initial submission the existing Grid Instructions required continued supply from this plant.

Seqwater noted the WGM submission recommended rationalising of the Woodford WTP and that this appeared to be inconsistent with the Grid Instructions. More specifically Seqwater submitted that the most recent draft May 2012 Annual Operations Plan now indicates that no supply will be required from Woodford WTP in "under the preferred operating mode". The AOP then states that:

- (a) in general, other supply options will be used in preference to the Woodford WTP, due to costs and water quality risks associated with raw water quality at those plants;

- (b) subject to further consultation with Unitywater, based on security measures and cost efficiency outcomes, there are potential benefits in permanently discontinuing supply from the Woodford WTP; and
- (c) in the interim, production will not be required from Woodford WTP, other than in a response to an adverse asset or water quality issue.

Seqwater submitted that these statements imply it is still possible that supply from this WTP may be required should some adverse event occur. It submits that if Seqwater does not undertake the renewals work needed Seqwater would be at risk of being unable provide to the required supply water if such events occur. For that reason, Seqwater submitted that it has not at this stage removed the proposed renewals works from its capital programme. However, if it is able to be confirmed that the WGM will not require future supply from this WTP then Seqwater will not undertake the proposed renewals or incur the related expenditure.

Authority's Analysis

Subsequent to the Authority's Draft Report, Seqwater held discussions with the WGM manager to clarify the ongoing operating strategy for the plant. The outcome of these discussions was that:

...the WGM... advised Seqwater that the Annual Operations Plan had been amended so that there would be no requirement at all for water from this WTP in the next 12 months. It was also agreed that work should commence to move toward the permanent decommissioning of this WTP.

Seqwater concedes that the budgeted expenditure associated with the refurbishments to the filter at the Woodford WTP (\$140,000) and the chemical delivery bund (\$65,000) is no longer required, and therefore not prudent" (SKM 2012).

Therefore the Authority considers that should the May AOP be approved, its recommendation that all proposed capital expenditure on the Woodford WTP is not prudent stands, and \$274,000 should be excluded from capital expenditure in 2012-13.

However, the Authority is bound under the Direction to accept the required system capacities as defined in the November 2011 AOP. To this end, Seqwater advised that, should supplies be required from the plant, the expenditure would be necessary. On this basis, the Authority would consider the proposed capital expenditure to be prudent.

Consistent with Chapter 3, the Authority proposes to estimate two alternate GSCs, without and with this expenditure, reflecting the May 2012 and November 2011 AOPs respectively.

Item 11: Caboolture WTP Upgrade

Draft Report

Seqwater's Submission

Seqwater has proposed a number of minor works to upgrade to the Caboolture WTP, at an estimated cost of \$511,000, to be commissioned in 2012-13.

Table 4.20: Caboolture WTP Proposed Capital Expenditure (\$'000)

| <i>Project Description</i> | <i>Cost</i> |
|--|-------------|
| Primary Filters 1 and 2 | 420 |
| Flash Mixing pH | 8 |
| Post Dosing pH | 8 |
| Sodium Hydroxide System | 15 |
| Delivered Water System - Pipework and Valves | 60 |
| Total | 511 |

Note: Totals may not add due to rounding.

[WGM's Submission](#)

The WGM (2012a) submitted that supply from the Caboolture WTP was not required.

Instead, the WGM noted that the Caboolture demand zone was currently being supplied from the Northern Pipeline Interconnector. The WGM submitted that this mode of operation was reflected in the current Annual Operations Plan (WGM 2011) and Grid Instructions.

The WGM considered that operating without the Caboolture WTP had no material impact on water security over the short or medium term. In relation to system reliability, the WGM submitted that there was sufficient reservoir capacity in this area to continue supply of water in periods when pipelines from Landers Shute or the Northern Pipeline Interconnector were being maintained. The WGM suggested that, given that no supply was required, the Caboolture WTP could be decommissioned, avoiding the need for any future capital expenditure.

[Seqwater's Response to the WGM's Submission](#)

Seqwater submitted that the proposed capital expenditure for the Caboolture WTP in 2012-13 was primarily related to renewal works rather than upgrades. Seqwater submitted that some of this renewals work may still be required irrespective of whether supply is delivered by the plant, in order to maintain compliance with other legislative obligations. Seqwater noted that switching off this plant would lead to a potential loss of water allocation of 4,200ML, which may have impacts on the timing and costs associated with bringing forward future water sources.

Seqwater noted that, if it was decided that supply is not required from Woodford WTP, there would be a need for operating expenditure associated with the decommissioning works.

[Authority's Analysis](#)

In the Draft Report, the Authority noted that the Direction Notice requires it to accept production forecasts that are consistent with Grid Instructions forecast in the WGM's Annual Operations Plan (WGM 2011) and any relevant information provided to GSPs in accordance with the System Operating Plan (QWC 2011). The Annual Operations Plan (WGM 2011) forecasts supply from the Caboolture WTP in 2012-13, in contradiction to the WGM's submission that supply is not required. However, the Authority noted that the Annual Operations Plan (WGM 2011) pre-dates the WGM's submission (WGM 2012). Furthermore, the Authority considered that the WGM's submission to the Authority constitutes relevant information provided Seqwater in accordance with the SOP (QWC 2011).

The Authority noted that Seqwater has considered that some capital expenditure may still be required, but has not provided further justification. The Authority noted that water allocation may go unused if WTPs are decommissioned, but they are not permanently lost. The Authority noted that the WGM holds water allocations in SEQ, not Seqwater. The Authority considered that the WGM will bear the consequences of unutilised water allocations resulting from its submission (WGM 2012).

On this basis, the Authority accepted the WGM's submission (WGM 2012) that supply from the Caboolture WTP is not required to meet its obligations under the SOP (QWC 2011). The Authority therefore recommended that all proposed capital expenditure on the Caboolture WTP is not prudent and has excluded \$511,000 of capital expenditure in 2012-13.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that at the time of its initial submission the existing Grid Instructions required continued supply from this plant.

It notes the WGM submission that recommended rationalising of the Caboolture and that this appeared to be inconsistent with the Grid Instructions. More specifically Seqwater submitted that the most recent (Draft) Annual Operations Plan (Grid Instructions) now indicates that no supply will be required from Caboolture WTP "under the preferred operating mode". It then states that:

- (a) in general, other supply options will be used in preference to the Caboolture WTP, due to costs and water quality risks associated with raw water quality at those plants;
- (b) subject to further consultation with Unitywater, based on security measures and cost efficiency outcomes, there are potential benefits in permanently discontinuing supply from the Caboolture WTP; and
- (c) in the interim, production will not be required from Caboolture WTP, other than in a response to an adverse asset or water quality issue.

Seqwater submitted that these statements imply it is still possible that supply from this WTP may be required should some adverse event occur. It submits that if Seqwater does not undertake the renewals work needed Seqwater would be at risk of being unable provide to the required supply water if such events occur. For that reason, Seqwater submitted that it has not at this stage removed the proposed renewals works from its capital programme. However, if it is able to be confirmed that the WGM will not require future supply from this WTP then Seqwater will not undertake the proposed renewals or incur the related expenditure.

The WGM reiterated its view that the Caboolture WTP will not be required in 2012-13.

Authority's Analysis

Subsequent to the Authority's Draft Report Seqwater held discussions with the WGM clarify the ongoing operating strategy for the plant. The outcome of these discussions was that:

...the WGM... advised Seqwater that the Annual Operations Plan had been amended so that there would be no requirement at all for water from this WTP in the next 12 months. It was also agreed that work should commence to move toward the permanent decommissioning of this WTP.

Seqwater conceded that the budgeted expenditure associated with the refurbishments to the primary filters at the Caboolture WTP (\$420,000) is no longer required, and therefore not prudent. (SKM 2012)

Therefore the Authority considers that should the May AOP be approved, its recommendation that all proposed capital expenditure on the Caboolture WTP is not prudent stands, and \$511,000 should be excluded from capital expenditure in 2012-13.

However, the Authority is bound under the Direction to accept the required system capacities as defined in the November 2011 AOP. To this end, Seqwater advised that, should supplies be required from the plant, the expenditure would be necessary. On this basis, the Authority would consider the proposed capital expenditure to be prudent.

Consistent with Chapter 3, the Authority proposes to estimate two alternate GSCs, without and with this expenditure, reflecting the May 2012 and November 2011 AOPs respectively.

Item 12: Luggage Point AWTP – BP Connection

[Draft Report](#)

[Seqwater's Submission](#)

Seqwater (2012a) proposed to undertake construction of a connection from the Luggage Point AWTP to the British Petroleum (BP) refinery at a cost of \$825,000 in 2012-13.

[WGM's Submission](#)

The WGM (2012a) submitted that this project was needed, provided that QUU finalise proposed contracts for supply of PRW to commercial and industrial customers. The WGM considered that further costs should not be incurred until such time as those contracts were executed.

[Seqwater's Response to the WGM's Submission](#)

Seqwater submitted that normal commercial arrangements will apply and Seqwater will not go ahead with the project unless and until customers are committed.

[Authority's Analysis](#)

In the Draft Report, subject to the receipt of further information and assessment, the Authority accepted that the construction of a BP connection is prudent, conditional on a finalised contract for supply of PRW to BP, as accepted by Seqwater.

[Seqwater's Submission on the Draft Report](#)

In its submission Seqwater (2012b) confirmed that it will provide further advice to the Authority when a supply contract has been finalised and accepted.

[Authority's Analysis](#)

The Authority has retained the finding from the Draft Report that the construction of a BP connection is prudent, conditional on a finalised contract for supply of PRW to BP, as accepted by Seqwater.

Item 13: Kooralbyn WTP Clarifier Upgrade

[Draft Report](#)

[Seqwater's Submission](#)

Seqwater (2012a) proposed to undertake \$0.5 million of upgrades to the clarifier at the Kooralbyn WTP in 2012-13. Seqwater submitted that that these upgrades were required for compliance and service purposes.

WGM's Submission

The WGM (2012a) recommended that further information is required to demonstrate the need for this expenditure.

The WGM recognised that these works may be required to address water quality risks. The WGM submitted that these water quality risks were highlighted by the WGM in its *2010-11 Annual Market Rules Review* and 18 January 2012 advice to the QWC. The WGM noted in that advice, that the risks related to the presence of protozoa for which, in the absence of detailed guidance, Seqwater has taken a conservative approach. The WGM submitted that the actual risk should be further quantified through detailed water quality monitoring prior to major capital investments being undertaken.

Seqwater's Response to the WGM's Submission

Seqwater submitted that it is currently in the planning stage for the Kooralbyn WTP and has not completed its evaluation of the possible options. Seqwater submitted that the works on the clarifier are intrinsically related to other sludge works and should occur together. Seqwater considered that water quality risks will be identified and investigated through the planning study and later stages of development.

Seqwater submitted that it is not currently planning to increase the capacity of Kooralbyn WTP and indicated that the project will not proceed if the planning study shows that it is not yet required.

Authority's Analysis

In the Draft Report, the Authority noted Seqwater's submission that the planning study has yet to indicate whether these works are required. Subject to the receipt of further information and assessment, the Authority proposed not to include this item in GSCs.

Seqwater's Submission on the Draft Report

Seqwater (2012b) considered the WGM's recommended approach a risky path of wait-and-see. However, Seqwater noted that it is not in a position to construct infrastructure without the certainty that it can recover the money invested. Seqwater has not at this stage removed the proposed works from its capital programme. Seqwater submitted that given the risks involved, it will continue with the proposed works unless it is able to be confirmed that the WGM recognises and accepts these risks and still does not wish for this project to be undertaken in 2012-13, in which case Seqwater stated that it will not undertake the proposed works or incur the related expenditure.

SKM's Review

SKM investigated the additional information provided by Seqwater and noted that the project scope is to:

- (a) assess the limitations of the existing sludge handling facilities for both normal operating conditions and wet weather conditions;
- (b) carry out a survey of the existing lagoons to confirm dimensions and critical levels;
- (c) review options for improving the existing sludge handling facilities including supernatant return;
- (d) consider how the works can be constructed whilst the plant remains operational and staged if applicable; and

- (e) prepare a preliminary design of the preferred options together with cost estimates for inputting into the 2012-13 budget.

SKM noted that the project brief document details that an options assessment was yet to be completed. On this basis, SKM recommended that the prudence of this project is yet to be established. However, SKM found that it is prudent to conclude the options assessment in order to determine the most appropriate path forward.

SKM noted that efficiency has not been assessed as the project is not at a stage of development that allows the assessment of efficiency.

[Authority's Analysis](#)

The Authority has retained its finding from the Draft Report and excluded all expenditure for this item. However, the Authority accepts SKM's finding that it is prudent for Seqwater to proceed with the options assessment.

[Item 14: Rathdowney WTP Sludge Handling Upgrade](#)

[Draft Report](#)

[Seqwater's Submission](#)

Seqwater (2012a) has proposed to undertake \$650,000 million of sludge handling upgrades to the Rathdowney WTP in 2012-13.

[WGM's Submission](#)

The WGM (2012a) recommended that further information was required to demonstrate the need for this expenditure.

The WGM submitted that the existing treatment capacity of the Rathdowney WTP of 0.4 ML per day exceeded forecast requirements over the next three to five years. For comparison, the WGM noted that the forecast production requirement for 2011-12 was 24 ML, which is equivalent to less than 0.07 ML per day.

The WGM submitted that mean day maximum month demand is about 23% of available treatment capacity. The WGM considered that, if sludge handling improvements are shown to be required due to environmental legislation or to maintain supply, then the equipment should be sized for no more than the predicted average demand in 2031 of 0.2 ML/day (based on medium growth forecasts).

[Seqwater's Response to the WGM's Submission](#)

Seqwater submitted that it is currently in the planning stage for the Rathdowney WTP and has not completed its evaluation of the possible options.

Seqwater is not currently planning to increase the capacity of Rathdowney WTP and indicated that the project will not proceed if the planning study shows that it is not yet required.

[Authority's Analysis](#)

In the Draft Report, subject to the receipt of further information and assessment, the Authority proposed not to include this item in GSCs.

[Seqwater's Submission on the Draft Report](#)

In response to the WGM's recommendation, Seqwater (2012b) submitted that its investigation showed that, due to poor sludge management, supernatant from the WTP overflows to the Logan River. Seqwater submitted that this is a breach of Seqwater's

general statutory environmental duty, which requires that it must not carry out any activity that causes, or is likely to cause, environmental harm unless it takes all reasonable and practicable measures to prevent or minimise the harm.

Seqwater submitted that this investment is reasonable considering it is required to meet Government legislation and to avoid environmental fines that run into the hundreds of thousands of dollars.

[SKM's Review](#)

SKM investigated the additional information provided by Seqwater and noted that this project was included in the project brief document relating to the Kooralbyn WTP clarifier upgrade (Item 13 above). As above, SKM considered that the prudence of this project is yet to be established. However, SKM found that it is prudent to conclude the options assessment in order to determine the most appropriate path forward.

SKM noted that efficiency has not been assessed as the project is not at a stage of development that allows the assessment of efficiency.

[Authority's Analysis](#)

The Authority has retained its finding from the Draft Report and excluded all expenditure for this item. However, the Authority accepts SKM's finding that it is prudent for Seqwater to proceed with the options assessment.

[Item 15: Bundamba AWTP Chemical Storage Area Covers](#)

[Draft Report](#)

[Seqwater's Submission](#)

Seqwater (2012a) has proposed to undertake \$1.037 million of capital expenditure to construct chemical storage area covers at Bundamba AWTP in 2012-13. Seqwater submitted that this project, reviewed by the Authority during the 2011-12 investigation, had been deferred from 2011-12 to 2012-13.

[Authority's Analysis](#)

In the Draft Report, the Authority noted that this project was submitted by the former WaterSecure during the 2011-12 investigation at a total cost of \$0.8 million, and related to the construction of separate chemical storage area covers at Bundamba 1A and Bundamba 1B AWTPs. Following SKM's review, the Authority recommended that the construction of a cover at Bundamba 1A was prudent and efficient at an expected cost of \$457,876 in 2010-11. However, the Authority recommended that the construction of a cover at Bundamba 1B was not prudent, due to the fact that Bundamba 1B is decommissioned.

The Authority received no new information from Seqwater regarding the prudence of the cover at Bundamba 1B, and notes that 1B remains decommissioned. The Authority considered that the use of chemical storage areas at a decommissioned plant is likely to be minimal. The Authority therefore again recommended that only \$457,876 of this capital expenditure project relating to Bundamba 1A is prudent, at the deferred timing of 2012-13.

Furthermore, the Authority encouraged Seqwater to only include previously excluded capital expenditure projects in its proposed program if the project justification has improved and is detailed in its submission to the Authority.

[Seqwater's Submission on the Draft Report](#)

Seqwater (2012b) submitted that the Draft Report suggests that Bundamba 1B AWTP remains decommissioned. However it submitted that Bundamba 1B is not a

decommissioned asset. Rather, the plant is functioning in hot standby operational mode and there has been no formal decision in relation to its decommissioning.

Seqwater also submitted that it is important to consider that the operational setup of Bundamba AWTP which does not involve a duplication of chemical tanks for each of 1A & 1B elements of the plant. The operational status of one half of the plant therefore does not halve the capital requirements relating to the chemical tanks.

However, Seqwater does not propose to further pursue approval for the Bundamba AWTP chemical building covers project in this 2012-13 regulatory process.

Authority's Analysis

As Seqwater does not propose to pursue approval for the Bundamba AWTP chemical building covers project in this 2012-13 regulatory process, the Authority has excluded expenditure related to this project from the GSCs.

Item 16: Beaudesert WTP Upgrade

Seqwater initially proposed \$9.0 million of capital expenditure at Beaudesert WTP, to be commissioned in 2014-15. As a result, this project is discussed in detail in Appendix B – Post 2012-13 Capital Expenditure. However, following stakeholder submissions and SKM's review, Seqwater presented a revised project scope of \$740,000, to be commissioned in 2012-13. As a result, the Authority's final recommendations are summarised here. On advice from SKM, the Authority recommends that Seqwater's revised scope of \$740,000 is prudent and efficient.

Formerly Post 2012-13 Capital Expenditure

Seqwater submitted additional revisions to post 2012-13 capital expenditure for three further projects, which are now expected to be completed in 2012-13. Table 4.21 refers.

Table 4.21: Post 2012-13 Capital Expenditure Revised to 2012-13

| Item | Project | Seqwater's initial submission | | Seqwater's revised submission | |
|------|------------------------|-------------------------------|-----------------------|-------------------------------|-----------------------|
| | | Cost | Year of Commissioning | Cost | Year of Commissioning |
| 17 | Molendinar WTP Upgrade | \$11.7m | 2014-15 | \$1.7m | 2012-13 |
| 18 | Mudgeeraba WTP Upgrade | \$11.2m | 2014-15 | \$0.5m | 2012-13 |
| 19 | Image Flat WTP Upgrade | \$11.5m | 2014-15 | \$1.0m | 2012-13 |

For each of these three items, the Authority did not engage SKM to review information provided by Seqwater in response to the Draft Report. However, the Authority considers that Seqwater has not yet demonstrated prudence and efficiency, and excluded these costs from its recommended Grid Service Charges. SKM's review of these 3 items as originally proposed by Seqwater is included more detail in **Appendix B**.

Summary of Prudency and Efficiency Review

In the Draft Report, in total, SKM reviewed eight items and found four to be prudent and efficient, while one is partially efficient and three have insufficient information to establish efficiency.

For the Final Report, SKM reviewed a further eight items (totalling 16) and found eight to be prudent and efficient, while one is partially efficient.

Consistent with the November 2011 AOP, of the total sample of \$25.8 million, the Authority could only accept a total of \$18.2 million, a reduction of 29%. Consistent with the May 2012 AOP, the Authority could only accept a total of \$17.4 million, a reduction of 32%.

As noted in Chapter 3, the Authority considered whether the findings of its consultants, SKM, give a clear indication of a systemic or widespread problem with Seqwater's capital expenditure planning and delivery processes that would justify extrapolation of the findings of SKM's sample to the broader un-sampled capital expenditure program.

Of the eight projects not found to be prudent and efficient:

- (a) explicit adjustments are recommended to two items (Gold Coast Desalination Plant Autoflush and Bundamba AWTP Chemical Storage Area Covers) which comprise 5% of Seqwater's proposed 2012-13 capital expenditure;
- (b) the exclusion of Woodford and Caboolture WTP upgrades (when applying the May 2012 AOP) is considered to be a consequence of a change in Grid operations rather than an adverse reflection on Seqwater's capital planning processes;
- (c) four projects have been excluded on the basis on insufficient information.

That is, in considering whether to extrapolate the identified savings to projects not reviewed only two projects are relevant (in (a) above). Both of these represented recording errors rather than reductions as a result of their proposed efficiency.

The Authority considers that in view of the short timeframe for the assessment, it is not appropriate to extrapolate a finding of insufficient information.

The Authority therefore considers that extrapolation is inappropriate in this case.

Table 4.22: Reviewed 2012-13 Capital Expenditure (\$'000)

| <i>No</i> | <i>Project Title</i> | <i>Initial Cost Estimate</i> | <i>Final Cost Estimate</i> | <i>Final Prudency</i> | <i>Final Efficiency</i> | <i>Draft Recommendation</i> | <i>Final Recommendation</i> |
|--------------------------|--|------------------------------|----------------------------|--------------------------|--------------------------|-----------------------------|-----------------------------|
| SKM Sampled Items | | | | | | | |
| 1 | Mt Crosby WTP Water Quality Improvement | 3,793 | 3,793 | Prudent | Efficient | 3,793 | 3,793 |
| 2 | Various WTP Chemical Dosing Improvements | 1,462 | 1,462 | Insufficient information | Insufficient information | 750 | 0 |
| 3 | Mt Crosby Eastbank WTP High Voltage Renewals | 1,434 | 1,434 | Prudent | Efficient | 690 | 1,434 |

| <i>N o</i> | <i>Project Title</i> | <i>Initial Cost Estimate</i> | <i>Final Cost Estimate</i> | <i>Final Prudence</i> | <i>Final Efficiency</i> | <i>Draft Recommendation</i> | <i>Final Recommendation</i> |
|--|--|--------------------------------------|------------------------------------|---------------------------|-----------------------------|---------------------------------|---------------------------------|
| 4 | North Pine WTP Fluoride Dosing Point Relocation | 1,048 | 1,048 | Prudent | Efficient | 1,048 | 1,048 |
| 5 | North Pine WTP Filter Upgrade | 4,551 | 4,551 | Prudent | Insufficient information | 2,297 | 255 |
| 6 | Gold Coast Desalination Plant Autoflush | 1,975 | 1,975 | Prudent | Partially efficient | 1,544 | 1,544 |
| 7 | Business Driven Projects from ICT Ops Plan Plant and Equipment | 1,700 | 1,700 | Prudent | Efficient | 1,700 | 1,700 |
| 8 | Gold Coast Desalination Plant - R&M-Asset Replacement | 3,812 | 3,812 | Prudent | Efficient | 3,812 | 3,812 |
| 9 | Holts Hill Chlorine Control Building Foundation Repairs | 2,263 | 2,263 | Prudent | Efficient | 2,263 | 2,263 |
| 10 | Woodford WTP Upgrades | 274 | 274 | Prudent/Not Prudent* | Not Independently Assessed | 0 | 274/ 0* |
| 11 | Caboolture WTP Upgrades | 511 | 511 | Prudent/Not Prudent* | Not Independently Assessed | 0 | 511/ 0* |
| 12 | Luggage Point AWTP – BP Connection | 825 | 825 | Prudent | Efficient | 825 | 825 |
| 13 | Kooralbyn WTP Clarifier Upgrade | 500 | 500 | Insufficient information | Not Independently Assessed | 0 | 0 |
| 14 | Rathdowney WTP Sludge Handling Upgrade | 650 | 650 | Insufficient Information | Not Independently Assessed | 0 | 0 |
| 15 | Bundamba AWTP Chemical Storage Area Covers | 1,037 | 0 | Withdrawn by Seqwater | Withdrawn by Seqwater | 458 | 0 |
| 16 | Beaudesert WTP Upgrade | n/a | 740 | Revised, prudent | Revised, efficient | 0 | 740 |
| Total Reviewed Items | | 25,835 | 25,538 | | | 19,180 | 18,199 / 17,414* |
| Total 2012-13 Non-Drought Capex | | 62,607 | 62,310 | | | | |
| Un-Sampled Items | | 36,772 | 36,772 | | | | |
| Items Reclassified to 2012-13 | | | | | | | |
| 17 | Molendinar WTP - Backwash Pump | n/a | 1,650 | Insufficient information | Not assessed | 0 | 0 |

| <i>No</i> | <i>Project Title</i> | <i>Initial Cost Estimate</i> | <i>Final Cost Estimate</i> | <i>Final Prudence</i> | <i>Final Efficiency</i> | <i>Draft Recommendation</i> | <i>Final Recommendation</i> |
|------------------------------|--------------------------------|------------------------------|----------------------------|--------------------------|-------------------------|-----------------------------|-----------------------------|
| 18 | Mudgeeraba WTP - Storage Works | n/a | 501 | Insufficient information | Not assessed | 0 | 0 |
| 19 | Image Flat WTP Upgrade | n/a | 1,000 | Insufficient Information | Not assessed | 0 | 0 |
| Total Items (Revised) | | 62,607 | 65,461 | | | | |

*Note: *As described in Chapter 3, the Authority has recommended two alternate GSCs, reflecting the November 2011 / May 2012 Annual Operations Plans. In the event that the May 2012 AOP is approved, the lower values should apply to these items*

Capitalised Interest

Seqwater's Submission

Subsequent to the Draft Report, Seqwater (2012b) submitted that for multi-year projects, significant expenditure may be committed and incurred in the years prior to its completion. Seqwater submitted that the Authority should apply interest during construction for ongoing, multi-year capital projects. Seqwater also proposed capitalised interest on projects incurred and commissioned within a one-year period.

Seqwater considered it appropriate to estimate interest costs by reference to the allowed rate of return, or regulatory WACC, because project financing is likely to reflect business gearing. The principal amount that the rate of return should be applied to should be based on an assumed expenditure profile, in turn based on past experience of the expenditure profile for similar assets.

Seqwater provided its capitalised interest costs on drought and non-drought projects completed in 2012-13 and multi-year projects incurring cost in 2012-13. Table 4.23 refers.

Table 4.23: Seqwater's Proposed Non-Drought Capitalised Interest Costs (\$)

| | <i>Drought</i> | <i>Non-drought</i> | <i>Total</i> |
|---|----------------|--------------------|--------------|
| 2011-12 projects | 327,000 | 438,856 | 765,856 |
| Multi-year projects commissioned in 2012-13 | - | 1,967,522 | 1,967,522 |
| 2012-13 projects | 851,777 | 524,959 | 1,376,736 |

Source: Seqwater (2012)

Authority's Analysis

For projects constructed and commissioned in the same year, unless regulated entities provide sufficient justification for the individual project in question, the Authority generally does not capitalise interest during construction. In this case, the Authority adds the principal value of the projects as at commissioning date, into the RAB.

The Authority notes that the amount of capitalised interest depends on:

- the expenditure profile of the project. Projects where significant expenditures were incurred early in the construction period would attract higher interest costs relative to

projects where significant expenditures were incurred late in the construction period;
and

- (b) the payment profile of the project which, in the case of external tendering may lag the expenditure profile of the project. In some instances, payment may be made to external contractors only at the completion of the project.

The Authority considers that Seqwater has not fully substantiated each of the factors above. The Authority found that interest costs for both drought and non-drought projects are approximately half of the Authority's regulatory WACC, assuming a uniform payment profile. This implies that Seqwater is incorrectly proposing that drought projects be capitalised at the Authority's WACC rate as opposed to the cost of debt.

Due to concerns regarding the payment profile of projects and the appropriate rate of return, the Authority does not accept Seqwater's proposed capitalised interest for the purposes of the 2012-13 GSCs.

However, the Authority does consider that there is merit in Seqwater investigating this matter further. The Authority considers that if Seqwater is claiming capitalised interest costs, it should submit details regarding the start date, payment profile and rate of return for each relevant project. To this end, the Authority notes that it will revisit actual 2011-12 capitalised interest costs during the next investigation of GSCs.

4.2.4 Summary of Capital Expenditure

Table 4.24: Recommended Capital Expenditure (\$ million)

| <i>Period</i> | <i>Capital Expenditure</i> | <i>Approved Forecast</i> | <i>Proposed</i> | <i>Draft Recommendation</i> | <i>Final Recommendation</i> |
|---------------|----------------------------|--------------------------|-------------------------|-----------------------------|-----------------------------|
| 2011-12 | Drought | 404.2 | 844.1 | 844.1 | 844.1 |
| | Non-Drought | 48.0 | 32.2 | 30.8 | 31.4 |
| | <i>Total</i> | <i>452.3</i> | <i>876.4</i> | <i>874.9</i> | <i>875.5</i> |
| 2012-13 | Drought | | 19.8 | 19.0 | 19.0 |
| | Non-Drought | | 65.5 [^] | 51.6 | 54.97/54.19* |
| | <i>Total</i> | | <i>85.3[^]</i> | <i>70.6</i> | <i>73.97/ 73.19*</i> |

*Note: *As described in Chapter 3, the Authority has recommended two alternate GSCs, reflecting the November 2011 / May 2012 Annual Operations Plans. In the event that the May 2012 AOP is approved, the lower values should apply to these items ^ Revised value*

4.2.5 Return on Capital

Drought Assets

Under the Direction Notice, the return on drought assets is to be set at the actual cost of debt incurred by Seqwater for its drought assets.

The cost of debt for drought assets is the book interest rate provided by the Queensland Treasury Corporation (QTC) for each asset plus administration and capital market charges. The Authority is required to adopt the QTC rates.

QTC submitted the cost of debt for Seqwater's drought assets as shown in Table 4.25. In applying these costs of debt, the Authority has made the following assumptions:

- (a) QTC provided actual costs of debt for the first three quarters of 2011-12. The Authority has adopted a simple average of the three quarters of actual 2011-12 costs of debt as an estimated actual for the 2011-12 year; and
- (b) QTC provided two debt accounts relating to WCRWS assets, with different costs of debt. The Authority has not been able to distinguish which assets the different costs of debt are applied to (despite efforts to do so). The Authority has instead adopted a weighted average cost of debt based on the book values provided by QTC to apply to all WCRWS assets.

Table 4.25: Cost of Debt Rates for Drought Assets

| <i>Asset</i> | <i>2011-12 Forecast</i> | <i>2011-12 Estimated Actual¹</i> | <i>2012-13 Forecast</i> |
|--|-----------------------------|---|-----------------------------|
| Brisbane Aquifer | 6.44% | 6.44% | 6.34% |
| Bribie Island Aquifer | 6.21% | 6.21% | 6.16% |
| Enoggera WTP | 6.38% | 6.38% | 6.30% |
| Ewen Maddock WTP Upgrades | 6.38% | 6.38% | 6.30% |
| Cedar Grove Weir | 6.73% | 6.73% | 6.58% |
| Bromelton Off-Stream Storage | 6.73% | 6.73% | 6.58% |
| Esk-Wivenhoe Pipeline | 6.58% | 6.58% | 6.46% |
| Enoggera project pain/gain liability | 6.38% | 6.38% | 6.30% |
| Coominya Pipeline | 6.58% | 6.58% | 6.46% |
| Hinze Dam Raising | 6.20% | 6.14% | 6.09% |
| Wyaralong Dam | 6.13% | 6.13% | 6.09% |
| Wyaralong Dam Access Road ² | 6.15% | 6.15% | 6.12% |
| Wyaralong WTP | 6.06% | 6.06% | 6.02% |
| Gold Coast Desalination Plant | 6.52% | 6.52% | 6.35% |
| Western Corridor Recycled Water Scheme | 6.52% | 6.52% | 6.45% ³ |

Note: ¹Estimated Actual calculated as a simple average of the actual cost of debt for the first three quarters of 2011-12. ²Wyaralong Dam Access Road was not separately defined in the 2011-12 forecast, but included as part of the broader Wyaralong Dam asset. ³Forecast cost of debt for WCRWS is a weighted average of two costs of debt that cannot be distinguished by asset.

QTC advised that the differences in interest rates represented differences in market interest rates when the borrowings were made and when the Water Infrastructure Debt Pool (WIDP) was rebalanced. The WIDP has a mix of fixed and floating rate debt instruments and is adjusted each quarter.

The Authority notes that the only significant change in estimated actual costs of debt for

2011-12, relative to forecast, is Hinze Dam Raising which has fallen from 6.20% to 6.14%. As the Direction Notice requires the GSPs' rate of return to be based on the actual cost of debt, the Authority has retrospectively adjusted Seqwater's 2011-12 recommended GSCs to account for this change.

Non-Drought Assets

For non-drought assets, the Authority must determine a pre-tax nominal WACC for non-drought assets based on parameters detailed in the Direction Notice. The cost of debt used in the WACC is the book interest rate forecast by QTC for each asset plus an administration and capital market charge and a Competitive Neutrality Fee. The inputs provided by QTC and the resulting WACC adopted by the Authority are shown in Table 4.26.

Table 4.26: QTC Input Parameters and Seqwater's WACC

| <i>Parameter</i> | <i>2011-12 Forecast</i> | <i>2011-12 Estimated Actual</i> | <i>2012-13 Forecast</i> |
|--------------------------|-----------------------------|-------------------------------------|-----------------------------|
| Non-Drought Cost of Debt | 8.01% | 7.97% | 8.04% |
| Risk Free Rate | 5.96% | 5.86% | 5.92% |
| WACC | 9.91% | 9.83% | 9.90% |

As the Direction Notice requires the GSPs' rate of return to be based on the actual cost of debt, the Authority has retrospectively adjusted Seqwater's 2011-12 recommended GSCs to account for the fall in the 2011-12 estimated actual WACC.

Return on Assets Summary

In total, the changes to 2011-12 estimated actual capital expenditure, costs of debt and WACC result in a fall in estimated actual 2011-12 return on capital. Table 4.27 refers.

Table 4.27: Return on Capital (\$ million)

| <i>Asset</i> | <i>Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|--|-------------------------|-------------------------------------|---|---|
| Return on Existing Drought Assets | 233.4 | 198.6 | 198.8 | 194.2 |
| Return on Existing Non-Drought Assets | 184.3 | 181.3 | 190.1 | 183.5 |
| Return on New Capex | 25.6 | 39.1 | 55.9 | 54.9 |
| Total Return on Assets | 443.2 | 419.0 | 444.7 | 432.7 |

Note: these figures may not add due to rounding.

4.2.6 Return of Capital

The Authority proposes to continue to adopt straight-line regulatory depreciation based on each asset's estimated useful life. The Authority will not depreciate separately identifiable land assets, consistent with its approach in 2011-12.

Estimated useful lives along with the written down asset values have been provided by the Price Regulator as part of the 1 July 2011 RAB. The Authority has accepted Seqwater's proposed asset lives for 2011-12 and 2012-13 capital expenditure (see sections 4.2 – 4.4).

As per the Authority's 2011-12 Review Thresholds, the Authority has included actual capital expenditure in Seqwater's RAB as at the actual commissioning date. The changes to 2011-12 estimated actual capital expenditure, relative to forecast, cause corresponding adjustments to Seqwater's depreciation revenue. Table 4.28 refers.

Table 4.28: Return of Capital (\$ million)

| <i>Asset</i> | <i>Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|---|-----------------------------|---|---|---|
| Existing Drought Assets Depreciation | 108.4 | 104.8 | 106.5 | 107.5 |
| Existing Non-Drought Assets Depreciation | 37.5 | 36.5 | 38.7 | 37.4 |
| New Capex Depreciation | 3.5 | 4.7 | 9.7 | 9.5 |
| Total Depreciation | 149.4 | 146.0 | 154.9 | 154.4 |

Note: these figures may not add due to rounding.

4.2.7 Asset Appreciation

The Authority's GSC modelling includes an allowance for inflation of the value of Seqwater's RAB. The Authority has adopted an inflation rate of 2.5% (the mid-point of the RBA's target range) in both 2011-12 and 2012-13. The Authority considers that the increase in Seqwater's RAB values due to inflation should be removed from Seqwater's annual GSCs to prevent an over-recovery of revenues. The Authority's recommended asset appreciation is included in Table 4.29.

Table 4.29: Asset Appreciation (\$ million)

| <i>Asset</i> | <i>Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|--|-----------------------------|---|---|---|
| Existing Drought Assets Appreciation | 90.0 | 76.2 | 77.0 | 75.5 |
| Existing Non-Drought Assets Appreciation | 46.5 | 46.1 | 48.0 | 46.3 |
| New Capex Appreciation | 10.1 | 15.9 | 22.2 | 21.9 |
| Total Appreciation | 146.6 | 138.2 | 147.2 | 143.7 |

Note: these figures may not add due to rounding.

4.2.8 RAB Roll-Forward

Seqwater's RAB value has been rolled forward from the 1 July 2011 values provided by the Price Regulator to the closing value as at 30 June 2013, utilising the Authority's recommended capital expenditure, appreciation and depreciation. Table 4.30 refers.

Table 4.30: RAB Roll-forward (\$ million)

| | <i>Drought Final</i> | <i>Non-drought Final</i> | <i>Total Final</i> |
|---|----------------------|--------------------------|--------------------|
| Opening RAB (1 July 2011) | 3,145.6 | 1,932.6 | 5,078.2 |
| <i>plus</i> 2011-12 Capital Expenditure | 844.1 | 31.7 | 875.8 |
| <i>less</i> Depreciation | 108.8 | 37.2 | 146.0 |
| <i>plus</i> Asset Appreciation | 91.9 | 46.3 | 138.2 |
| Opening RAB (1 July 2012) | 3,972.8 | 1,973.4 | 5,946.2 |
| <i>plus</i> 2012-13 Capital Expenditure | 19.7 | 55.1 | 74.8 |
| <i>less</i> Depreciation | 113.1 | 41.3 | 154.4 |
| <i>plus</i> Asset Appreciation | 96.3 | 47.4 | 143.7 |
| Closing RAB (30 June 2013) | 3,975.8 | 2,034.6 | 6,010.3 |

Note: these figures may not add due to rounding.

4.2.9 Working Capital

Working Capital was included as an allowable cost in 2011-12, but as discussed in section 3.4, it has been re-categorised as a component of the Capital Charge in 2012-13.

2011-12 Working Capital

Seqwater was paid a \$6.3 million working capital allowance in 2011-12, and submitted that no adjustment was required.

The Authority notes that the Direction Notice requires that the rate of return earned by Seqwater is based on the actual cost of debt. As the calculation of return on working capital utilises the WACC determined by QTC's submitted actual cost of debt, the Authority recommends that Seqwater's 2011-12 working capital allowance be updated. Table 4.31 refers.

2012-13 Working Capital

Draft Report

For the Draft Report, Seqwater submitted no change to the working capital assumptions contained in the Authority's 2011-12 Final Report of 45 average debtor days and 30 average creditor days. The Authority understood that Seqwater was not seeking an allowance for critical spares in the 2012-13 year.

Following the Draft Report, Seqwater has clarified that it was not seeking any additional critical spares allowance beyond the \$912,000 approved in 2011-12.

The Authority accepts Seqwater's submission, and has calculated a working capital allowance as per Table 4.31.

Table 4.31: Seqwater's Working Capital Requirements (\$ million)

| <i>Working Capital Requirement</i> | <i>Approved Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|------------------------------------|----------------------------------|---------------------------------|-------------------------------------|-------------------------------------|
| Average Accounts Receivable | 86.9 | 83.9 | 88.7 | 86.5 |
| Average Accounts Payable | 21.1 | 20.7 | 22.8 | 22.9 |
| Average Debtor Days | 45 | 45 | 45 | 45 |
| Average Creditor Days | 30 | 30 | 30 | 30 |
| Critical Spares | 0.9 | - | 0.9 | 0.9 |
| Total Working Capital Requirement | 66.6 | 64.0 | 66.0 | 64.6 |
| Rate of Return (WACC) | 9.91% | 9.83% | 9.91% | 9.90% |
| Return on Working Capital | 6.6 | 6.3 | 6.2 | 6.4 |

Note: these figures may not add due to rounding.

4.2.10 Summary of Capital Charge

Draft Report

In the Draft Report, the Authority noted that the increase in Capital Charges in 2012-13 largely reflects the recent commissioning of drought assets Wyaralong Dam and the Hinze Dam Raising.

In its draft review of the 2012-13 GSC modelling, the Authority considered that it had a computational error relating to the timing of cash flows comprising the 2011-12 Capital Charge. The error was estimated to result in an under-statement of 2011-12 Capital Charges of \$7.3 million for the pre-merger Seqwater and \$4.2 million for the former WaterSecure.

In presenting revised 2011-12 Capital Charges, which incorporate estimated actual capital expenditure and costs of debt, the Authority's Draft Report included an allowance to correct for this perceived error.

Final Report

As noted in Chapter 3, the Authority has revisited the modelling approach to be adopted and considers the approach adopted in the 2011-12 Final Report is appropriate. The adjustment applied in the Draft Report is no longer relevant.

The revised Capital Charge is compared to the Draft Report Capital Charge in Table 4.32.

Table 4.32: Capital Charge Summary (\$ million)

| | <i>Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|-----------------------------------|-----------------------------|-------------------------------------|---|---|
| Return on Assets | 443.2 | 419.0 | 444.7 | 432.7 |
| <i>plus</i> Depreciation | 149.4 | 146.0 | 154.9 | 154.4 |
| <i>less</i> Asset Appreciation | -146.6 | -138.2 | -147.2 | -143.7 |
| <i>plus</i> Working Capital | 6.6 | 6.0 | 6.7 | 6.1 |
| <i>less</i> Historic Adjustment | - | - | -11.3 | -21.4 |
| Recommended Capital Charge | 452.3 | 432.9 | 447.3 | 428.1 |

Note: these figures may not add due to rounding.

4.3 Fixed Operating Charge

The Direction Notice requires that the Authority assess the prudence and efficiency of all fixed 2012-13 operating costs proposed by the GSPs. As documented in the 2011-12 Review Thresholds, the Authority has not made any adjustment for over or under-expenditure of Fixed Operating Charges in 2011-12.

4.3.1 Overview

Seqwater (2012a) has proposed fixed operating charges of \$235.6 million in 2012-13.

Comparison to 2011-12

Seqwater (2012a) submitted that 2012-13 fixed operating costs were forecast to increase from that approved for 2011-12 GSCs by \$14.7 million. Seqwater attributed the increases to:

- inflation, at an assumed rate of 2.5%;
- re-categorisation of former Allowable Costs and variable costs as a fixed operating expenditure; and
- step-change increases in costs that are largely outside of Seqwater's control.

Accounting for the above factors, Seqwater submitted that its proposed costs of \$235.6 million represented a 4.6% increase in real terms relative to estimated actual costs in 2011-12. Table 4.33 refers.

Table 4.33: Seqwater Proposed Operating Costs relative to 2011-12

| <i>Adjustments</i> | <i>Specific Item</i> | <i>\$ million</i> |
|---|--|--------------------|
| 2012-13 Proposed Fixed Operating Charge | | 235.6 |
| Less costs previously treated as allowable costs or variable costs, and now in fixed | QCA Levy | -1.4 |
| | Gold Coast Desalination Plant electricity costs now correctly re-classified as fixed | -1.2 |
| Less one-off cost increases outside Seqwater's control that are forecast for 2012-13 but not included in 2011-12 | State Government Waste Levy and additional levies for trade waste | -1.3 |
| | Implementing Flood Commission of Inquiry outcomes | -1.2 |
| | New assets (Wyaralong and Hinze dams) | -1.2 |
| Plus costs considered fixed in 2011-12 and treated as variable for 2012-13 | | +1.7 |
| Total adjustments | | -4.6 |
| 2012-13 Fixed Operating Costs (adjusted) | | 231.0 |
| 2011-12 Fixed Operating Costs (estimated actual, in 2012-13 dollars) | | 220.9 |
| Real increase in Fixed Operating Charge | | 10.1 (4.6%) |

Seqwater submitted that a real increase in costs of only 4.6% has been achieved despite increases in costs, cost inputs and new costs impositions. Examples include:

- (a) labour cost increases in accordance with the EBA and staff contracts (\$3.8 million);
- (b) increases to contractor rates for maintenance services (\$1.0 million)
- (c) increases to insurance premiums (\$1.8 million);
- (d) increasing costs for water quality monitoring and testing (\$1.0 million);
- (e) an increase in the minor works and renewals stemming from the 2011 flood event (\$4.2 million);
- (f) increasing costs associated with implementing a more robust environmental compliance framework (\$1.2 million);
- (g) additional asset management costs, largely driven by changes to the SOP (\$2.2 million); and
- (h) new initiatives to mitigate water quality risks in catchments (\$2.7 million).

Offsetting these cost increases are cost saving initiatives, including:

- (a) replacing staff contractors with full time employees (\$3.8 million); and
- (b) implementation of a handover strategy and close-out strategy in relation to WCRWS and GCDP (\$9.1 million).

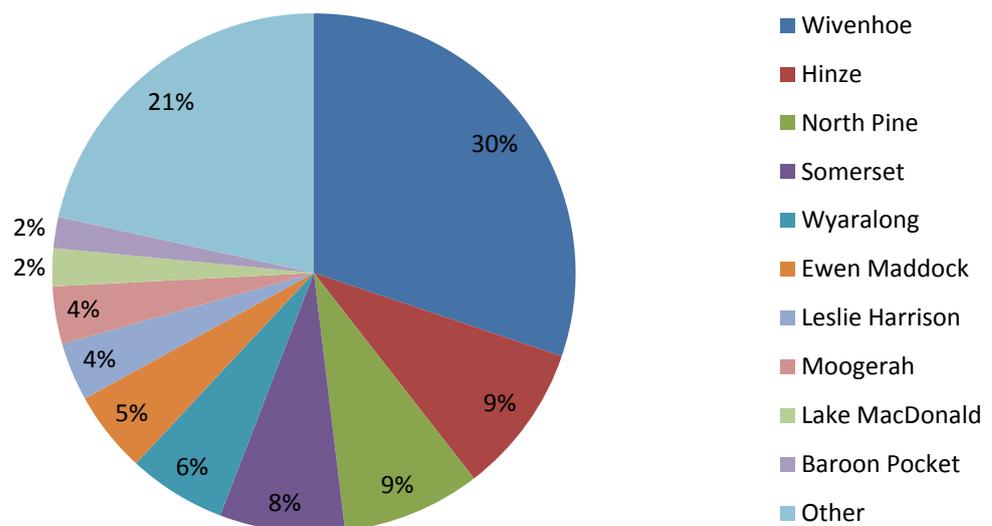
Seqwater submitted that the largest contribution to the increase in fixed operating costs was employee expenses, with an additional 62.5 FTEs budgeted for 2012-13. The basis for this increase is addressed in the review of subsequent costs items below. Seqwater noted that this cost increase has been moderated by a decline in contractor costs, which are being replaced by permanent employees.

Direct Dam Costs

Seqwater’s Submission

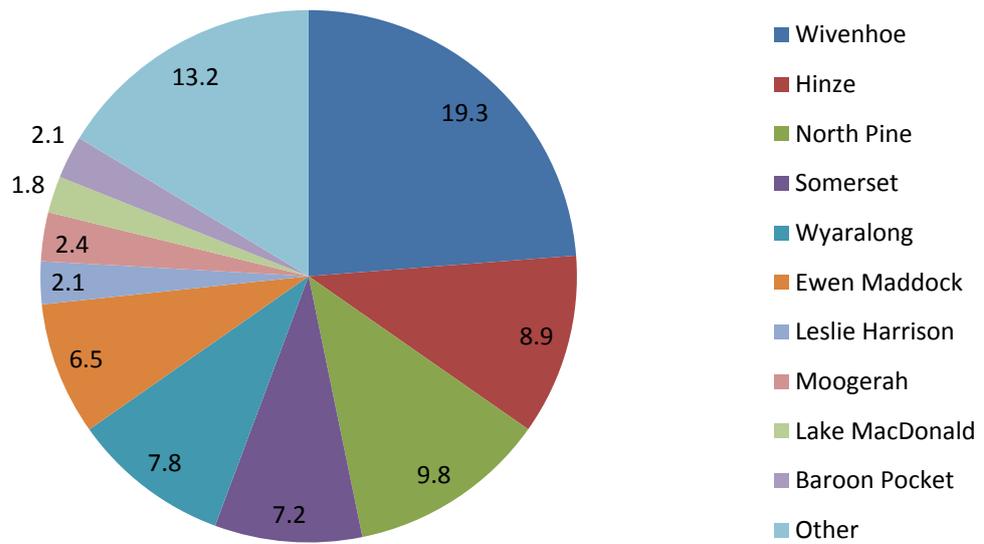
Seqwater (2012a) submitted that direct costs are those that can be allocated at an asset level. Seqwater submitted \$28.3 million of direct costs associated with its dams. Seqwater presented costs and FTEs for each of the 10 largest dams by costs, as well as a total of the remaining dams. Wivenhoe Dam is the largest dam by cost, comprising 30% of Seqwater’s total direct dam costs.

Figure 4.1: Direct Dam Costs by Dam



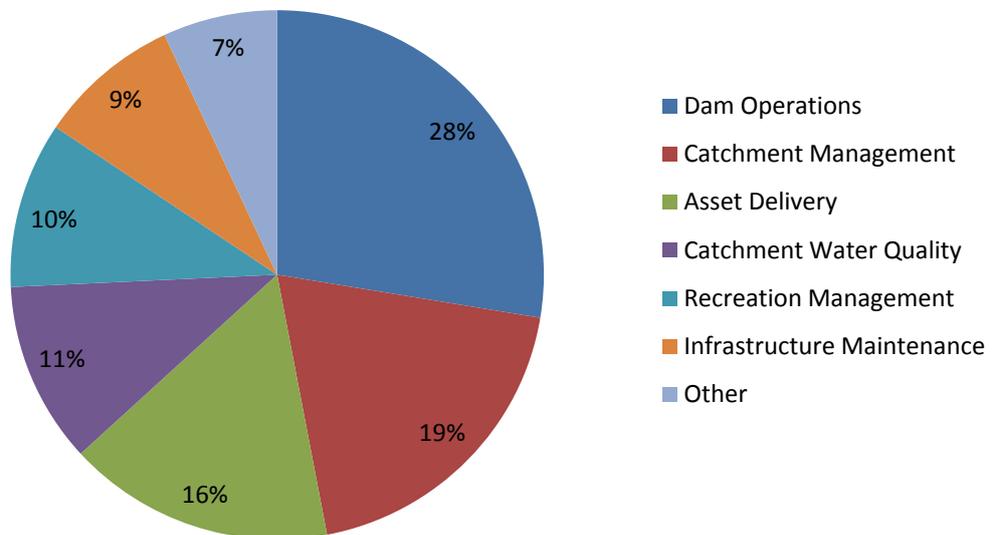
Seqwater employs 81 FTEs that are directly allocated to dam operations, 19.3 of which are allocated to Wivenhoe Dam.

Figure 4.2: Direct FTEs by Dam



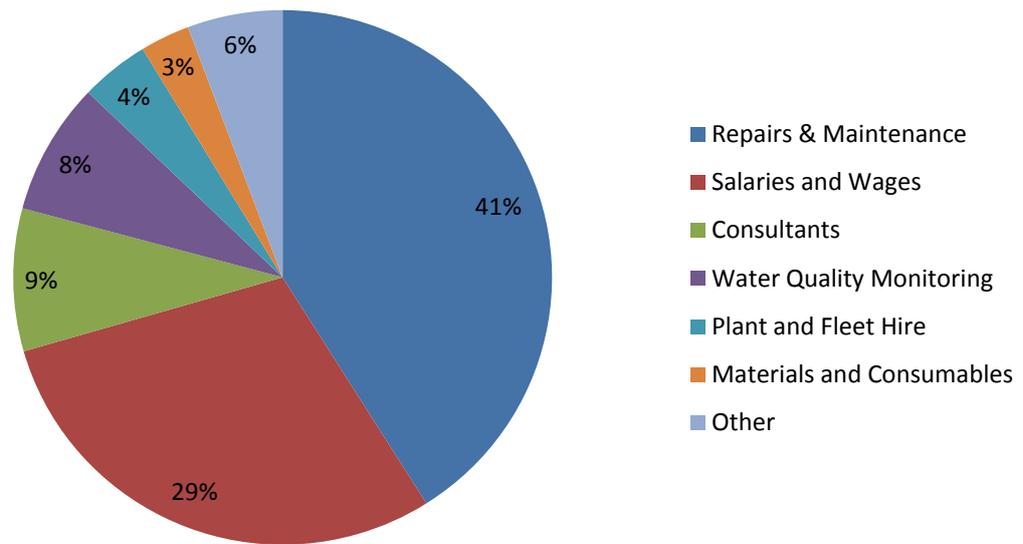
Seqwater categorised its fixed operating cost submission to the Authority by cost activity or function. This categorisation displays the purpose that the proposed expenditure is intended to achieve. Seqwater categorises almost 50% of direct dam costs as relating to either Dam Operations or Infrastructure Maintenance activities.

Figure 4.3: Dam costs by Activity



Seqwater provided additional detail of direct dam costs by cost type. Repairs and Maintenance costs are the largest cost category, followed by Salaries and Wages.

Figure 4.4: Dam Costs by Type

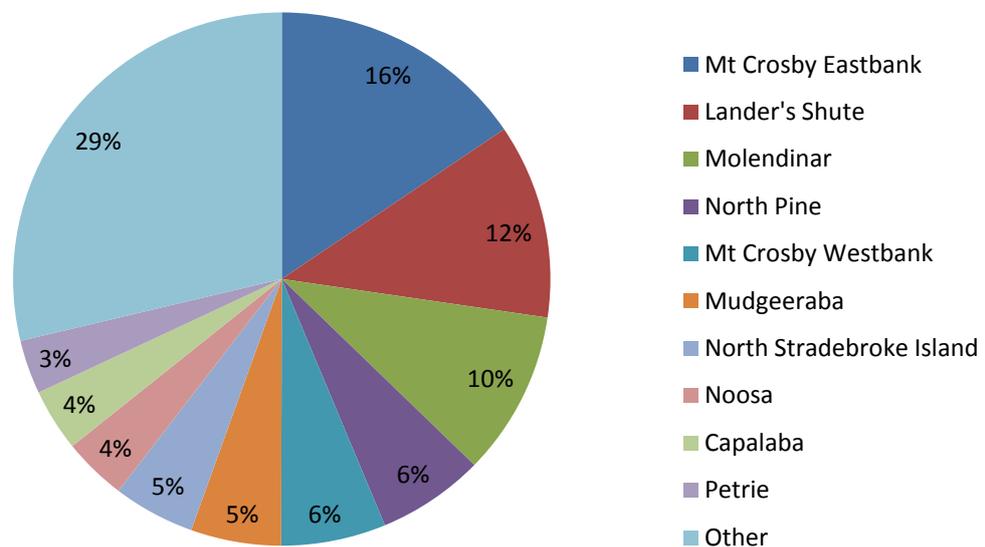


Direct Water Treatment Plant Costs

Seqwater's Submission

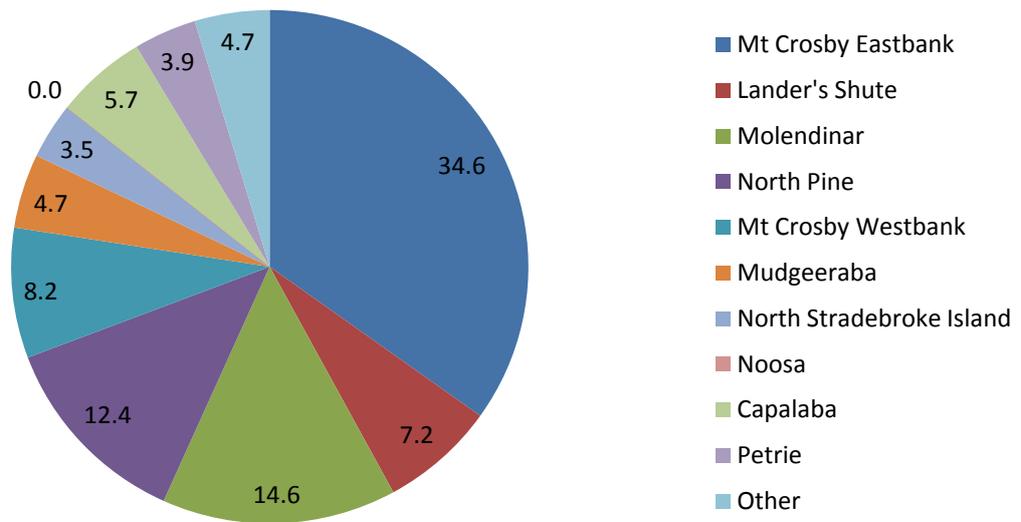
Seqwater (2012a) submitted \$48.7 million of direct costs associated with its WTPs. Seqwater presented costs and FTEs for each of the 10 largest WTPs by cost, as well as a total for the remaining WTPs.

Figure 4.5: Direct WTP Costs by WTP



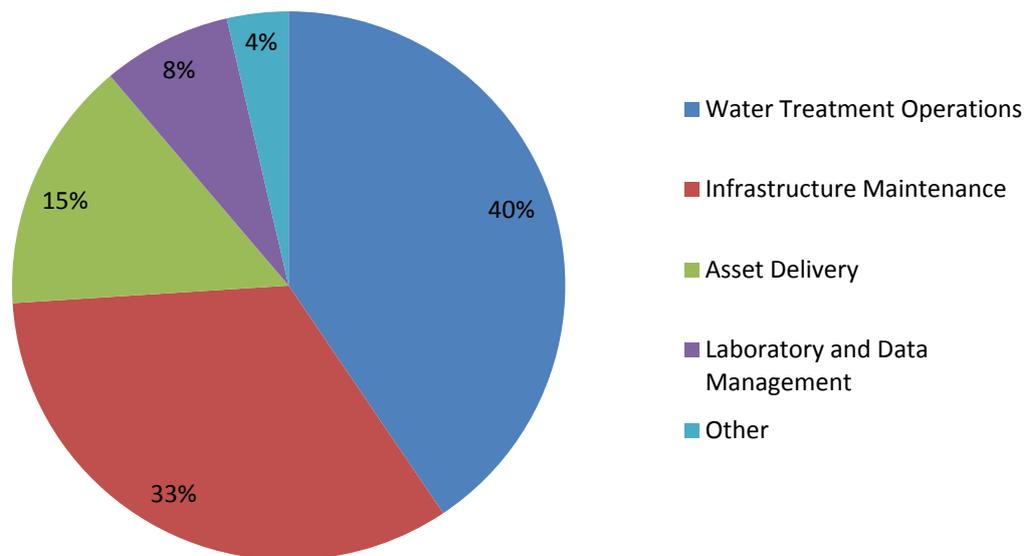
Seqwater provided information on the allocation of 99 FTEs that are directly attributed to WTPs. Mt Crosby Eastbank employs over one-third of all direct FTEs in the WTPs.

Figure 4.6: Direct FTEs by WTP

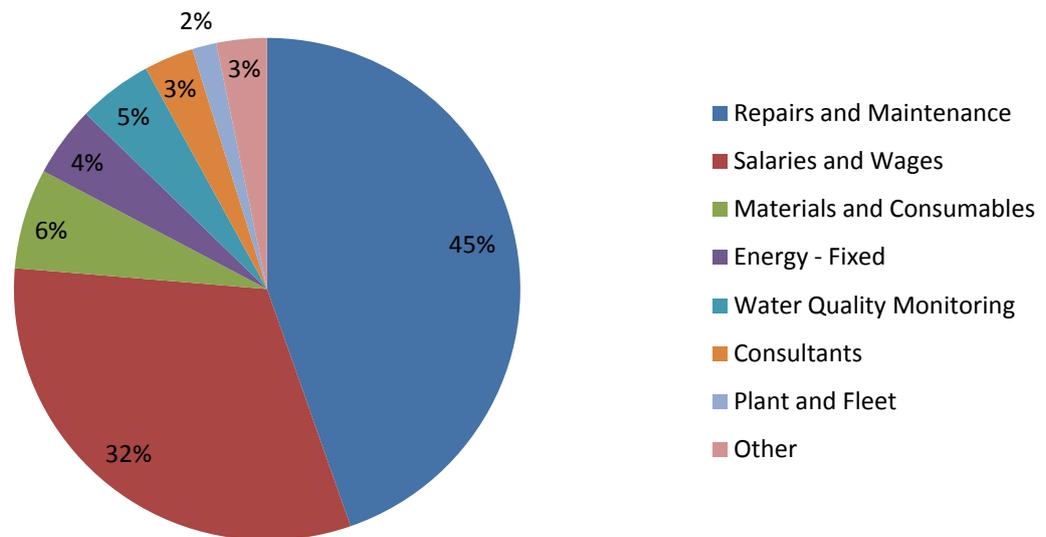


Seqwater also provided a breakdown of direct WTP costs by activity or function. Seqwater categorises almost three-quarters of direct WTP costs as either WTP Operations or Infrastructure Maintenance (Figure 4.7 below).

Figure 4.7: WTP Costs by Activity



Seqwater provided additional detail of direct WTP costs by cost type, of which, almost half is contributed by Repairs and Maintenance costs (Figure 4.8 below).

Figure 4.8: WTP Costs by Type

Direct Purified Recycled Water Costs

Seqwater incurs fixed operating costs relating to the operation of the WCRWS, which includes three AWTPs (Bundamba, Luggage Point and Gibson Island) and PRW network pipelines. The large majority of direct PRW costs are incurred by the scheme operator, Veolia. As a consequence, Seqwater's classification of costs by activity varies slightly from costs incurred directly by Seqwater. Over 95% of direct costs at the GCDP relate to operation of the plant. Forecast direct costs at Gibson Island AWTP are comparatively low, due to the fact that the plant is mothballed and not forecast to produce any water in 2012-13. Table 4.34 refers.

Table 4.34: PRW Costs by Activity (\$'000)

| | <i>Network</i> | <i>Bundamba</i> | <i>Luggage Point</i> | <i>Gibson Island</i> | <i>Total</i> |
|---------------------------|----------------|-----------------|----------------------|----------------------|---------------|
| Operational Integration | 7,153 | 6,305 | 5,933 | 1,910 | 21,301 |
| Engineering Support | - | 469 | 44 | 200 | 714 |
| Strategic Asset Readiness | - | 50 | 100 | 55 | 205 |
| Total | 7,153 | 6,825 | 6,077 | 2,165 | 22,219 |

Note: Totals may not sum due to rounding.

The costs of operating the WCRWS largely relate to employee expenses and repairs and maintenance. Seqwater also included a cost relating to the Operator Margin, which is the profit margin earned by Veolia in operating the WCRWS. Table 4.35 refers.

Table 4.35: PRW Costs by Type (\$'000)

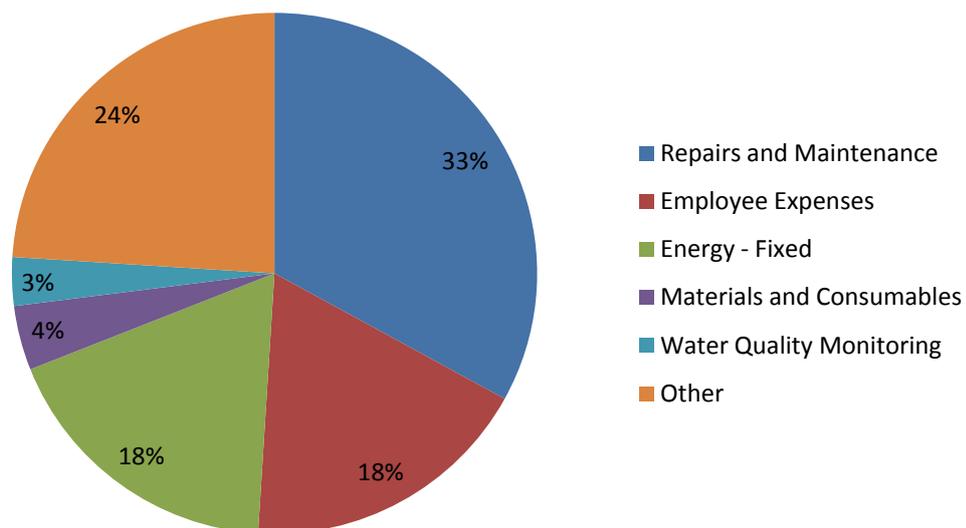
| | <i>Network</i> | <i>Bundamba</i> | <i>Luggage Point</i> | <i>Gibson Island</i> | <i>Total</i> |
|--------------------------|----------------|-----------------|----------------------|----------------------|---------------|
| Employee Expenses | 1,263 | 2,419 | 2,226 | 320 | 6,228 |
| Repairs & Maintenance | 2,997 | 1,279 | 1,365 | 464 | 6,104 |
| Water Quality Monitoring | 260 | 543 | 404 | 80 | 1,286 |
| Energy - Fixed | 480 | 90 | 45 | 348 | 963 |
| Consultants | - | 519 | 144 | 255 | 919 |
| Other | 2,153 | 1,974 | 1,893 | 699 | 6,719 |
| Total | 7,153 | 6,825 | 6,077 | 2,165 | 22,219 |

Note: Totals may not sum due to rounding.

Direct Desalination Costs

Seqwater (2012a) submitted forecast direct costs associated with the GCDP of \$15.9 million in 2012-13. Seqwater’s cost allocation by activity for the GCDP is not as detailed as for dams and WTPs, as the vast majority of direct costs associated with GCDP are incurred by the operator, Veolia. Seqwater provided direct desalination costs by type, over half of which relate to repairs and maintenance and employee expenses.

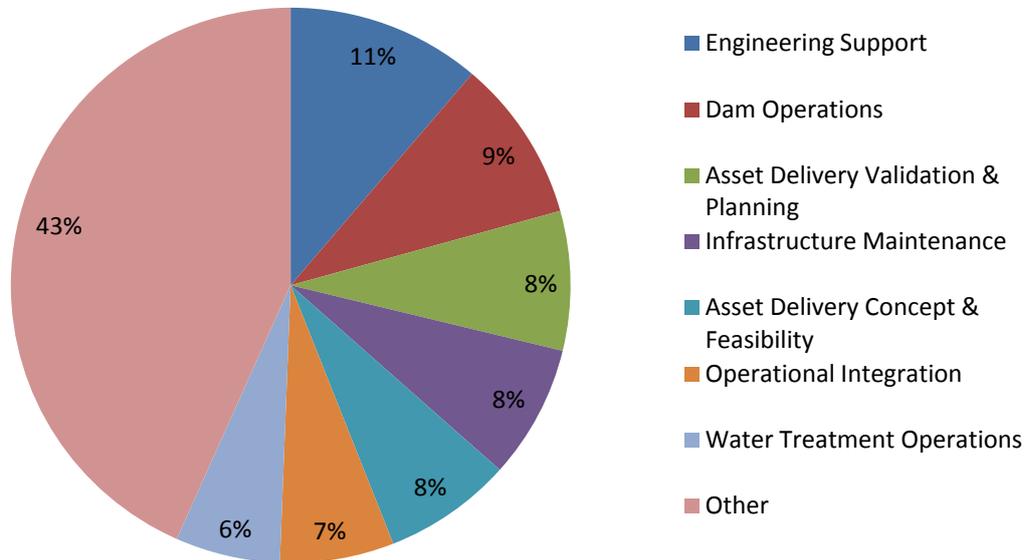
Figure 4.9: Desalination Costs by Type



Non-Direct Costs

Seqwater (2012a) submitted Non-Direct costs (that are asset related, but not directly allocated to an asset) of \$52.8 million in 2012-13. Significant cost activities include Engineering Support and various components of Asset Delivery.

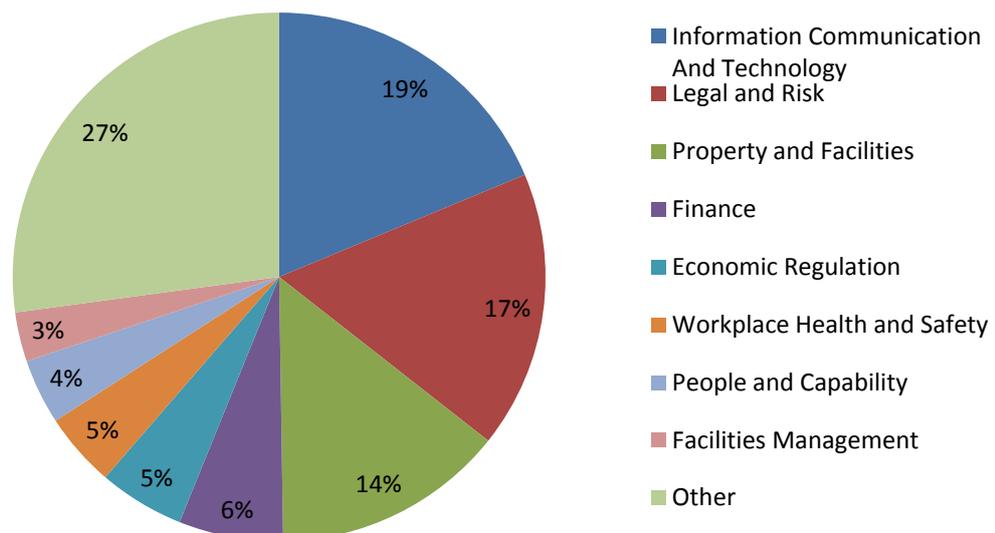
Figure 4.10: Non-Direct Costs by Activity



Corporate Overheads

Seqwater (2012a) submitted that it expects to incur corporate overheads of \$62.1 million in 2012-13, with the largest cost categories being Information Communication and Technology and Legal and Risk.

Figure 4.11: Corporate Overhead Costs by Activity



4.3.2 Prudency and Efficiency Review

The Authority engaged SKM to review the prudency and efficiency of Seqwater’s fixed operating costs.

For opex to be included the GSCs, it is required to be prudent (demonstrated need for the expenditure) and efficient (least cost and consistent with relevant benchmarks, having regard to prevailing market conditions, historical trends and the potential for efficiency gains or economies of scale).

SKM and the Authority sampled 12 fixed operating cost items for detailed review of prudence and efficiency. The sample accounted for 14% of Seqwater's proposed fixed operating costs.

Item 1: Wivenhoe Dam – Catchment Management

Seqwater's Submission

Seqwater included a 2012-13 forecast of \$746,000 for salary and wage costs (\$299,478) and repairs and maintenance (\$446,350) relating to catchment management at Wivenhoe Dam.

SKM's Review

SKM noted that the salary and wage budget for the Wivenhoe Dam included two FTE staff associated with Catchment Management and Maintenance while the cost for Repairs and Maintenance was contracted to external parties.

Table 4.36: Catchment Management Costs at Wivenhoe Dam (\$'000)

| <i>Cost</i> | <i>2011-12</i> | <i>2012-13</i> | <i>% change</i> |
|-----------------------|----------------|----------------|-----------------|
| Salaries and Wages | 61 | 299 | +387% |
| Repairs & Maintenance | 420 | 446 | +6% |

Prudence Review

SKM noted that catchment management was a necessary function of water storage management and Seqwater must comply with legislative obligations which would not be possible without effective catchment management. SKM also noted that the Direction Notice requires the Authority to accept the current scope of catchment management activities as prudent.

SKM therefore accepted that this expenditure was prudent.

Efficiency Review

SKM noted that the forecast 2012-13 expenditure for Salaries and Wages (\$299,500) was a significant increase from that incurred in 2011-12 when \$61,500 was budgeted. SKM reported that this large increase was attributable to an improved cost allocation process of labour resources that was implemented during 2011-12. As a result more allocation was made directly to the assets rather than to the overhead costs.

SKM reported that the costs for Repairs and Maintenance contracted to external parties increased slightly from \$420,000 to \$446,000, an increase of about 6%. SKM stated that most of the increase was due simply to the indexation of existing contracts. However, some contracts were due for renewal and Seqwater had allowed a larger increase in these new contracts to reflect market conditions. SKM considered this a reasonable expectation.

SKM noted that a panel of service providers was in place for Seqwater repairs and maintenance services, and the 2012-13 budget was built up based on the work order history.

SKM considered that the costs were in accordance with Seqwater's procurement policies and procedures. SKM considered that the salary and wage costs, which relate to 2 FTEs that service a catchment area of 7,020 km², appeared reasonable.

SKM concluded that this expenditure was efficient.

No submissions on this item were received in response to the Draft Report.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

Item 2: Hinze Dam – Catchment Management

Seqwater's Submission

Seqwater (2012a) forecast \$490,717 for catchment management expenditure at Hinze Dam in 2012-13. Table 4.37 provides a breakdown of the budgeted costs.

Table 4.37: Catchment Management Cost Breakdown (\$)

| <i>Description</i> | <i>Cost</i> |
|-------------------------------------|----------------|
| Fire Management | 30,000 |
| Lyons Property Maintenance | 30,000 |
| Compensatory Habitat Maintenance | 239,000 |
| Erosion Control Works | 10,000 |
| Land Management for Hinze Catchment | 55,000 |
| Pest Management | 10,000 |
| Terrestrial Weed Management | 117,000 |
| Total | 490,000 |

Note: Totals may not sum due to rounding.

SKM's Review

SKM noted that this cost item increased by 126% relative to 2011-12.

Prudency Review

SKM noted that the Ministerial Direction requires the Authority to accept the current scope of catchment management activities as prudent.

SKM therefore accepted this expenditure as prudent.

Efficiency Review

SKM noted that Seqwater ascribed the increase in cost to additional requirements of compensatory habitat maintenance. SKM reported that these new requirements were imposed by the Coordinator General, and therefore accepted the increase in activities.

SKM noted that 100% of the proposed tasks were to be performed by external parties, and that the Panel Contract under which external parties were engaged was let in accordance with Seqwater's procurement policies and procedures.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 3: North Pine Dam – Employee Costs

Seqwater's Submission

Seqwater (2012a) forecast \$342,000 of employee costs at North Pine Dam in 2012-13, based on 3.4 FTE employees.

SKM's Review

SKM noted that the employee costs relate to three FTEs at North Pine Dam (including a trainee) and 0.4 of an FTE relating to a Coordinator who supervised all Dams in Seqwater's North District. SKM noted that the employee costs included wages and salaries as well as on-costs such as superannuation, leave, overtime, etc.

Table 4.38: North Pine Dam Employee Costs (\$)

| <i>Cost</i> | <i>2011-12</i> | <i>2012-13</i> | <i>% change</i> |
|---------------------|----------------|----------------|-----------------|
| Salaries and Wages | 267,201 | 339,771 | |
| Protective Items | - | 2,000 | |
| Fringe Benefits Tax | 150 | - | |
| Uniforms | 1,200 | - | |
| Total | 268,551 | 341,771 | +27.3% |

Note: Totals may not sum due to rounding.

Prudency Review

SKM noted that North Pine Dam required daily inspections and one full-time dam operator on call at all times. Hence two staff was the minimum needed to meet this requirement. SKM also noted that North Pine Dam was classified as an extreme hazard dam with gates and a regulated Flood Mitigation Manual. SKM considered that this was the reason for the high allocation of the Dam Coordinator's time (0.4 FTE) to this dam.

SKM advised that Seqwater had a program to provide training for trainee dam operators with a view to long term employment. Seqwater indicated to SKM that the age profile among Seqwater dam operators was very high and the trainee program of one trainee operator per District was intended to provide a succession plan.

SKM concluded that this expenditure was prudent.

Efficiency Review

SKM noted that Seqwater provided all resources for the operation of North Pine Dam internally, rather than using contractors. SKM considered that utilising contractors to operate dams that have significant risk issues relating to dam safety, flood operations and the provision of water supply was not appropriate.

SKM noted that about half of the 27% increase from the 2011-12 level was due to the employment of the trainee (\$33,400) as Seqwater implemented its trainee program as part of its succession planning. Another \$16,000 increase was due to an increase in the allocation of the Dam Operations Coordinator's time from 30% in 2011-12 to 40% to reflect the increase in time required for spillway management and monitoring given the high risk nature of the North Pine Dam where a number of events recently occurred where water levels breached the spillway gate mechanism which was located above the top of the gate.

The remaining increase was due to the expected increase in overtime due to flooding. SKM noted that the previous 2011-12 budget was based on dry conditions where overtime was low. With the end of the drought, and the return of floods, increased overtime was expected to be required.

SKM also noted that resources employed at North Pine Dam were hired through normal recruitment processes including advertising and interviews. SKM considered that the employment cost details provided to SKM appeared to be reasonable.

During flood events, North Pine Dam requires a team of six to eight operators, who were sourced from standby operators seconded from other areas. SKM noted that this reduced the number of full time staff required at the dam to provide for ad hoc flood duty.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 4: Gold Coast Desalination Plant – Water Quality Monitoring

Seqwater's Submission

Seqwater (2012a) forecast \$520,030 for water quality monitoring at the GCDP in 2012-13, an increase of 4% relative to 2011-12. Table 4.42 provides a breakdown of the budgeted costs.

SKM's Review

SKM noted that although the GCDP is operated by Veolia, more of the Water Quality Monitoring costs are outsourced to other providers, including:

- (a) routine testing of feed water (sea water) and water at various stages of production undertaken by Brisbane Water Technologies; and
- (b) testing required for environmental monitoring undertaken with FRC Environmental.

Prudency Review

Seqwater stated in the development approval for the GCDP that it required a testing regime for the following streams:

- (a) water discharged to the environment;
- (b) waters in the receiving environment;
- (c) groundwater;
- (d) landfill gas; and
- (e) marine ecosystem monitoring.

Seqwater submitted that WGM's Operating Strategy required Seqwater to be able to deliver water within 24 hours during hot standby mode and that certain water quality tests required three days turnaround. Seqwater therefore argued that Seqwater was not afforded a reduced testing regime.

Seqwater submitted to SKM that testing was required under the SEQ Water Grid Quality Management Plan and Seqwater's approved Drinking Water Quality Management Plan (Seqwater 2010).

SKM agreed that continued testing was required under Hot Standby mode and that water quality monitoring was a legislative requirement.

SKM concluded that this expenditure was prudent.

Efficiency Review

SKM noted that Seqwater differentiated between the testing required during hot standby mode and the testing required during normal operations. SKM provided a detailed cost breakdown (Table 4.39).

Table 4.39: Water Quality Monitoring Cost Breakdown (\$)

| <i>Description</i> | <i>Cost</i> |
|---|----------------|
| Hot standby external analyses – Brisbane Water Laboratories | 100,205 |
| External analyses - tanks | 53,354 |
| Environmental analyses | 319,741 |
| Hot standby internal analyses | 34,534 |
| Internal analyses – Normal operations (6 weeks of 2012-13) | 12,196 |
| Total | 520,030 |

Note: Totals may not sum due to rounding.

Seqwater provided SKM with a full list of all the types of tests that were undertaken and the number of tests per year required. SKM found that the cost per test varied considerably. However, SKM considered that in light of the contract between Seqwater and GCDP Alliance and Seqwater's scrutiny of the procurement process of Veolia, the overall cost of the testing was efficient.

However, SKM noted that a longer lead-in time for production from the GCDP during Hot Standby could potentially result in cost efficiencies relating to water quality monitoring.

SKM concluded this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 5: Gold Coast Desalination Plant – Repairs and Maintenance

Seqwater's Submission

Seqwater (2012a) forecast \$5,167,444 for repairs and maintenance at the GCDP for 2012-13.

SKM's Review

Table 4.40: Gold Coast Desalination Plant Repairs and Maintenance (\$)

| <i>Cost</i> | <i>2011-12</i> | <i>2012-13</i> | <i>% change</i> |
|-------------------------|----------------|----------------|-----------------|
| Repairs and Maintenance | 4,655 | 5,167 | +11.0% |

Prudency Review

SKM noted that the GCDP was to operate in Hot Standby Mode for most of 2012-13. Under Hot Standby Mode, Seqwater must be able to deliver water to the water grid from the plant within 24 hours of a request. SKM considered that Seqwater must maintain the plant in a state where it can produce water at any time to meet its Grid Contract obligations.

SKM concluded that this expenditure was prudent.

Efficiency Review

In its review of 2011-12 GSCs, SKM examined the scope of work and costs for repairs and maintenance at the GCDP and concluded that these costs were prudent and efficient.

SKM noted that the schedule of work and assumed hours had not changed since this review, and remained based on the schedule developed in 2010-11. However the maintenance requirements varied year to year depending on scheduled refurbishments in line with manufacturers' recommendations. The changes to the budget from last year can be explained by:

- (a) a 3.6% increase in unit rates;
- (b) an increase in the preventive maintenance budget due to scheduled pump overhauls; and
- (c) a corresponding increase in the corrective maintenance budget which was set at 13% of the preventive maintenance budget.

These increases were partly offset by:

- (a) the removal of the cost centre referred to as R & M Asset Replacement – Mechanical; and
- (b) a reduction in the Spare Parts budget.

SKM considered that comparison with Wage Price Index and Consumer Price Index increases indicated that the rates negotiated with Veolia were reasonable, and the original scope of work and costs for repairs and maintenance for 2011-12 were assessed as efficient.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 6: Western Corridor Pipeline Network – Repairs and Maintenance

Seqwater's Submission

Seqwater (2012a) forecast \$2,997,198 for repairs and maintenance of the pipeline network in 2012-13.

SKM's Review

SKM found that there was a 79% increase in forecast expenditure between 2011-12 and 2012-13. SKM reported that this was mainly due to \$726,000 worth of pipeline easement vegetation control being inadvertently excluded from last year's submission. If this had been included correctly in 2011-12, the increase between years would be 36%.

The remainder of the increase was due to:

- (a) an increase in unit rates across all sections as a result of negotiations with Veolia (3.6%);
- (b) an increase in preventive maintenance budget due to structural inspections and tank cleaning in accordance with maintenance schedules (\$241,000);
- (c) new provisional allowances in the corrective maintenance budget for pipeline failure and swale repair following heavy rain events (\$200,000); and
- (d) an increase in the Spare Parts budget due to a supplier change and need for electrofusion couplings (\$40,000).

Prudency Review

SKM noted that the WCRWS was supplying industrial users such as power stations, and there was a possibility of purified recycled water being delivered to the Wivenhoe Dam to augment drinking water supplies in the case of a drought.

SKM considered that expenditure on repairing and maintaining the Pipeline Network was required to enable Seqwater to meet its obligations under the Grid Contract.

SKM concluded that this expenditure was prudent.

Efficiency Review

During the 2011-12 investigation, SKM examined the scope of work and costs for repairs and maintenance of the Pipeline Network, and concluded that these costs were prudent and efficient. Seqwater's submission stated that the schedule of work and assumed hours had not changed since this review.

SKM established that the reason for the large increase in cost between 2011-12 and 2012-13 was that a large portion of costs for vegetation control of pipeline easements was not included in the 2011-12 submission. This accounted for around half of the cost increase between years.

In relation to unit rates, SKM noted that the Wage Price Index rose by an average of 3.7% between December quarter 2010 and December quarter 2011, and the Consumer Price Index rose by 3% over the same period. SKM considered that this indicated that the unit rate increase of 3.6% for 2012-13 as negotiated with Veolia was reasonable.

SKM noted that the new provisional allowances in the corrective maintenance budget for pipeline failure and swale repair formed almost 40% of the total corrective maintenance budget. SKM recommended that an appropriate proportion was 10-15%. On this basis, SKM recommended that the total efficient cost for the provisional allowances was \$75,600, calculated as 15% of the total corrective maintenance budget of \$504,000. This equated to a reduction to Seqwater proposed expenditure of \$124,400.

SKM therefore concluded that this expenditure was efficient, with the exception of \$124,400 relating to provisional allowances for breakdowns.

Authority's Analysis

The Authority accepts SKM's recommendations and has included a revised efficient cost of \$2,872,798 in its recommended GSCs.

No further submissions were received on this item following the Draft Report.

Item 7: Bundamba AWTP – Employee Costs

Seqwater's Submission

Seqwater (2012a) forecast \$2.419 million of employee costs at Bundamba AWTP in 2012-13.

SKM's Review

SKM indicated that operation of the Western Corridor Recycled Water Scheme (of which Bundamba AWTP is a part) was outsourced to Veolia Water Australia (Veolia) under an operations and maintenance agreement. SKM noted that the employee costs at Bundamba AWTP related to Veolia's labour costs. These labour costs were for plant operations, including maintenance tasks that were not outsourced to specialist third party maintenance contractors.

Table 4.41: Bundamba AWTP Employee Costs (\$)

| <i>Cost</i> | <i>2011-12</i> | <i>2012-13</i> | <i>% change</i> |
|-------------------|----------------|----------------|-----------------|
| Employee Expenses | 2,053,999 | 2,418,984 | +17.8% |

Prudency Review

SKM noted that labour was a necessary input to the operation of the Bundamba AWTP, which was required under the Grid Contract. The WGM's Annual Operation Plan forecast demand of 4,380 ML for 2012-13 and SKM indicated that labour resources were required to operate and maintain the plant.

SKM concluded that this expenditure was prudent.

Efficiency Review

SKM noted that the hourly rates were based on the rates that applied in 2011-12, indexed at 3.5%. SKM reported that this rate of increase was subject to negotiation with Veolia, and was the same rate as Seqwater's Enterprise Bargaining Agreement. Employee costs were derived from an agreed schedule of Veolia employees, their hourly rates, and the total number hours of work for the year. These included four hours overtime per operator per month.

SKM noted that Seqwater required Veolia to model its labour requirements for the various tasks, representing good practice given the information that is available. Seqwater undertakes analysis of Veolia's staffing resources as part of the budget review with Veolia. The analysis includes:

- (a) a comparison of the FTE numbers proposed by Veolia against the actual number employed in 2010-11 and 2011-12; and
- (b) analysis of employee costs, hourly rates and FTE numbers.

SKM examined Seqwater's process and considered it to be adequate. SKM noted that due to constraints of the contractual arrangement with Veolia, there were no other alternative methods for delivering this service in 2012-13.

SKM advised that, for 2012-13, the FTEs proposed for operation of the WCRWS (of which Bundamba AWTP is a part) totalled 66.5, compared to 67.8 in 2011-12 and 78 in 2010-11.

According to SKM, Seqwater did not explain why the employee cost allocated to Bundamba increased by almost 18% in 2012-13, while the number of FTEs employed by the WCRWS in total reduced by 1.9% from 67.8 in 2011-12 to 66.5 in 2012-13.

Seqwater indicated to SKM that 2012-13 included a provision for an increase in the number of FTEs for Project Management work, to reflect the proposed program of capital work. However, as this increase was directly related to the capital works program, SKM considered that there should be no impact on the operating expenditure and employee cost at Bundamba AWTP.

In the absence of additional information explaining the cost increase, SKM concluded that the cost increase was not justified. Instead, SKM recommended an efficient amount of \$2,085,127 for 2012-13. SKM based this amount on a 3.5% increase in hourly rates and a 1.9% decrease in the required number of FTEs, relative to 2011-12 costs. The net effect was an increase of 1.5%.

Authority's Analysis

The Authority accepted SKM's conclusion that this expenditure was prudent but not efficient, on the grounds that insufficient information is available to assess all the cost

components, and has included an amount of \$2,085,127 in its recommended GSCs, 13.8% less than proposed by Seqwater.

Seqwater's Submission on the Draft Report

Seqwater (2012b) provided additional information in relation to the forecast increase in Bundamba AWTP labour costs for 2012-13. The information provided included:

- (a) conversion of some consulting roles into FTE's for 2012-13 resulting in a transfer of budgeted costs from the consulting budget to the labour cost budget;
- (b) transfer of some operations management functions from the WCRWS office to the Bundamba AWTP (increasing the Bundamba AWTP labour budget for 2012-13); and
- (c) a reduction of maintenance costs due to less reliance on external contractors as compared to 2011-12, but with an associated increase to the Bundamba AWTP labour budget for 2012-13.

SKM's Review

SKM examined the budgets for 2011-12 and 2012-13 and confirmed expenditure reductions for both consultants and strategic asset maintenance for Bundamba AWTP for 2012-13. SKM noted that the identified reductions in maintenance and consultants were well in excess of any increase in employee expenses.

SKM also analysed the estimated hours for personnel recorded under Employee Costs in the budgets. SKM found that some of the employee hours that were formerly recorded under 'Scheme Wide Allocations' in the 2011-12 budget have been included directly within the Bundamba AWTP budget in 2012-13.

SKM noted that the 17.8% increase in Bundamba AWTP Employee expenses was offset by a 42.3% decrease in Scheme Wide Employee Expenses associated with Bundamba AWTP.

Given the lack of published benchmarking data for staffing levels of advanced water treatment plants, SKM stated that no firm view can be made regarding the reasonableness of staffing at Bundamba AWTP. However, SKM compared like for like Employee Expenses in the 2011-12 and 2012-13 budgets and noted an allowance for an annual increase in wage and salaries of 3.5% is in line with current industry market conditions.

Given the overall reduction in the operation of the Bundamba AWTP, SKM concluded that the employee expenses are efficient.

Authority's Analysis

The Authority accepts SKM's findings that this expenditure is prudent and efficient and has included the cost of \$2,418,984 as originally proposed by Seqwater.

Item 8: North Pine WTP – Planned Infrastructure Maintenance

Seqwater's Submission

Seqwater (2012a) forecast \$627,535 for planned infrastructure maintenance at North Pine WTP in 2012-13, a 7% increase relative to 2011-12. Table 4.42 provides a breakdown of the budgeted costs.

Table 4.42: Planned Infrastructure Maintenance – Cost Breakdown (\$)

| <i>Description</i> | <i>Cost</i> |
|-------------------------|----------------|
| Salaries and Wages | 191,813 |
| Repairs and Maintenance | 392,150 |
| Consumables | 43,572 |
| Total | 627,535 |

Seqwater submitted that its asset maintenance program was influenced by having only piecemeal asset history for assets transferred to Seqwater in 2008.

SKM's Review

Prudency Review

SKM considered that should planned maintenance not be performed the operations of the infrastructure would deteriorate to a point where Seqwater will no longer be able to fulfil its regulatory requirements.

SKM concluded that this expenditure was prudent.

Efficiency Review

SKM noted that the staff costs related to Planned Infrastructure Maintenance were based on an allocation of six FTEs split three ways between scheduled maintenance, planned maintenance and reactive maintenance. SKM considered the staff allocation and roles to be appropriate for a WTP of this size, but expected the amount allocated to planned maintenance to decrease as Seqwater develops a better understanding of its assets.

SKM noted that Seqwater included a 10% increase for the repairs and maintenance component due to an expected increase in Panel of Providers price schedules which is being renewed in July 2012. SKM considered it prudent to allow for additional increases in light of uncertainty and an expected change in market conditions.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 9: Mt Crosby Westbank WTP – Scheduled Infrastructure Maintenance

Seqwater's Submission

Seqwater (2012a) forecast \$508,280 for scheduled infrastructure maintenance at Mt Crosby Westbank WTP in 2012-13, a 10% increase relative to 2011-12. Table 4.43 provides a breakdown of the budgeted costs.

Table 4.43: Planned Infrastructure Maintenance Cost Breakdown (\$)

| <i>Description</i> | <i>Cost</i> |
|-------------------------|----------------|
| Repairs and Maintenance | 457,452 |
| Consumables | 50,828 |
| Total | 508,280 |

*SKM's Review**Prudency Review*

Seqwater indicated that the scheduled maintenance tasks identified are time based and were determined by:

- (a) statutory obligations (e.g. fire system testing) or industry standards (e.g. voltage tests for some electrical items);
- (b) the maintenance requirements that were specified by the equipment manufacturer; and
- (c) in the cases where none of the above was applicable the Strategic Maintenance Team relied on the experience and knowledge of the maintenance staff.

SKM considered that should scheduled maintenance not be performed the operations of the infrastructure will deteriorate to a point where Seqwater will no longer be able to fulfil its regulatory requirements.

SKM concluded that this expenditure was prudent.

Efficiency Review

Seqwater advised SKM that most maintenance tasks were outsourced to some 49 contractors (drawn from a panel of providers) performing maintenance services full time at some sites, and other contractors employed on an as-needs basis depending on workloads.

SKM noted that Seqwater included a 10% cost increase due to an expected increase in Panel of Providers price schedules which is being renewed in July 2012. SKM considered it prudent to allow for additional increases in light of uncertainty and an expected change in market conditions.

SKM noted that although no allowance was made for internal staff to manage contractors, Seqwater advised that a labour budget was allocated to Mt Crosby Eastbank WTP which covered nearby asset locations including Mt Crosby Westbank WTP.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 10: Molendinar WTP – Repairs and Maintenance

Seqwater's Submission

Seqwater (2012a) forecast \$1,288,530 for repairs and maintenance at Molendinar WTP in 2012-13. Seqwater submitted that a large component of the cost associated with this item was related to the removal and disposal of sludge from the clarifiers. At present the Molendinar WTP discharges the sludge from the clarifiers into an Allconnex owned and operated waste pipeline. Table 4.44 refers.

Table 4.44: Repairs and Maintenance cost breakdown (\$)

| <i>Description</i> | <i>Cost</i> |
|---|------------------|
| Sludge Removal (Allconnex Charge) | 1,263,530 |
| Garbage Pick-up | 1,500 |
| Annual Site Clean | 500 |
| Contingency for Clean-up of Environmental Spill | 23,000 |
| Total | 1,288,530 |

SKM's Review

SKM noted that due to an increased level of cost reporting in 2012-13, this cost item could not be directly compared to 2011-12.

Prudency Review

SKM considered that for the effective operation of a WTP it was a requirement that the sludge be removed at regular intervals.

SKM concluded that this expenditure was prudent.

Efficiency Review

SKM noted that Seqwater's proposed sludge removal costs included a contingency of \$23,000 for the event of an environmental spill based on experience and recent history, including an alum incident in 2011-12. SKM considered that this was efficient in areas that have a high concentration of chemicals within a confined area.

SKM noted that the amount that Allconnex charges to its customers was subject to regulation by the Authority.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient. However, as noted in section 4.2.4 below, the Authority has recommended that sludge disposal costs be included as a variable cost, rather than the fixed operating cost submitted by Seqwater. The Authority has therefore accepted a fixed operating cost relating to repairs and maintenance totalling \$25,000 and transferred the sludge disposal component (\$1,263,530) to variable costs.

No submissions on this item were received in response to the Draft Report.

Item 11: People and Culture Costs (HR costs)

Seqwater's Submission

Seqwater (2012a) forecast costs of \$4.35 million related to its People and Culture team in 2012-13. Seqwater submitted that the People and Culture team was responsible for designing and delivering the services and programs to enhance the availability and capability of its human resources to deliver the strategic and operational objectives of the business.

SKM's Review

SKM noted that Seqwater has proposed a 13% increase relative to 2011-12.

Table 4.45: Seqwater's proposed People and Culture Costs (\$'000)

| <i>Cost</i> | <i>2011-12</i> | <i>2012-13</i> | <i>% change</i> |
|-----------------------------|----------------|----------------|-----------------|
| Salaries and Wages | 1,392 | 1,477 | +6% |
| Recruitment Fees | 198 | 460 | +132% |
| Training | 1,720 | 1,870 | +9% |
| Other Supplies and Services | 540 | 543 | +1% |
| Total | 3,850 | 4,350 | +13% |

Prudency Review

SKM noted that, as with most large organisations, human resource employees were required to design and deliver services and programs to enhance resource availability and capability to deliver the strategic and operational objectives of the business.

SKM reported that the role of People and Culture was to ensure the availability of capable staff for all areas of the organisation to meet its operating and strategic roles. It required a variety of recruitment strategies to be engaged in order to attract the most suitable candidate. SKM considered that while this area was not a core function of Seqwater, it was a required support function.

SKM concluded that this expenditure was prudent.

Efficiency Review – Salaries and Wages

SKM noted that salaries and wages were calculated based on previous year's costs, and related to 12.6 FTEs. The forecast costs included a 5% increase for employees on common law contracts which also had a 10% bonus component. SKM reported that costs associated with employees on Enterprise Bargaining Agreements had a 3.5% increase for the full year and a 3% increase based on the employee's anniversary date. SKM considered that the 6% increase in costs was above the 3.5% annual pay increase based on the Enterprise Bargaining Agreement. However, after taking into consideration performance based increases beyond that stipulated by the Enterprise Bargaining Agreement, SKM concluded that the increase in salaries and wages was not unreasonable.

SKM concluded that this expenditure was efficient.

Efficiency Review – Recruitment Fees

SKM noted that Seqwater expected to require recruitment for 121 permanent roles in 2012-13. SKM reported that most of the vacancies will be advertised externally and recruitment agencies will be engaged for a number of specialist roles which have proven hard to fill. Seqwater assumed that 22 roles will need to be managed by recruitment agencies which will incur a placement fee of between 12% and 20% of the total salary package at a total cost of \$425,760. In addition, advertising costs for recruitment that does not use external consultants were expected to cost \$34,371.

Seqwater indicated that the 132% increase in recruitment fees relative to 2011-12 reflected the centralisation of all recruitment costs following merger with WaterSecure.

SKM noted that over 90% of the budgeted cost was the placement fee for 22 roles that required assistance from recruitment agencies at a cost of almost \$20,000 per FTE. SKM noted that recruiting 99 FTEs using internal resources was expected to cost less than \$35,000, a cost of about \$350 per FTE. SKM considered that, while there may be an argument for using recruitment agencies for some difficult to fill vacancies, it expected that recruitment agencies be engaged to identify senior management/staff at Senior Manager and above level. SKM recommended that this related to six, rather than 22 positions, with a resulting \$195,600 decline in the forecast recruitment fee budget.

On this basis, SKM recommended that Seqwater's proposed Recruitment Fees were not efficient, and considered that a value of \$264,400 was a more appropriate level of expenditure.

Efficiency Review - Training

SKM noted that Seqwater expected to use external providers to develop and run the training programs required as Seqwater was not a registered training organisation. SKM reported that the engagement of services will be in accordance with Seqwater's procurement processes. SKM noted that the budget for training was expected to increase by 8.7% from the 2011-12 level. SKM considered that this increase can be explained by the additional Microsoft Application Training cost of \$110,000 due to be undertaken in 2012-13. After accounting for this cost, the budgeted increase was within the expected rate of inflation.

SKM concluded that this expenditure was efficient.

Efficiency Review - Other Supplies and Services

SKM noted that all the work in this area will be completed by various specialist external parties. Due to the specialist nature of the services required and the volume of work, Seqwater stated that it was not feasible to complete using in-house resources. SKM noted that this cost item was expected to increase by 0.5% relative to 2011-12.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepted SKM's conclusions that all components of the People and Culture cost forecast are prudent and efficient, with the exception of Recruitment Fees. The Authority adopted SKM's revised cost estimates in its recommended GSCs. Table 4.46 refers.

Seqwater's submission on Draft Report

Seqwater (2012b) stated that to attract the most suitable candidates required a variety of recruitment strategies to be employed and that the costs incurred would depend on the specific strategy engaged.

Seqwater commented that in such tight market circumstances, the cost of attaining the information advantage an external recruiter enjoys with regards to established networks, existing talent pools and expertise in market segments, would likely be lower than the costs Seqwater may have to incur to fill specialist / technical vacancies internally.

Seqwater noted that given the emphasis of its recruitment strategy is to target specialist/technical candidates through external agencies out of necessity due to current labour market dynamics, SKM's premise that only 'senior management/staff' roles are eligible for external recruitment processes seems disjointed from recent market realities. Seqwater considered that SKM's view disregards the on-going 'war for talent' in regard to specialist/technical roles that are subject to increasing demand arising from the resources boom.

SKM's Review

In response to Seqwater, SKM considered it is evident that Seqwater's preferred approach, at least for some roles, is to appoint external recruiters without first engaging internal recruiters. With this approach Seqwater seek to avoid the "opportunity cost of lost time, the need to run another recruitment process to fill the initial vacancy following a failed round, as well as the direct and indirect effect on Seqwater's business caused by the productivity loss of a foregone labour resource over the recruiting period". However, SKM considered that the use of external recruiters may not have the advantages anticipated by Seqwater due to competition from resource industries.

In conclusion, SKM did not consider that the additional information provided by Seqwater was sufficient to alter the conclusion that Seqwater's proposed Recruitment Fees were not efficient, and that a value of \$264,400 was a more appropriate level of expenditure.

Authority's Analysis

The Authority accepts SKMs findings that the proposed Recruitment Fees was not efficient and that a value of \$264,400 is the appropriate level of expenditure. Table 4.46 refers.

Table 4.46: Recommended People and Culture Costs (\$'000)

| <i>Cost</i> | <i>Seqwater Proposed</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|-----------------------------|--------------------------|---|---|
| Salaries and Wages | 1,477 | 1,477 | 1,477 |
| Recruitment Fees | 460 | 264 | 264 |
| Training | 1,870 | 1,870 | 1,870 |
| Other Supplies and Services | 543 | 543 | 543 |
| Total | 4,350 | 4,154 | 4,154 |

Item 12: ICT Services

Seqwater's Submission

Seqwater (2012a) forecast \$12,870,544 for ICT services in 2012-13, which included:

- (a) Salaries and wages (38 FTEs) - \$4,002,598;
- (b) Contractor costs - \$1,845,600;
- (c) Telecommunications - \$2,658,332;
- (d) IT expenses - \$3,635,134; and
- (e) Other expenses - \$728,880.

SKM's Review

SKM noted that Seqwater's budgeted costs represented a 12% increase relative to the combined costs for WaterSecure and Seqwater submitted as part of the 2011-12 GSC investigation.

Prudency Review

SKM assessed that each of the components of ICT expenditure was required for Seqwater to meet its obligations under the Grid Contract and the SOP (QWC 2011) in a timely and cost-effective manner.

SKM concluded that this expenditure was prudent.

Efficiency Review

SKM noted that Seqwater was pursuing an in-house service model with a move to replace most contractors with permanent staff over three years. SKM noted that this was due to Seqwater's use of high-end and tailored infrastructure hardware that makes outsourcing difficult. The contractors will reduce to effectively zero in 2015, resulting in a planned 40 permanent FTEs and a planned saving of \$1.8 million.

SKM cited a cost benchmarking report undertaken by KPMG that placed Seqwater's ICT cost near the median benchmark value.

SKM concluded that this expenditure is efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

No submissions on this item were received in response to the Draft Report.

Item 13: WTP Decommissioning Costs

Seqwater's Submission

Subsequent to the Draft Report, Seqwater provided a revised submission relating to the decommissioning costs. Seqwater has several water treatment plants which are currently not used, because they are either non-operational or not required to supply water to the SEQ Water Grid. These plants are located at:

- (a) Albert River;
- (b) Aratula;
- (c) Maleny;
- (d) Toogoolowah; and
- (e) Woorim.

Seqwater stated that it has obligations under various legislation to maintain these sites thus incurring associated costs. Seqwater considers that there are inherent risks associated with the ongoing ownership of these plants. Seqwater submits that the best way to manage these assets in the future is to decommission them and sell or transfer the assets.

Seqwater stated that the outcome of this change is to increase proposed Fixed Operating Charges from \$0.9 million in its initial submission to \$3.6 million in its revised submission.

SKM's Review

SKM noted that the costs are estimated at \$3.665 million. SKM's review focussed on the costs of decommissioning, but noted that the option selection appears very sensitive to the income estimate.

SKM reviewed the business case for this project and found that the nominated cost driver for the project was efficiency. The business case stated that the service need of the project is to achieve the more effective use of existing operations and maintenance staff and to reduce ongoing expenditure to fulfil regulatory obligations.

The business case listed the options considered as:

- (a) Option 1 - "Status Quo";
- (b) Option 2 - Decommissioning of the assets and sale or transfer of ownership.

Option 1 involved the continuation of the current practices for maintaining the site in a safe and presentable manner including work to ensure the site can be left unattended in a safe condition; routine inspections and maintenance to ensure site appearance, integrity and safety; maintaining compliance with any legislative obligations, such as fire safety and environmental protection; routine maintenance of site to maintain professional appearance, keep safe and clean; and repairs of assets as required to keep safe.

Option 2 involved dismantling and disposal of the built assets including disposal of land assets, and where possible, the sale of Seqwater owned land associated with the assets. For each plant, sub-options were considered relating to full or partial decommissioning of the site.

SKM noted that a NPV analysis of the options was undertaken which concluded that the preferred option is Option 2 as it has a greater whole of life benefit, achieves a reduction of risk and provides ongoing operational efficiencies. Based on documents and advice provided by Seqwater, SKM considered that the decision making process appears acceptable and that the project is prudent.

Efficiency Review

For each of the five WTPs to be commissioned, SKM assessed the cost estimating methodology for the following items:

- (a) quantities;
- (b) direct costs;
- (c) indirect costs/preliminaries;
- (d) contractor's margin; and
- (e) contingency.

SKM considered that for some sub-components, the majority of the cost comprises of items that are lump sum hence it is not possible to verify the cost estimates. However, for each of the WTP decommissioning projects, SKM concludes that the rates used appear reasonable and that the cost estimating methodology is appropriate. SKM's breakdown of project costs is shown in Table 4.47.

Table 4.47: Decommissioning Costs by WTP (\$)

| <i>WTP</i> | <i>Cost</i> |
|----------------|------------------|
| Albert River | 710,000 |
| Aratula | 69,256 |
| Maleny | 751,439 |
| Toogoolawah | 580,000 |
| Woorim | 1,429,926 |
| Overhead costs | 124,000 |
| Total | 3,664,621 |

SKM noted that Seqwater had yet to complete its stakeholder engagement process, which is a milestone after which the continuation of specific projects will be reconsidered. However, SKM considered that the scope of works and cost appeared acceptable, the standard of works is consistent with the risk assessment and the proposed timing is achievable. On this basis, SKM concluded that the proposed expenditure is efficient.

Authority's Analysis

The Authority accepts SKM's finding that the expected expenditure of \$3.7 million is prudent and efficient.

However, the Authority notes that Seqwater will earn income from disposal of assets, including land. The Authority considers that Seqwater should only recover the net cost of decommissioning. To this end, the Authority recommends that the actual proceeds from asset disposal are treated as a revenue offset, and subject to an ex-post adjustment.

Summary of Prudency and Efficiency Review

In the Draft Report, in summary, SKM reviewed 12 cost items and recommended cost reductions to three totalling \$654,000 or 2.1% of the value of the sampled items.

For the Final Report, following review of submissions received, one additional item was reviewed (decommissioning of unused WTPs) and considered prudent and efficient, while one item (employee costs at Bundamba AWTP) previously considered to be partially efficient is now considered to be efficient.

Further, Seqwater advised that decommissioning costs of \$3.7 million should be treated as fixed opex rather than capex. SKM considered this expenditure to be prudent and efficient. This effectively increased the total proposed fixed opex from \$235.6 million to \$238.3 million.

The recommended cost reduction, excluding the sludge handling costs (now reclassified as variable costs), is \$320,000 (Items 6 and 11), or about 0.9% of sampled items.

The Authority considered whether it would be appropriate to extrapolate this 0.9% adjustment across un-sampled fixed operating costs. The Authority notes that much of the identified savings related to recruitment costs which are not considered representative of cost types for extrapolation purposes.

The Authority considers that SKM's findings of over-estimated contingency costs relating to repairs and maintenance to the recycled pipeline network are of concern but was not identified as such in other repair and maintenance items reviewed.

Therefore, the Authority does not consider it appropriate to extrapolate the adjustment to other fixed cost items (which in most cases do not involve repair and maintenance activities). The Authority also notes the small sample size of 14% total proposed fixed operating costs.

Notwithstanding this, the Authority proposes to apply an overall efficiency target of a 2.5% (in addition to the specific savings identified in the analysis above) to fixed operating costs. This adjustment is incorporated in recommended GSCs. Details of the analysis underlying the efficiency target are provided in Chapter 6.

A summary of reviewed items is shown in Table 4.48.

Table 4.48: Prudence and Efficiency of Fixed Operating Costs (\$'000)

| <i>No</i> | <i>Cost</i> | <i>Seqwater initial proposal</i> | <i>Seqwater revised proposal</i> | <i>Prudence</i> | <i>Efficiency</i> | <i>QCA Draft Recommended</i> | <i>QCA Final Recommended</i> |
|-----------|---|--|--|-----------------|---|----------------------------------|----------------------------------|
| 1 | Wivenhoe Dam - Catchment Management | 746 | 746 | Prudent | Efficient | 746 | 746 |
| 2 | Hinze Dam - Catchment Management | 491 | 491 | Prudent | Efficient | 491 | 491 |
| 3 | North Pine Dam - Employee Costs | 342 | 342 | Prudent | Efficient | 342 | 342 |
| 4 | Gold Coast Desalination Plant - Water Quality Monitoring | 520 | 520 | Prudent | Efficient | 520 | 520 |
| 5 | Gold Coast Desalination Plant - Repairs & Maintenance | 5,167 | 5,167 | Prudent | Efficient | 5,167 | 5,167 |
| 6 | Pipeline Network - Repairs & Maintenance | 2,997 | 2,873 | Prudent | Partially efficient | 2,873 | 2,873 |
| 7 | Bundamba AWTP - Employee Expenses | 2,419 | 2,419 | Prudent | Efficient | 2,085 | 2,419 |
| 8 | North Pine WTP - Planned Infrastructure Maintenance | 628 | 628 | Prudent | Efficient | 628 | 628 |
| 9 | Mt Crosby Westbank WTP - Scheduled Infrastructure Maintenance | 508 | 508 | Prudent | Efficient | 508 | 508 |
| 10 | Molendinar WTP – Repairs and Maintenance | 1,289 | 1,289 | Prudent | Efficient, but 1,264 of sludge disposal costs considered variable rather than fixed | 26 | 26 |
| 11 | People and Culture | 4,350 | 4,350 | Prudent | Partially efficient | 4,154 | 4,154 |
| 12 | ICT Services | 12,871 | 12,871 | Prudent | Efficient | 12,871 | 12,871 |
| 13 | WTP Decommissioning Costs | 900 | 3,665 | Prudent | Efficient | n/a | 3,665 |

| | | | | | |
|-------------------------------|----------------|----------------|--|----------------|----------------|
| <i>Subtotal</i> | 33,228 | 35,869 | | 30,411 | 34,410 |
| Fixed Opex items not reviewed | 202,345 | 201,641* | 3,059 of sludge disposal costs transferred to variable | 200,186 | 198,581 |
| Total | 235,573 | 237,509 | | 230,597 | 232,991 |
| Sample coverage | 14% | | | | |

Note: *Seqwater revised fixed electricity costs down by \$703,934 and QCA levy costs down by \$936

4.3.3 QCA levy

Seqwater submitted that, due to a change in the definition of Allowable Costs, the QCA levy should be considered a component of the Fixed Operating Charge. The Authority accepts Seqwater's submission.

2011-12 QCA levy

Seqwater (2012a) submitted that the QCA fee for 2011-12 was initially estimated at a total of \$1.2 million for Seqwater and WaterSecure in 2011-12, but has actually incurred \$1.292 million.

The Authority notes that Seqwater's estimate of \$1.2 million is a summation of the rounded amounts listed in the Authority's 2011-12 Final Report (\$0.6 million for Seqwater and \$0.6 million for WaterSecure). The Authority confirms that its 2011-12 GSC modelling included an allowance of \$646,000 each for Seqwater and WaterSecure. As a result, the Authority recommends that no adjustment is required for this item.

2012-13 QCA levy

As a separate exercise is required to review each of the previous Seqwater and WaterSecure costs, and LinkWater costs, the QCA levy will be allocated 2/3 to the new Seqwater and 1/3 to LinkWater (as for 2011-12).

The Authority has included an allowance of \$1,366,000 in its 2012-13 GSCs, an increase of 5.8% relative to 2011-12.

Subsequent to the Draft Report, Seqwater submitted that its initially proposed fixed operating costs had included an amount of \$1,366,936, rather than the rounded \$1,366,000 that will be recovered by the Authority. The Authority has therefore subtracted the additional \$936 from Seqwater's total fixed operating costs.

4.3.4 Sludge Disposal Costs

Draft Report

Seqwater's Submission

As noted above, Seqwater (2012a) proposed to recover sludge disposal costs as a fixed cost for WTPs, but as a variable cost for the GCDP and WCRWS. Seqwater submitted that there

was little variation in source water quality at GCDP and WCRWS, so that the costs for sludge disposal were relatively stable on a \$/ML basis.

Seqwater submitted that the relationship between water produced and sludge disposal costs at WTPs was normally not linear. Seqwater noted that the quality of raw water sourced from rivers and dams can vary significantly due to rainfall (which causes turbidity, discolouration and algae). Seqwater reported that the sludge disposal costs may display step changes, or have little correlation with water production. For example, Seqwater submitted that Mt Crosby Eastbank WTP utilised on-site sludge drying methods combined with heavy machinery hire and that the most significant costs associated with sludge disposal were for the machinery hire. Seqwater considered that these costs were essentially fixed periodical costs that bore little correlation with the quantity of sludge on site, other than for infrequent occasions where the quantity of sludge passes a tipping threshold and the costs escalate significantly from there due to the need for transport the sludge to off-site locations.

Seqwater included sludge disposal costs as part of the Repairs and Maintenance component of Water Treatment Operations. Seqwater noted that this cost was distinguished from the Repairs and Maintenance component of Infrastructure Maintenance, which included more typical asset maintenance activities.

Authority's Analysis

The Authority disagreed with Seqwater's submission. The Authority considered that sludge is a direct by-product of water treatment, and costs associated with its disposal should therefore be considered a variable cost. The Authority therefore reduced the Repairs and Maintenance component of Seqwater's fixed operating charge by \$4.3 million and instead included a \$/ML charge for sludge handling for each WTP (see Table 4.50 below).

While the Authority acknowledged that this represents a change of pricing methodology relative to 2011-12, the Authority considers it better reflects the underlying cost drivers, and aligns the treatment of WTP variable costs to those incurred at the GCDP and AWTPs. The Authority was prepared to reconsider its position in the Final Report if Seqwater could demonstrate that sludge disposal costs have no correlation (rather than a non-linear correlation) with water production.

The Authority acknowledged that the relationship between water produced and sludge costs may be non-linear and difficult to forecast. However, the Authority did not consider that non-linearity is a sufficient reason to include a cost as a fixed cost and notes that classifying sludge disposal as a fixed cost does not make it any easier to forecast. To address the issue of forecasting risk, the Authority recommended that Seqwater's variable costs are billed to the WGM based on actual volumes, and that raw water quality events are considered a Review Event for the purposes of the Review Thresholds (see Chapter 7).

Seqwater's Submission on the Draft Report

In response to the Authority's analysis that sludge is a direct by-product of water treatment, and costs associated with its disposal should therefore be considered a variable cost, Seqwater (2012b) noted that this view assumed that the costs of sludge disposal varied with output, and as set out in Seqwater's previous submission, this was not the case. Seqwater considered that the conclusion in the Draft Report confused sludge production (which is mostly variable) with the costs of disposing of that sludge (which are generally fixed).

Further, in response to the Authority's comment that it is prepared to reconsider its position if Seqwater can demonstrate that sludge disposal costs have no correlation with water production, Seqwater stated that it is willing to undertake such analysis and present this to

the Authority for future grid service charge investigations for 2013-14 and beyond. However, in the meantime, Seqwater submitted that the current arrangements, where sludge disposal costs are treated as a fixed costs at WTPs, be continued for 2012-13 on the basis that this approach is less likely to assign (in error) material volume risk to Seqwater.

However, Seqwater stated that should the Authority maintain its current position, efforts should be made to minimise the financial impact on Seqwater of treating sludge disposal as variable costs. Seqwater suggested the following options:

- (a) firstly, a process should be in place for Seqwater to apply for any additional costs associated with abnormal weather events causing poor raw water quality, which in turn can increase sludge disposal costs; and
- (b) secondly, a true-up should be conducted at the end of 2012-13 to ensure that in practice there is a direct pass-through of the actual costs of sludge disposal incurred, accompanied by supporting analysis showing the relationship between volumes produced and the line items for sludge disposal, on a monthly basis. This would then enable recovery of the fixed and variable costs of sludge disposal where they actually fall.

Seqwater commented that if no mechanisms are set up to mitigate the risks of non-recovery of sludge disposal costs through variable operating charges, this would have the effect of imposing volume risk on Seqwater, contrary to the express instructions contained in the Ministerial Direction.

Authority's Analysis

While the Authority notes that there may be a fixed cost element to sludge disposal, the Authority considers that sludge is primarily a direct by-product of water treatment, and costs associated with its disposal should therefore be considered a variable cost. That is, in general, higher volumes of throughput would correspond to higher volumes of sludge.

The Authority is open to Seqwater undertaking further analysis to demonstrate that sludge disposal costs have no correlation with water production. The Authority will consider Seqwater's findings for the 2013-14 review.

With regards to minimising any financial impacts of treating sludge disposal as a variable cost, the Authority notes that any significant variation in costs due to raw water quality would be considered a Review Event for the purposes of the Review Thresholds (see Chapter 7). The Authority considers that the process outlined in the Review Thresholds is sufficient and does not accept Seqwater's proposals of additional cost pass-through true-up mechanisms.

4.3.5 Fixed Electricity Network Costs

Draft Report

Seqwater submitted regulated network costs of \$2.13 million, made up of both distribution and transmission charges, which are incurred at large WTPs only. A 20.9% increase was assumed for distribution costs based on an estimated 16.9% increase as stated in Energex's Statement of Expected Price Trends 2011-12 (Energex 2011) plus a further 4% was applied based on historical typical variances between the Expected Price Trend estimates and approved rates provided by Energex. Seqwater assumed a 19% increase for the transmission costs based on the average increase of these costs over the past two years.

The Authority noted that the Australian Economic Regulator (AER) approved Energex's distribution charges to increase by 16.44% in 2012-13. The AER's draft decision (AER 2011)² approved PowerLink's transmission charges to increase by 13.38% for 2012-13. On this basis, the Authority considered that Seqwater's assumed increases in network costs (20.9% distribution and 19% transmission) were too high. The Authority instead adopted a 16.44% increase in distribution costs and a 13.38% increase in transmission costs as per the AER's decisions.

In the Draft Report, the Authority was provided with insufficient details to replicate Seqwater's translation of network cost increases into electricity price increases. In the absence of better information, the Authority weighted the respective network cost increases by their broad weighting in electricity prices generally, resulting in an 8% increase in electricity prices.

Submissions on the Draft Report

Subsequent to the Draft Report, Seqwater provided the Authority with more information on network costs for 2012-13. Seqwater advised that, based on the current allocations of water at each WTP, total fixed costs will amount to \$1.42 million, which represents a reduction of almost \$0.70 million (or 33%) to that proposed in Seqwater's initial submission. In particular, fixed charges at Mt Crosby Eastbank and Mt Crosby Westbank have declined by \$0.66 million to \$0.87 million. However, this reduction in fixed costs is more than offset by higher variable charges of around \$1.39 million (discussed in more detail below).

Seqwater advised that nine sites, accounting for around \$0.18 million of fixed electricity costs, remain subject to a small amount of continuing uncertainty because their network tariff group for 2011-12 (8200) will be discontinued from 1 July 2012. As Energex is yet to advise of the new tariffs, Seqwater assumed network prices based on the most likely tariff to apply in 2012-13.

Authority's Analysis

The Authority accepts Seqwater's revised network costs and has adjusted the GSCs to reflect \$1.42 million of fixed electricity costs.

4.3.6 Fixed Operating Cost Summary

In the Draft Report, the net effect of the Authority's review of sampled fixed opex items is to reduce Seqwater's proposed fixed opex from \$235.6 million to \$230.6 million, a reduction of \$5.0 million.

Of this difference:

- (a) \$654,000 were savings identified by SKM for the sampled items; and
- (b) \$4.32 million of sludge disposal costs were transferred to variable costs.

The Authority's draft recommended fixed operating costs are compared to Seqwater's proposed fixed operating costs in Table 4.49. Also shown are the approved 2011-12 fixed operating costs for comparison, based on combining Seqwater and WaterSecure costs.

For the Final Report, the Authority re-instated fixed operating expenditure for one item, Seqwater provided a revised estimate of de-commissioning costs, increasing from \$900,000

² The AER's final decision on PowerLink's transmission charges is not expected until 30 April 2012.

to \$3.7 million. A minor adjustment was also made to Seqwater's QCA levy forecast. In total, the identified efficiency savings were \$320,000.

Table 4.49: Fixed Operating Costs (\$m)

| <i>Item</i> | <i>Approved 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Seqwater Proposed 2012-13</i> | <i>QCA Draft Recommendation 2012-13</i> | <i>Seqwater Revised 2012-13</i> | <i>QCA Final Recommendation 2012-13</i> |
|-------------------------------------|-----------------------------|---|--|---|---|---|
| Direct costs | 122.2 | 111.1 | 115.1 | 110.3 | 117.1 | 112.7 |
| <i>Dams</i> | 38.6 | 24.4 | 28.3 | 28.3 | 28.3 | 28.3 |
| <i>WTPs</i> | 46.9 | 41.9 | 48.7 | 44.4 | 50.8 | 46.4 |
| <i>PRW</i> | 22.7 | 28.7 | 22.2 | 21.7 | 22.1 | 22.1 |
| <i>Desalination</i> | 14.0 | 16.0 | 15.9 | 15.9 | 15.9 | 15.9 |
| Non-direct Costs | 42.4 ² | 47.4 | 58.2 | 58.2 | 58.2 | 58.2 |
| Corporate Overheads ¹ | 55.0 | 63.7 | 62.1 | 61.9 | 62.1 | 61.9 |
| Total | 219.6 | 222.2 | 235.6 | 230.6 | 237.5 | 233.0 |

Note: ¹Includes QCA levy. ²Non-direct costs in 2011-12 are made up of Seqwater's Business Overheads, unallocated Dam and WTP costs and WaterSecure's Asset Owner Costs. Totals may not add due to rounding.

4.4 Variable Operating Charge

4.4.1 2011-12 Variable Operating Charge

In its 2011-12 Final Report, the Authority recommended that Seqwater should not bear volume or source risk.

In its 2012-13 submission, Seqwater noted that forecast water demand in 2011-12 was higher than actual demand. This had cost implications for Seqwater at the Luggage Point and Bundamba AWTPs, which were less cost efficient at low volumes and when operated in stop-start mode. Seqwater proposed to finalise its claim for an adjustment to GSCs due to lower than expected demand after the Authority's Draft Report.

The Authority accepts Seqwater's approach.

4.4.2 2012-13 Seqwater's Submission

Seqwater (2012a) submitted that variable operating charges consist of:

- (a) electricity (green and black);
- (b) treatment chemicals;
- (c) sludge disposal (at GCDP and AWTPs only); and
- (d) operator margin (at GCDP and AWTPs only).

Seqwater submitted a total variable operating charge of \$39.3 million, based on a production forecast of 282,587 ML of water in 2012-13. This compared to a forecast maximum amount

of \$30.0 million, based on a maximum production forecast of 284,571 ML included in the Authority's 2011-12 Final Report.

Seqwater submitted that the increase in costs relative to 2011-12 was as a result of:

- (a) the inclusion of Veolia's Operator Margin at the GCDP and AWTPs, which was previously considered a fixed cost;
- (b) the introduction of the Waste Reduction and Recycling Act 2011, which imposes a waste levy on sludge from the AWTPs and GCDP of \$50/tonne;
- (c) higher energy costs per ML due to low production volumes at the AWTPs;
- (d) changes to regulated electricity tariffs;
- (e) introduction of the Carbon Tax; and
- (f) price increases under existing contracts for chemicals.

Table 4.50: Seqwater's Proposed Variable Operating Costs by Asset (\$/ML)

| <i>Asset</i> | <i>Approved 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Proposed 2012-13</i> | <i>Proposed % change relative to estimated actual</i> |
|------------------------|-----------------------------|-------------------------------------|-----------------------------|---|
| Mt Crosby Eastbank WTP | 66 | 71 | 89 | 25% |
| Mt Crosby Westbank WTP | 66 | 71 | 98 | 38% |
| Molendinar WTP | 48 | 51 | 60 | 18% |
| North Pine WTP | 49 | 51 | 74 | 45% |
| Landers Shute WTP | 43 | 44 | 50 | 14% |
| Mudgeeraba WTP | 62 | 67 | 83 | 24% |
| Noosa WTP | 144 | 144 | 247 | 72% |
| Other WTPs | 98 | 108 | 132 | 22% |
| GCDP | 678 | 771 | 1,015 | 32% |
| Bundamba AWTP | 366 | 456 | 678 | 49% |
| Luggage Point AWTP | 412 | 539 | 810 | 50% |

4.4.3 Variable Electricity Costs

Seqwater (2012a) submitted that electricity for WTPs is procured under a contract that was made following a competitive tender process in 2010. Seqwater estimated that this contract will save around \$1.8 million in 2012-13. This cost saving occurs as raw electricity prices are fixed until the end of the contract in December 2013, although increases still arise from pass-through items such as the impacts of the carbon tax, changes to regulated transmission/distribution prices and costs associated with the *Renewable Energy (Electricity) Act 2000*.

Carbon Price

Draft Report

Seqwater submitted carbon price estimates for large and small WTPs based on increases cited in the Queensland Treasury publication “Carbon Impacts on Queensland, August 2011” (Queensland Treasury 2011). The Treasury report suggested an 82% pass through of the carbon price would occur, which Seqwater estimated would translate to a 10% increase in retail electricity prices. In preparing preliminary forecasts for 2012-13, Seqwater assumed a more conservative pass through of 100% of the carbon price at large WTPs based on advice from Seqwater’s electricity retailer (TRUenergy). For the small WTPs, the 10% retail electricity increase was assumed.

In the Authority’s recent Draft Determination on Regulated Retail Electricity Prices 2012-13 (QCA 2012), the Authority’s consultant ACIL estimated that the average carbon price pass through would be 87% for 2012-13. At the same time, the Authority noted that the exact retail price effect depends on the carbon price passed through by TRUenergy and should be apparent by the time of the Authority’s Final Report.

For the Draft Report, the Authority therefore recommended an increase in retail energy costs to account for the introduction of a carbon price of 10% for all WTPs, not just small WTPs.

Submissions on the Draft Report

Seqwater (2012b) stated that its energy retailer, TRUenergy, advised that the carbon tax cost, which will be passed through to Seqwater each month, is calculated using a carbon intensity factor, which is determined on a monthly basis. The cost of carbon will therefore also vary monthly, throughout the year. Seqwater stated that it has no control over these costs as they are set, and passed on, by its electricity retailer.

Seqwater contended that this variability increased the difficulty in correctly forecasting the carbon tax cost ex-ante. Therefore, Seqwater has proposed to pass through the carbon cost to the WGM each month, as this approach will ensure that the actual costs are passed through.

Authority’s Analysis

The Authority understands that the Australian Energy Market Operator (AEMO) will be responsible for setting a carbon intensity index each month and that this will be determined by the mix of generation supplying electricity to each region within the national electricity market (NEM). Given the mix of generation tends to change each month, this means the index will change and so will the associated carbon costs.

In Queensland, the variation in the carbon intensity factor tends to be between 0.82 and 0.86 tonnes of carbon dioxide per megawatt hour of generation (AEMO, 2012). This will in turn lead to a monthly variation in carbon costs of around 4% - 5%. The Authority acknowledges that this variability could impose a potential risk to Seqwater if carbon was included in an estimate of variable electricity costs, albeit minor.

On this basis, the Authority accepts Seqwater’s proposed cost pass-through. The recommended GSCs exclude the cost of carbon in electricity and are therefore lower than estimates in the Draft Report (which included a 10% carbon cost allowance). The Authority recommends that Seqwater include a separate item on its GSC invoices relating to carbon costs, supported by appropriate documentation from its electricity provider. In the event that this documentation is not available, the Authority recommends an end-of-year adjustment should be made.

Green Energy

Draft Report

Seqwater submitted that in October 2009, its board decided to purchase 10% of its energy needs at WTPs as green energy at a cost of \$0.1 million. Seqwater submitted that the inclusion of green energy into Seqwater's energy portfolio accorded with the then government vision statement: *Towards Q2: Tomorrow's Queensland* (Queensland Government 2008). Seqwater sought confirmation from government whether it has any requirements of Seqwater with respect to purchasing green energy into the future.

Seqwater submitted that costs relating to retailer obligation levels under the *Renewable Energy (Electricity) Act 2000* (SRES34, LRET35 & GEC36) were confirmed in January each year. Seqwater's estimates for these charges were calculated by applying prices provided by TRUenergy.

In the Draft Report, the Authority considered that the *Towards Q2* vision statement was not sufficient justification for green energy purchases at WTPs to be included in the GSCs. The Authority was not aware of any requirements in *Towards Q2* regarding Seqwater's energy procurement. The Authority considered that for Seqwater's claim that green energy was required by government policy to be justified, it requires a specific direction, rather than a broad, whole-of-government vision statement. In the absence of specific government direction, the Authority considered that green energy did not represent the least cost option and, as such, was not efficient. The Authority removed Seqwater's Green Energy allowance of \$0.1 million from recommended GSCs.

Submissions on the Draft Report

On 25 May 2012, Seqwater received advice from the Queensland Government confirming its decision to discontinue all existing state-based carbon reduction schemes to ensure agencies were not subject to overlapping of State and Federal obligations when the carbon tax was introduced on 1 July 2012. Seqwater therefore concluded that costs associated with the purchase of green energy should be removed from the recommended 2012-13 GSCs.

Authority's Analysis

The Authority accepts Seqwater's withdrawal of its claims for Green Energy costs.

Expiry of Notified Tariffs at WCRWS and the GCDP

Draft Report

Seqwater submitted that, in 2011-12, it procured electricity for the Gold Coast Desalination Plant (GCDP) and the Western Corridor Recycling Water Scheme (WCRWS) under Notified Tariff 43. Seqwater submitted that, while Notified Tariffs will no longer be accessible to large customers (using more than 100MWh per annum) from 1 July 2012, it believed it reasonable to base costs on Tariff 43, with an assumed increase of 11.39% in 2012-13 which represented the simple average of regulated tariff increases over the past four years.

Seqwater submitted that it (and Veolia) had commenced the process to procure electricity from the contestable market for both the GCDP and the WCRWS.

In the absence of more information, the Authority considered that Seqwater's assumption of basing its 2012-13 electricity costs on Tariff 43 was acceptable. However, it did not consider Seqwater's assumed increase of 11.39% to Tariff 43 was appropriate as the Authority noted that Seqwater successfully obtained a lower electricity price when it

transferred from a regulated rate to a market contract for electricity at its WTPs. As a result, the Authority was not convinced that the cost of electricity on a market contract would be higher than what Seqwater paid on Tariff 43. Therefore, the Authority recommended no increase in electricity tariffs for the GCDP and WCRWS in 2012-13, relative to 2011-12.

Submissions on the Draft Report

Seqwater (2012b) submitted to the Authority that it will not be in a position to procure energy from the contestable market before 1 July 2012 (likely to be August 2012), due to the uncertainty around the utilisation of the assets. In particular, Seqwater referenced the Minister for Energy and Water Supply (2012) of a formal review of the deployment of the GCDP.

Seqwater stated that it did not believe it would be prudent to finalise a contract regarding energy supply until reviews of the GCDP and the WCRWS are complete. Doing so would possibly incur additional costs if energy use occurred outside consumption scenarios set in the contract. Seqwater advised that it did not expect to have finalised market contract prices until August 2012.

Instead, Seqwater proposed to apply an interim charge for 2012-13 with an end of year adjustment to reflect actual electricity prices over the period. Seqwater submitted quotes provided by Origin Energy for one site in the WCRWS:

- (a) 23.19c per kWh (flat consumption charge); and
- (b) 47.44c per day supply charge.

Seqwater proposed to apply the above rates for energy supply at all other sites within the WCRWS and the GCDP for 2012-13, and proposed an end of period adjustment with respect to actual energy prices incurred. Seqwater advised that the quoted rates differed from the 2011-12 regulated Tariff 43 rates included in Seqwater's submission, as they had a lower fixed cost component and a single rate for both peak and off-peak usage.

Authority's Analysis

The Authority considers that the rates quoted by Origin are not sufficiently defined to be accepted as a recommended approach. They contain no details of whether the rates include carbon or whether they would apply at the remaining WCRWS sites and the GCDP.

Instead, the Authority recommends no change from the Draft Report. That is, the 2011-12 regulated Tariff 43 rates will apply at the WCRWS and the GCDP sites in 2012-13. Table 4.52 below provides a summary of the variable electricity charges to apply at the GCDP and the WCRWS. The Authority proposes an end of period adjustment to account for the actual electricity cost (including any consequential impacts on fixed electricity costs at GCDP and WCRWS) incurred unless the change is significant in which case it would be considered under the Review Thresholds (Chapter 7).

Renewable Energy Certificates (RECs)

Draft Report

Seqwater submitted that the GCDP had certain Queensland Government requirements for carbon neutrality. Seqwater met this requirement through its purchase and surrender of renewable electricity certificates (RECs). Seqwater purchased a total of 182,098 RECs in 2009 at a price of \$43.38/MWh. Seqwater anticipated that these RECs would be exhausted during 2012-13 and new certificates would be required. However, Seqwater did not

commence a procurement process for the purchase of new certificates or sufficient green energy to maintain the plant's green energy status, pending advice from Government about whether the requirement for the plant to be carbon neutral will continue in 2012-13.

The Authority considered that, in the absence of a formal Government direction, carbon neutral energy procurement cannot be considered the least cost option. As such, Seqwater's approach to seeking Government clarification regarding the carbon neutrality of the GCDP prior to incurring expenditure is appropriate. For the Draft Report, the Authority recommended that electricity prices exclude the cost of achieving carbon neutrality.

Submissions on the Draft Report

As noted above, on 25 May 2012, the Queensland Government decided to discontinue the previous requirement for the GCDP's operations to be carbon neutral. This decision was to ensure agencies were not subject to overlapping of state and federal obligations when the carbon tax was introduced on 1 July 2012.

However, Seqwater contended that, given that it was required by the Market Rules to adhere to the government policy requiring the GCDP to be carbon neutral at the time it purchased RECs, the Authority should, at minimum, allow it to recover the cost of the remaining RECs it purchased in 2009.

Seqwater has advised the Authority that, after surrendering RECs for 2011-12, it will retain an estimated 19,274 RECs going into 2012-13. Based on a per unit REC purchase price of \$43.38, this would represent a total value of \$836,106.

Authority's Analysis

The Authority acknowledges that Seqwater is required to adhere to government requirements and, as such, there was an expectation to purchase RECs to ensure GCDP was carbon neutral.

Given the state government intends to discontinue the previous government's requirement to offset 100% of carbon emissions produced at the GCDP, the Authority considers it appropriate to no longer include a variable cost item associated with the cost of purchasing RECs in the 2012-13 GSCs.

The Authority considers Seqwater's request to allow it to recover the cost associated with the remaining RECs that it purchased in 2009 to be reasonable, but believes the least cost option would be to sell any RECs it retains after 30 June 2012.

The Authority is aware that the current value of RECs is lower than at the time the RECs were purchased. Given the current price of a REC³ is \$36.13 (Green Markets 2012)⁴, the difference between what Seqwater paid and the market price is \$139,737. As this represents an unforeseen, once-off cost due to a change in government policy, the Authority has included an amount of \$139,737 in its recommended 2012-13 Allowable Costs.

³ Since 1 January 2012, the Federal Government revised its Renewable Energy Target Scheme, resulting in a number of differences, including the name given to renewable energy certificates associated with large scale generation, which are now referred to as Large-scale Generation Certificates (LGCs)

⁴ This estimate of the price of a REC as at 19 June 2012 is based on information provided at <http://www.greenmarkets.com.au>.

Energy Cost Summary

Taking into account the adjustments described above, the Authority's recommended electricity costs are detailed in Table 4.51.

Table 4.51: Seqwater's Recommended Variable Energy Costs

| <i>Water Treatment Plant</i> | <i>MWh</i> | <i>kWh/ML</i> | <i>\$ per ML</i> |
|------------------------------|------------|---------------|------------------|
| Banksia Beach | 3,140 | 2,150.76 | 175.04 |
| Caboolture | 305 | 497.60 | 69.00 |
| Dayboro | 17 | 132.39 | 90.00 |
| Enoggera | 138 | 511 | 62.50 |
| Esk | 185 | 846.92 | 193.70 |
| Ewan Maddock | 832 | 462.32 | 43.93 |
| Image Flat | 193 | 34.73 | 4.57 |
| Jimna | 8 | 596.08 | 175.79 |
| Kenilworth | 51 | 567.16 | 122.10 |
| Kilcoy | 553 | 879.42 | 112.54 |
| Lander's Shute | 383 | 13.31 | 3.93 |
| Linville | 6 | 433.64 | 97.43 |
| Lowood | 2,041 | 863.12 | 111.94 |
| North Pine | 5,459 | 162.79 | 9.89 |
| Petrie | 1,715 | 271.76 | 30.70 |
| Somerset Dam | 0 | 13.00 | 48.42 |
| Woodford | 837 | 2,625.00 | 204.21 |
| Amity Point | 76 | 634.18 | 114.70 |
| Beaudesert | 473 | 763.16 | 146.21 |
| Boonah-Kalbar | 381 | 768.65 | 112.28 |
| Canungra | 62 | 792.18 | 141.18 |
| Capalaba | 1,618 | 410.39 | 61.81 |
| Dunwich | 103 | 671.38 | 141.50 |
| Kooralbyn | 187 | 1,099.97 | 227.04 |
| Molendinar | 6,063 | 121.72 | 11.81 |
| Mt Crosby Eastbank | 35,861 | 439.55 | 31.69 |

| | | | |
|-------------------------|---------------|---------------|--------------|
| Mt Crosby Westbank | 6,328 | 439.55 | 31.69 |
| Mudgeeraba | 4,336 | 236.71 | 25.99 |
| North Stradbroke Island | 6,267 | 660.43 | 50.30 |
| Point Lookout | 159 | 585.59 | 90.94 |
| Rathdowney | 17 | 653.25 | 122.23 |
| South Maclean | 568 | 778.55 | 202.74 |
| Total | 78,365 | 20,116 | 30.00 |

Source: Seqwater (2012c) Note: Total \$ per ML value is an average across Seqwater's WTPs

Table 4.52: Variable electricity charges at GCDP and WCRWS (\$/ML)

| <i>Plant/Location</i> | <i>2011-12 Approved Forecast</i> | <i>2011-12 Estimated Actual</i> | <i>2012-13 Proposed</i> | <i>2012-13 Recommended</i> |
|-------------------------------|----------------------------------|---------------------------------|-------------------------|----------------------------|
| GCDP - 33% | 539.28 | 637.11 | 731.02 | 546.89 |
| GCDP - 66% | 539.28 | 637.11 | 697.02 | 521.46 |
| GCDP - 100% | 539.28 | 637.11 | 697.02 | 521.46 |
| Bundamba | 138.91 | 268.51 | 295.32 | 220.94 |
| Luggage Point - Low Flow Days | 142.54 | 305.27 | 428.31 | 320.43 |
| Luggage Point - Other | 142.54 | 305.27 | 353.92 | 264.78 |
| Network | 112.88 | 165.66 | 158.44 | 118.53 |

4.4.4 Operator Margin

Seqwater's Submission

Seqwater's inclusion of Veolia's Operator Margin as a variable cost represented a change to the approach adopted by WaterSecure in 2011-12. Seqwater submitted that a portion of the Operator Margin varied by volume and should be included as a variable cost as it better reflected the underlying cost structure in the operations contract.

Authority's Analysis

The Authority accepts Seqwater's submission and proposes to include the operator margin as a variable cost.

4.4.5 Chemical Dosing Contingency

Draft Report

Seqwater (2012a) submitted that one of the reasons for the increase in chemical costs relative to 2011-12 was the inclusion of a contingency for poor water quality events. Seqwater noted

that chemical dosing rates will change throughout the year due to events such as storms or rainfall. Seqwater developed its dosing forecasts based on historical raw water quality and allowed a contingency for minor raw water events. On average, this contingency contributed 5% of the total 29% increase in chemical costs.

The Authority included an allowance in the 2011-12 Review Thresholds to account for poor raw water quality events. The Authority recommended that this approach be continued in 2012-13, and has formalised feed water quality events as a Review Event.

As a result, the Authority considered that Seqwater is appropriately protected against raw water quality events without the need to make a contingency. The Authority has therefore removed specific chemical dosing contingencies for North Pine WTP (19%) and Petrie WTP (27%), as well as an average contingency for a number of smaller WTPs (5%) from its recommended GSCs.

Seqwater's Submission on the Draft Report

In response to the Authority's Draft Report, Seqwater (2012b) stated that the chemical contingencies included by SunWater were not an insurance against possible extraordinary raw quality events; rather they reflected an estimate of the additional costs that Seqwater will probably incur. This is because during certain periods of the year (summer wet season, dam releases and temperature changes) water quality deteriorates which results in higher treatment chemical costs.

Seqwater further noted that to make an application to recover unexpected costs from extreme events would involve judgement as to where to draw the line between what was the expected level of raw water quality (to be included in the budget) versus what should be counted as an extraordinary event (where Seqwater should lodge a request to recover additional costs incurred).

Seqwater suggested formulating an average raw water quality measure (for each WTP) based on multiple years' worth of raw water quality data, including years before and after the Millennium Drought, but excluding extreme events such as the January 2011 Queensland Floods. Seqwater considered that this approach would help demonstrate the spread of costs of an average summer wet season across the year, which is an alternative approach to applying a seasonal loading that appears as a contingency.

Authority's Analysis

The Authority notes that Seqwater's initial submission identifies no material difference between 2011-12 estimated actual chemical costs and 2011-12 forecast chemical costs for any of its WTPs, including those that Seqwater is claiming an additional contingency. This implies that Seqwater's approved 2011-12 chemical charges were sufficient to cover chemical costs.

Further, the Authority notes that Seqwater has listed the contingency as contributing to the increase in chemical costs, and relates to those plants that did not have a contingency in 2011-12. The Authority notes that even for plants that did not have contingency built into their forecast 2011-12 charges, the estimated actual charges are the same as the approved forecast charges, indicating that an additional allowance is unwarranted. Therefore, the Authority does not consider that chemical charges should be increased to allow for a contingency.

Further, the Authority does not consider that events such as the wet season, dam releases and temperature changes are best addressed by a contingency, as they are readily predictable.

Instead, the Authority considers that these events would be included in Seqwater's base chemical cost forecast and reflected in historical data and chemical costs. The Authority therefore does not accept Seqwater's submission and has maintained its draft recommendation that chemical contingencies should be removed.

The Authority accepts Seqwater's suggestion to formulate expected chemical costs based on historical raw water quality data for future investigations. The Authority considers that chemical cost forecasting without consideration of historical data is inappropriate.

4.4.6 Prudence and Efficiency Review

The Authority engaged SKM to review the prudence and efficiency of Seqwater's variable operating costs.

For opex to be included the GSCs, it is required to be prudent (demonstrated need for the expenditure) and efficient (least cost and consistent with relevant benchmarks, having regard to prevailing market conditions, historical trends and the potential for efficiency gains or economies of scale).

SKM and the Authority sampled four variable cost items for detailed review of prudence and efficiency. These items accounted for \$5.47 million or 14% of Seqwater's forecast total variable cost of \$39.3 million.

Item 1: Mt Crosby Eastbank WTP - Electricity

Draft Report

Seqwater's Submission

Seqwater (2012a) forecast \$2,502,811 for electricity at Eastbank WTP during 2012-13, for the treatment of 81,858 ML of water at a unit rate of \$30.68/ML (excluding the impact of the carbon tax). The total cost was divided between black power (\$2,303,554) and green power (\$199,258).

SKM's Review

SKM noted that electricity costs for the Mt Crosby WTPs were supplied through one meter, with costs allocated 85% to Eastbank and 15% to Westbank, in line with the WGM's forecasts of production volumes from the plants.

SKM noted that the forecast unit rate for 2012-13 (\$30.68/ML) represented a 6.2% increase relative to 2011-12 (\$28.90/ML).

Table 4.53: Mt Crosby Eastbank Electricity Costs

| <i>Cost</i> | <i>2011-12 Estimated Actual</i> | <i>2012-13 Forecast</i> | <i>% change</i> |
|----------------------------|-------------------------------------|-----------------------------|-----------------|
| Black Electricity (\$'000) | 2,209 | 2,304 | +4.3% |
| Green Electricity (\$'000) | 193 | 199 | +3.1% |
| Total (\$'000) | 2,402 | 2,503 | +4.2% |
| ML | 83,119 | 81,585 | |
| \$/ML | 28.9 | 30.7 ¹ | +6.2% |

Note: ¹Excludes the impact of the carbon tax

SKM noted that the Mt Crosby Eastbank WTP was a Grid-connected, critical base-load plant; the biggest in SEQ by capacity and by volume supplied. SKM considered that the operating costs associated with purchasing electricity were necessary in order to operate Mt Crosby Eastbank.

SKM concluded that this expenditure was prudent.

SKM noted that Seqwater secured competitive rates for electricity during the tender process in 2010 which were valid until December 2013. Off-peak and peak assumptions were applied based on operational requirements and historical data to forecast costs. SKM noted that these electricity costs were benchmarked to the market.

SKM concluded that this expenditure cost was efficient.

Authority's Analysis

The Authority accepted SKM's conclusion that this expenditure is prudent and that the means by which the electricity is procured are efficient. However, as discussed in more detail in section 4.3.3 above, the Authority did not consider that Seqwater's assumptions in forecasting electricity costs are sound. The Authority removed Seqwater's allowances for green energy, and adjusted Seqwater's expected price increase due to carbon taxes, transmission and distribution costs. The Authority therefore approved a \$/ML energy cost of \$27.48/ML for Mt Crosby Eastbank.

Submissions on the Draft Report

In response to the Draft Report, Seqwater (2012c) submitted that variable operating charges should be reviewed to reflect the actual prices payable for the year, including the actual network tariffs. Seqwater also foreshadowed that the fixed operating charge might need to be adjusted to reflect any change in fixed energy costs arising from the actual network charges payable.

Seqwater's updated energy cost for Mt Crosby Eastbank is \$31.69/ML, excluding the cost of carbon tax, green energy and statutory environmental charges.

Authority's Final Recommendation

The Authority's treatment of carbon tax costs, green energy and statutory environmental charges relating to energy, is discussed in Section 4.4.3 above.

Since the Authority accepts SKM's conclusion that this expenditure is prudent and that the means by which the electricity is procured are efficient, the Authority has therefore approved a \$/ML energy cost of \$31.69/ML for Mt Crosby Eastbank.

As noted above, the Authority has presented alternate expected energy costs based on volumes included in the November 2011 Annual Operations Plan (\$2.59 million) and the May 2012 Annual Operations Plan (\$2.61 million).

Item 2: Landers Shute WTP – Treatment Chemicals

Seqwater's Submission

Seqwater (2012a) forecast \$1,315,450 for treatment chemicals at the Landers Shute WTP to treat a forecast 28,753 ML of water at a unit cost of \$45.75/ML.

SKM's Review

SKM noted that the 2012-13 forecast unit price (\$/ML) for treatment chemicals increased by 14% relative to that forecast for 2011-12, and that the total price increased by 20% relative to 2011-12 estimated actuals (see Table 4.54).

Table 4.54: Landers Shute Chemical Treatment Costs (\$)

| <i>Cost</i> | <i>2011-12 Forecast</i> | <i>2011-12 Estimated Actual</i> | <i>2012-13 Forecast</i> |
|----------------|-----------------------------|-------------------------------------|-----------------------------|
| Chemical Costs | 1,007,886 | 1,091,690 | 1,315,450 |
| ML | 25,100 | 25,100 | 28,753 |
| \$/ML | 40.2 | 43.5 | 45.8 |

Source: Seqwater (2012)

Prudency Review

SKM noted that the chemical budget associated with running Landers Shute WTP was driven by forecast supply volumes from the WGM, translated from demand predictions for specific supply areas in line with SEQ System Operating Plan objectives.

SKM considered that Seqwater had a requirement to chemically treat water to deliver water to the standards required by the various regulatory bodies.

SKM concluded that this expenditure was prudent.

Efficiency Review

SKM noted that the 2012-13 forecast cost increased by 20% relative to the 2011-12 estimated actual, in spite of a reduced base dosage. Seqwater included an additional chemical dose contingency allowance for risk of wet weather and natural events, which contributed 19% points to the increase in total variable chemical costs for this facility, which was offset by other factors to result in a 14% increase in \$/ML.

SKM reported that this contingency did not extend to major events such as an extreme weather or water quality event like the major flood events that occurred in January 2011.

SKM reported that Seqwater assumed that chemical costs will increase as per historical increases or in nominal terms by between 2.50% and 3.75% depending on the individual chemical.

SKM noted that treatment chemicals are fully sourced from external suppliers under three contracts secured through open tenders from panels of providers, created in compliance with internal procurement procedures. SKM considered that the treatment chemicals for Landers Shute were all supplied under contracts procured by competitive tenders in line with Seqwater's procurement policies and procedures.

SKM concluded that this expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that Seqwater's chemical costs are prudent. The Authority also accepts that the procurement cost of chemicals is efficient, but as noted above, does not consider that Seqwater should be entitled to an allowance for contingency.

On this basis, the Authority has reduced Seqwater's efficient chemical treatment costs at Lander's Shute WTP by 19% to \$1,096,208 and recommends a \$/ML chemical cost of \$38.13/ML for Landers Shute WTP.

The Authority notes that Seqwater also included specific chemical dosing contingencies for North Pine WTP (19%) and Petrie WTP (27%), as well as an average contingency for a number of smaller WTPs (5%). The Authority has also removed these contingencies from its recommended GSCs. See Table 4.57 below for more detail.

Item 3: Molendinar WTP – Sludge Disposal

As noted in Section 4.2.4 above, the Authority considers that sludge disposal is a variable cost and has transferred it from fixed operating costs. SKM reviewed sludge disposal costs at Molendinar as part of its review of fixed costs (See Item 10 in fixed operating costs above for more information).

The Authority accepts SKM's conclusion that this expenditure is prudent and efficient.

Item 4: Luggage Point AWTP – Electricity

Seqwater's Submission

Seqwater (2012a) forecast \$1,651,999 for electricity the Luggage Point AWTP in 2012-13, for the production of 3,858 ML at a unit cost of \$428.26/ML.

SKM's Review

SKM noted that the cost forecast for Luggage Point AWTP was an interim figure. The plant was currently eligible for notified tariffs, but rule changes from July 2012 will mean that electricity must be procured under a market contract. Seqwater proposed that the Variable Operating Charge for 2012-13 be based on actual contracted energy prices once these are known.

SKM noted that there is a large increase in forecast unit rates due to smaller forecast production volumes. SKM considered that because there are major energy costs associated with starting up and shutting down the plant, a smaller volume leads to significantly higher unit costs. Table 4.55 refers.

Table 4.55: Luggage Point Electricity Costs (\$)

| <i>Cost</i> | <i>2011-12 Forecast</i> | <i>2011-12 Estimated Actual</i> | <i>2012-13 Forecast</i> |
|-------------------|-----------------------------|-------------------------------------|-----------------------------|
| Electricity Costs | 1,041,000 | 1,114,222 | 1,651,999 |
| ML | 7,300 | 3,650 | 3,858 |
| \$/ML | 143 | 305 | 428 |

Prudency Review

SKM noted that Seqwater was required to produce water at the Luggage Point AWTP under the Grid Contract. Electricity is essential to allow the Luggage Point plant to operate; hence this expenditure was required in order for Seqwater to meet its obligations.

SKM concluded that this expenditure was prudent.

Efficiency Review

Seqwater proposed a scheme of two tariffs for Luggage Point: one that was set to recover the costs when the plant was operating at very low daily production rates (less than 10.5 ML per day), and another when daily production exceeded this threshold. This arose from the WGM's forecast for 2012-13 which anticipated low volume requirements for the first part of the period, followed by an increase later on as new industrial users required larger volumes. SKM considered this two-tariff system to be a suitable method of helping to ensure more accurate recovery of costs and therefore avoid the need for price review claims.

The assumed average unit price for 2012-13 was \$0.14/kWh, compared to \$0.11/kWh in the original 2011-12 submission.

The plant was currently being supplied under notified tariffs, but these will not be available for 2012-13. Seqwater proposed to update the unit rates for electricity based on actual contracted energy prices once these are known.

The method of procurement was still under negotiation, let alone the actual terms and rates of the future contract, so SKM concluded that there was insufficient information to judge whether the expenditure will be efficient. However, if the new contract is procured in such a way that the final rates reflect the market, SKM recommended that the expenditure should be efficient.

Authority's Analysis

The Authority accepts SKM's conclusion that the 2012-13 Luggage Point electricity costs are prudent, but that due to timing or contract negotiation, insufficient information is available to judge their efficiency.

As discussed in more detail in section 4.4.3 above, the Authority does not consider that Seqwater's assumptions in forecasting electricity costs are sound.

The Authority therefore recommends that the 2011-12 regulated Tariff 43 rates will apply at the WCRWS and the GCDP sites in 2012-13. This translates to \$/ML energy cost of \$320/ML for Luggage Point AWTP.

The Authority notes that Seqwater's proposed Luggage Point AWTP volumes do not reconcile with those provided by the WGM. Volumes included in the November 2011 Annual Operations Plan (4,705 ML) and the May 2012 Annual Operations Plan (4,716 ML) both exceed Seqwater's proposed 3,858 ML. As a result, the Authority recommends alternate expected energy costs for 2012-13 of \$1,507,623 (consistent with the November 2011 Annual Operations Plan) and \$1,511,148 (consistent with the May 2012 Annual Operations Plan).

Summary of Prudence and Efficiency Review

In summary, SKM reviewed four variable operating expenditure items and recommended that three were prudent and efficient.

SKM did not identify any cost savings as a result of not prudent or not efficient variable operating costs. However, the Authority has removed a 19% contingency for treatment chemicals at Lander's Shute WTP, as well as corresponding treatment chemical contingencies at other WTPs that were not included in SKM's sample.

As noted above, the Authority has also adjusted Seqwater's assumptions regarding forecast electricity costs. The Authority has applied its adjustments to each of Seqwater's assets, including Luggage Point AWTP for which SKM had insufficient information to review in its sample. Table 4.56 refers.

Table 4.56: Prudence and Efficiency of Variable Operating Costs (\$'000)

| <i>No</i> | <i>Cost</i> | <i>Seqwater proposed</i> | <i>Prudence</i> | <i>Efficiency</i> | <i>QCA Draft Recommendation</i> | <i>QCA Final Recommendation</i> |
|-----------|--------------------------------------|--------------------------|-----------------|---|---------------------------------|---------------------------------|
| 1 | Mt Crosby Eastbank WTP - Electricity | 2,503 | Prudent | Partially efficient, green energy cost premium removed. | 2,242 | 2,585/2,612 |
| 2 | Landers Shute WTP – Treatment | 1,315 | Prudent | Partially efficient, 19% contingency removed | 1,096 | 1,096 |
| 3 | Molendinar WTP – Sludge Disposal | 0 | Prudent | Efficient and transferred from fixed costs | 1,264 | 1,264 |
| 4 | Luggage Point AWTP – Electricity | 1,652 | Prudent | Insufficient information to establish efficiency, Authority estimate adopted. | 1,692 | 1,508/1,511* |
| | <i>Subtotal</i> | <i>5,470</i> | | | <i>6,294</i> | <i>6,453/6,483</i> |
| | Variable Opex items not reviewed | 33,875 | | Sludge Disposal costs transferred from fixed costs, energy costs reduced, chemical dosing contingencies removed | 33,584 | 34,310/32,931 |
| | Total | 39,345 | | | 39,878 | 40,762/39,415 |
| | Sample coverage | 14% | | | | |

*Note: *As described in Chapter 3, the Authority has recommended two alternate GSCs, reflecting the November 2011 / May 2012 Annual Operations Plans. In the event that the May 2012 AOP is approved, the lower values should apply to these items.*

4.4.7 Variable Tariff Structure

Seqwater (2012a) proposed a number of changes to the tariff structure, based on an increased understanding of the likely levels of demand and the operating features of the GCDP and AWTPs.

Hot Standby Tariff

Seqwater's Submission

Seqwater submitted that during Hot Standby mode, the GCDP was required to be flushed twice per week to prevent fouling of membranes and to manage pH levels in the Southern Regional Water Pipeline. During this flushing process, 25ML of water are produced as a matter of course, and this water is delivered to the WGM. Seqwater submitted that the production of this water should not be subject to a price signal to the WGM, as the water was being produced anyway, and the costs cannot be avoided by Water Grid optimisation.

Further, Seqwater noted that the costs associated with flushing are not strictly fixed costs, since these costs are not incurred when the GCDP is operational, only in Hot Standby mode. With a level of uncertainty about how many weeks of the year the GCDP will be operational, Seqwater considered it would be difficult to forecast actual flushing costs.

Instead, Seqwater proposed to charge the costs on a per event basis. Seqwater estimated that each flush will cost \$35,585, to be incurred twice a week during Hot Standby mode.

Authority's Analysis

The Authority notes that the inclusion of a Hot Standby per flush tariff introduces a large amount of complexity into the tariff structure for what is a small proportion of Seqwater's total costs. The Authority considers that, in a retail environment, this additional complexity would be detrimental to customers' understanding of prices. However, as the WGM is an institutional customer with responsibility for the short term operating settings of the Water Grid, the WGM is well equipped to handle tariff complexity. The Authority notes that tariffs that better reflect the underlying cost driver provide the WGM a greater ability to optimise costs on a Water Grid-wide basis.

For this reason, the Authority accepts Seqwater's proposal to charge the WGM for GCDP electricity costs incurred in Hot Standby on a per event basis.

Utilisation Tariffs

Seqwater's Submission

Seqwater (2012a) also submitted that \$/ML electricity costs change depending on the level of utilisation of the GCDP and AWTPs, with greater cost efficiency being achieved at higher levels of utilisation. As a consequence, Seqwater proposed to include separate charges (expressed as a \$/ML tariffs) for different levels of utilisation:

- (a) GCDP – at 33% utilisation;
- (b) GCDP – at 66% utilisation;
- (c) GCDP - at 100% utilisation;
- (d) Luggage Point - Low Flow Days (<10.5ML/day); and
- (e) Luggage Point – Other Days.

Authority's Analysis

For reasons set out above, the Authority considers that the WGM is well equipped to handle additional tariff complexity. The Authority notes that tariffs that better reflect the underlying cost drivers provide the WGM a greater ability to optimise costs on a Water Grid-wide basis.

For this reason, the Authority accepts Seqwater's proposal to charge the WGM for GCDP and AWTPs electricity costs on a utilisation basis.

4.4.8 Variable Operating Charge Summary

The Authority recommends that Seqwater charge the WGM variable operating charges based on actual volumes delivered and the Authority's recommended \$/ML variable charges. The Authority's recommendations are included in full in Table 4.57.

Table 4.57: Final Recommended Variable Operating Charges

| <i>Asset</i> | <i>Energy</i> | <i>Chemicals</i> | <i>Sludge Disposal, Other</i> | <i>Total</i> |
|-----------------------------|---------------|------------------|-----------------------------------|---------------|
| | <i>\$/ML</i> | <i>\$/ML</i> | <i>\$/ML</i> | <i>\$/ML</i> |
| Banksia Beach WTP | 175.04 | 42.11 | 10.58 | 227.73 |
| Caboolture WTP | 69.00 | 69.95 | 204.28 | 343.24 |
| Dayboro WTP | 90.00 | 42.23 | 27.31 | 159.54 |
| Enoggera WTP | 62.50 | 385.20 | 20.98 | 468.68 |
| Esk WTP | 193.70 | 156.90 | 5.29 | 355.89 |
| Ewan Maddock WTP | 43.93 | 85.12 | 26.61 | 155.66 |
| Image Flat WTP | 4.57 | 52.86 | 13.46 | 70.89 |
| Jimna WTP | 175.79 | 145.57 | 150.47 | 471.82 |
| Kenilworth WTP | 122.10 | 90.45 | 28.61 | 241.16 |
| Kilcoy WTP | 112.54 | 51.85 | 16.38 | 180.76 |
| Lander's Shute WTP | 3.93 | 38.13 | 17.91 | 59.97 |
| Linville WTP | 97.43 | 97.18 | - | 194.61 |
| Lowood WTP | 111.94 | 42.42 | 13.50 | 167.86 |
| Noosa WTP | - | - | 15.98 | 15.98 |
| North Pine WTP | 9.89 | 52.36 | 1.07 | 63.33 |
| Petrie WTP | 30.70 | 56.53 | 7.75 | 94.98 |
| Somerset Dam Township WTP | 48.42 | 192.47 | 37.65 | 278.53 |
| Woodford WTP | 204.21 | 103.03 | 24.22 | 331.46 |
| Amity Point WTP | 114.70 | 17.06 | 6.87 | 138.63 |
| Beaudesert WTP | 146.21 | 68.88 | 83.06 | 298.16 |
| Boonah-Kalbar WTP | 112.28 | 89.54 | 41.53 | 243.35 |
| Canungra WTP | 141.18 | 47.80 | - | 188.98 |
| Capalaba WTP | 61.81 | 68.38 | 51.67 | 181.86 |
| Dunwich WTP | 141.50 | 18.23 | 5.39 | 165.11 |
| Kooralbyn WTP | 227.04 | 77.83 | 121.18 | 426.04 |
| Molendinar WTP | 11.81 | 43.28 | 25.35 | 80.44 |
| Mt Crosby Eastbank WTP | 31.69 | 57.09 | 3.66 | 92.44 |
| Mt Crosby Westbank WTP | 31.69 | 57.51 | 3.15 | 100.44 |
| Mudgeeraba WTP | 25.99 | 48.71 | 65.90 | 140.60 |
| North Stradbroke Island WTP | 50.30 | 28.77 | 13.89 | 92.96 |
| Point Lookout WTP | 90.94 | 14.07 | 3.04 | 108.05 |
| Rathdowney WTP | 122.23 | 80.02 | - | 202.25 |
| South Maclean WTP | 202.74 | 97.06 | 112.88 | 412.68 |
| GCDP - 33% Utilisation | 546.89 | 95.24 | 103.09 | 745.22 |
| GCDP - 66% Utilisation | 521.46 | 89.05 | 99.80 | 710.31 |
| GCDP - 100% Utilisation | 508.74 | 89.05 | 98.39 | 696.27 |
| Bundamba AWTP | 220.94 | 210.38 | 162.18 | 593.49 |

| <i>Asset</i> | <i>Energy</i> | <i>Chemicals</i> | <i>Sludge Disposal, Other</i> | <i>Total</i> |
|--|---------------|------------------|-----------------------------------|---------------|
| Luggage Point AWTP - Low Flow Days (<10.5ML/day) | 320.43 | 214.38 | 153.35 | 688.16 |
| Luggage Point AWTP - Other | 264.78 | 214.38 | 146.11 | 625.27 |
| PRW Network | 118.53 | - | 15.41 | 133.94 |
| | <i>\$/Day</i> | <i>\$/Day</i> | <i>\$/Day</i> | <i>\$/Day</i> |
| GCDP - Hot Standby production days | 29,881 | 3,103 | - | 32,983 |
| GCDP - Hot Standby non-production days | 0 | 2,287 | - | 2,287 |

4.4.9 Forecast Demand

Under the Direction Notice, the Authority is required to adopt the demand forecast consistent with the WGM's Annual Operations Plan.

For the Draft Report, the Authority adopted the demand forecasts set out in the November 2011 Annual Operations Plan, which were 0.7% higher than those provided by Seqwater.

Subsequent to the Draft Report, the QWC submitted that the section of the November 2011 Annual Operations Plan that contains production forecasts by asset (Attachment 7) was explicitly not approved.

The Authority also received a submission from the WGM containing the May 2012 Annual Operations Plan, which the WGM noted is not yet approved by the QWC. As a result, there are no approved production forecasts that the Authority can apply. As discussed in Chapter 3, the Authority has therefore provided two alternative recommendations, reflecting the November 2011 and March 2012 Annual Operations Plans. Table 4.58 refers.

Table 4.58: Forecast Water Production for 2012-13 (ML)

| <i>Asset</i> | <i>November 2011 Annual Operations Plan Forecast Volume</i> | <i>May 2012 Annual Operations Plan Forecast Volume</i> |
|------------------------|---|--|
| Mt Crosby Eastbank WTP | 81,586 | 82,436 |
| Mt Crosby Westbank WTP | 14,397 | 14,547 |
| Molendinar WTP | 49,813 | 49,813 |
| North Pine WTP | 33,536 | 34,468 |
| Landers Shute WTP | 28,753 | 28,753 |
| Mudgeeraba WTP | 18,317 | 18,317 |
| Noosa WTP | 3,943 | 3,943 |
| Other WTPs | 36,031 | 33,964 |
| GCDP | 8,110 | 7,078 |
| Bundamba AWTP | 5,342 | 5,355 |
| Luggage Point AWTP | 4,705 | 4,716 |
| Total | 284,533 | 283,390 |

For the GCDP, Seqwater provided the following forecast for each mode throughout 2012-13. Following the Draft Report, the Authority received the May 2012 Annual Operations Plan from the WGM, which included a lower total production forecast for the GCDP. For the purposes of recommending alternative GSCs, the Authority has accepted the May 2012 production forecasts, and applied them to the various capacity modes at the GCDP using the same proportion of production at 33% capacity and 66% capacity as proposed by Seqwater (see Table 4.59).

Table 4.59: GCDP Production Forecast by Capacity Utilisation

| <i>Mode</i> | <i>Weeks</i> | <i>Days</i> | <i>Seqwater Proposed Production Forecast (ML)¹</i> | <i>Alternative Production Forecast (ML)²</i> |
|---------------------------------|--------------|-------------|---|---|
| Hot Standby Production Days | 39 | 78 | 1,950 | 1,950 |
| Hot Standby Non-Production Days | 39 | 195 | 0 | 0 |
| 33% Capacity | 6 | 42 | 1,848 | 1,538 |
| 66% Capacity | 7 | 49 | 4,312 | 3,590 |
| 100% Capacity | 0 | 0 | 0 | 0 |
| Total | | 364 | 8,110 | 7,078 |

Note:¹ Consistent with the November 2011 Annual Operations Plan (WGM, 2011)

² Consistent with the May 2012 Annual Operations Plan (WGM, 2012)

In the Draft Report, the Authority noted that Seqwater's production forecast at the GCDP, in total, matches the demand forecast by the WGM in its November 2011 Annual Operations Plan (WGM 2011). On this basis, the Authority accepted Seqwater's proposed production forecast by utilisation of capacity.

These volumes have been applied to the Authority's recommended \$/ML variable operating costs to estimate a total expected Variable Operating Charge of \$40.8 million (consistent with the November 2011 AOP) or \$39.4 million (consistent with the May 2012 AOP). Relative to Seqwater's submission, the expected value of the Authority's recommended variable operating charges includes a sludge disposal cost, which is partly offset by lower than expected electricity costs estimated by Seqwater.

4.5 Allowable Costs

As noted in Section 3.8, Seqwater submitted that the working capital allowance and QCA levy, which were considered Allowable Costs in 2011-12, should be included in the Capital Charge and Fixed Operating Charge respectively in 2012-13. The Authority accepts this submission, and has discussed these costs in the relevant sections above.

4.5.1 2011-12 Allowable Costs

QWC levy

The QWC originally forecast a levy to be paid by Seqwater of \$10.3 million in 2011-12, which the Authority included in its recommended 2011-12 GSCs.

As discussed in Section 3.5, the QWC subsequently notified the Authority that the 2011-12 levy required adjustment due to where QWC incurred less than the estimated user charges. As a consequence, the 2011-12 QWC levy incurred by Seqwater was \$3.8 million less than the allowance included in 2011-12 GSCs.

In the Draft Report, the Authority therefore adjusted Seqwater's 2012-13 Allowable Costs to account for an over recovery of the QWC levy. Subsequent to the Draft Report, Seqwater submitted that it had already accounted for this difference in its invoicing of the WGM within 2011-12, and that there is no need for any additional deduction.

On this basis, the Authority has removed its adjustment to account for an over recovery of 2011-12 Allowable Costs.

Integration Costs

Seqwater submitted that, although it had incurred integration costs relating to the merger with WaterSecure on 1 July 2011, it will not be in a position to submit its costs to the Authority until after the Final Report. Seqwater intended to make a final claim as part of the GSCs from 1 July 2013.

The Authority accepts Seqwater's approach.

Floods Commission of Inquiry

Seqwater submitted that, although it had incurred investigation costs relating to the Commission of Inquiry in 2011-12, it was not yet in a position to provide a finalised cost estimate. Seqwater proposed to make a final claim prior to the Authority's Final Report, but has not yet made its claim to the Authority.

The Authority will review Seqwater's claim when it is received.

4.5.2 2012-13 Allowable Costs

QWC levy

Seqwater (2012a) submitted that the only Allowable Cost relevant for 2012-13 was the QWC levy. Seqwater estimated that this cost equalled \$10.6 million, based on a 2.5% increase relative to 2011-12.

The Authority notes that QWC had not yet finalised its budgeting for the 2012-13 year, and had not provided an estimate of the 2012-13 QWC levy at the time of the Authority's Draft Report. The Authority therefore accepted Seqwater's submission of a 2.5% escalation to the 2011-12 QWC levy as an interim estimate.

Subsequent to the Draft Report, the Government has indicated⁵ that the QWC will be abolished on 1 July 2012. The Authority considers that a levy payable by Seqwater to the QWC or any successor organisation remains an allowable cost, as required by the Direction Notice and has retained its forecast from the Draft Report of \$10.6 million. However, the Authority notes that it is possible that this cost will not be incurred by Seqwater, dependent on the Government's decisions relating to the QWC.

Loss on Disposal of RECs

As noted above, the Authority recommends that as a result of a change in government policy, Seqwater no longer requires RECs purchased to offset carbon emissions at the GCDP. The Authority has included an amount of \$139,737 in its recommended 2012-13 Allowable Costs, representing the difference between what Seqwater paid for the RECs and the estimated current market price.

Future Merger

Subsequent to the Draft Report, the Government announced the future merger of Seqwater, LinkWater and the WGM. Seqwater submitted that the possible associated merger and integration expenses should be recovered, with some of these costs likely to occur in 2012-13. Seqwater submitted that these costs should be considered Allowable Costs.

The Authority notes that it is required to recommend separate Grid Service Charges for Seqwater and LinkWater, and has included no allowance for future merger costs in its recommended GSCs. The Authority notes that the future merger is expected to result in cost savings as well as possible integration costs. However, the Authority accepts Seqwater's submission that any future merger net cost savings should be in a future review.

Class action

Seqwater submitted that there have been various media reports about a potential class action and noted that the Queensland Commission of Audit had also flagged this possibility. Seqwater notified the Authority of this possibility, and submitted that it may seek consideration of relevant costs in 2012-13 as an Allowable Cost, but has not budgeted for any costs.

The Authority notes the possibility of a class action, and recommends that the question of whether water users should bear any corresponding cost implications as an Allowable Cost should be considered only upon resolution of any legal proceedings.

Table 4.60 documents the Authority recommended Allowable Costs.

⁵ <http://statements.cabinet.qld.gov.au/MMS/StatementDisplaySingle.aspx?id=79640>

Table 4.60: Summary of Allowable Costs (\$ million)

| | <i>Approved 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Forecast 2012-13</i> | <i>2012-13 Draft Recommendation</i> | <i>2012-13 Final Recommendation</i> |
|------------------------------------|-----------------------------|---|-----------------------------|---|---|
| QWC Levy | 10.3 | 6.5 | 10.6 | 6.8 | 10.6 |
| Loss on Disposal of RECs | | | | | 0.1 |
| Integration Costs | TBA | TBA | | TBA | TBA |
| Floods Commission of Enquiry | TBA | TBA | | TBA | TBA |
| Total | 10.3 | 6.5 | 10.6 | 6.8 | 10.7 |

Note: TBA - Seqwater proposed to provide an estimate of Integration and Floods Commission costs when final costs are known.

4.6 Revenue Offsets

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to continue the regulatory arrangements set in 2011-12, which treated services that Seqwater provides in addition to water supply as a revenue and cost pass-through. Seqwater submitted that it is not practical to undertake an extensive cost allocation exercise for these activities. Under this arrangement, all costs incurred by Seqwater in providing these services are recovered through the GSCs. To offset this cost, all revenue earned from these services is explicitly subtracted from Seqwater's GSCs. Table 4.61 shows Seqwater's proposed revenue offsets for 2012-13.

Authority's Analysis

As discussed in section 3.8, the Authority accepted Seqwater's proposed regulatory treatment of revenue offsets. The Authority noted the charges relating to irrigators will be subject to subsequent review in a separate investigation. However, as discussed in section 3.8, the Authority recommended additional revenue offsets relating to 50% of revenue relating to mini-hydro (\$360,000) and telecommunication leases (\$30,000).

Seqwater's Submission on the Draft Report

As noted in Chapter 3, Seqwater (2012b) submitted that it needs appropriate incentives to encourage use of water grid assets by other parties. Seqwater further noted that there are a number of issues that have been subject to interim arrangements pending detailed review, and that in this context, treatment of non-regulated services has been considered in isolation and prematurely by the Authority.

Seqwater therefore proposed that the interim arrangements [that Seqwater retains 100% of revenues] should be continued in 2012-13 and that treatment of non-regulated revenues be considered in full once the longer term regulatory regime is in place.

Authority's Analysis

The Authority considers that a sharing arrangement for these net revenues allows Seqwater and LinkWater to earn revenues in excess of costs and therefore provides sufficient incentive to seek revenue contributions from third parties wishing to access grid infrastructure for non-regulated activities, while also providing benefits for water users.

Table 4.61: 2012-13 Revenue Offsets (\$'000)

| <i>Revenue</i> | <i>Seqwater Proposed</i> | <i>Draft Recommendation</i> | <i>Final Recommendation</i> |
|--|--------------------------|-----------------------------|-----------------------------|
| Charges paid by irrigators and non-SEQ urban and industrial customers (excluding Renewals Annuity) | 3,434 | 3,434 | 3,434 |
| Recreation Charges and Leases | 1,063 | 1,063 | 1,063 |
| Mini-hydro Electricity Sales | - | 180 | 180 |
| Telecommunications Leases | - | 15 | 15 |
| Total | 4,498 | 4,693 | 4,693 |

Note: Totals may not sum due to rounding.

4.7 2011-12 Review Events

Seqwater's Submission

Seqwater submitted that it incurred additional costs resulting from events that meet the review criteria and thresholds set by the Authority. Seqwater has not applied for a mid-year review arising from these changes, but instead proposes to provide a formal application to the QCA for these claims when the underlying projects and costs are finalised.

In the meantime, Seqwater has provided a preliminary indication of its likely claims in Table 4.62 below.

Table 4.62: Seqwater's likely claims for 2011-12 Review Events

| <i>Type</i> | <i>Description</i> | <i>Estimated cost (\$ million)</i> |
|--------------------------------------|---|--|
| Change in law or government policy | Additional requirements under the Environmental Protection and Biodiversity Act for Banksia Beach WTP and borefield | 0.2 |
| | Changes in water quality standards required by the SEQ Water Grid Manager at Molendinar and Mudgeeraba WTPs | 0.1 |
| | Implementing the interim findings of the Floods Commission of Inquiry | 1.8 |
| | Increases to council waste charges | 0.419 |
| | Compliance with the new Disaster Readiness Amendment Bill | TBA |
| | Compliance costs following the implementation of the Koala Protection Policy | 0.1 |
| | Impacts on energy costs from the pass through of costs arising from the Renewable Energy (Electricity) Act 2000. | 0.7 |
| | Impacts on energy costs from the pass through of Higher network charges and market charges | 0.3 |
| | Additional operating costs arising from the Waste Reduction and Recycling Regulation (Qld) 2011 | 0.1 |
| | Additional compliance costs arising from the Waste Reduction and Recycling Regulation (Qld) 2011 | 0.1 |
| Changes in forecast demand for water | The forecast demands used to develop 2011-12 Variable Charges for the Luggage Point and Bundamba AWTPs are well above actual demand. This has meant that the plant has had to operate under start-stop mode to produce smaller daily volumes, increasing the energy and other costs for small production runs. Analysis shows that the actual variable costs to January 2012 at these plants has been around \$0.5M higher than the variable charge revenue. This under-recovery is due to the increased costs from these short production runs which are a result of a change in the WGM's demand forecast. The annual impact could therefore be around \$1.0M | 1.0 |
| | Emergency events | |
| | Post-flood water quality investigations | 0.1 |
| | Flood repair costs that are operating costs. | TBA |
| Total | | 4.719 |

Authority's Analysis

The Authority has not undertaken any review of Seqwater likely claims, but will review Seqwater's formal 2011-12 Review Events submission when it is received.

4.8 Merger Efficiencies

Draft Report

The amalgamation of Seqwater and WaterSecure occurred on 1 July 2011. The State Government's requirements of the merger were that:

- (a) employees that transferred from WaterSecure to Seqwater were to receive the same terms and conditions of employment as they received at WaterSecure; and
- (b) no forced redundancies were to be implemented for transferred staff under the terms of their enterprise bargaining agreements (EBAs) for a three-year period until December 2013.

The Direction Notice requires the Authority to provide advice on potential efficiency improvements and business savings based on good industry practice. To achieve this goal, SKM was engaged by the Authority to identify any potential efficiency improvements and achievable operating cost savings as a result of the merger of Seqwater and WaterSecure.

In order to identify potential efficiency improvements that may be realised as a result of the Seqwater/WaterSecure merger, SKM reviewed organisational structures, roles and responsibilities, as well as major alliance contracts associated with the two pre-merged organisations.

SKM reported that around \$2 million in operating cost savings had already been realised and also identified future potential improvements and achievable cost savings that were expected to take place in the short, medium and longer terms as a result of the amalgamation of the two utilities.

Short Term Merger Savings

SKM noted that the Government policy requirement had a notable impact on the quantum of any immediate to short term efficiency gains (1-2 years) that could be achieved by reducing staff levels. This situation effectively challenged the merged entity to determine how it can efficiently utilise the resources from both entities until the end of 2013 when these policies would expire. SKM considered that, in addition to their labour constraints, the existing contracts for the supply of products and services also minimised the ability to realise any immediate or short term efficiency benefits that may be possible from the merger.

The major and most immediate saving that resulted from the merger resulted from a direct reduction in the number of board members and executive managers. The pre-merger number of board members of 10 (five for Seqwater and five for WaterSecure) was reduced to seven post merger. SKM considers that Seqwater's board membership should be further reduced to five members once their respective board members' terms expire.

The pre-merger number of executive management FTEs was 26.3 (15.3 for Seqwater and 11 for WaterSecure) and this declined post merger to 15.5, a net reduction of 10.8 FTEs.

The cost savings attributed to the above reduction in board members and executive staff was in the order of \$2 million. SKM stated that no other costs savings associated with labour have been achieved. However, SKM notes that further cost savings could be achieved by reducing the number of board members to five and through 'natural attrition' of Seqwater staff.

Contracts for the operations and maintenance of the GCDP, the operations of the WCRWS and the operations and maintenance of Noosa water treatment plant exist with Veolia and John Holland (former) and Veolia (latter two).

As such, Seqwater has limited ability to seek efficiencies by pooling these activities with those at Seqwater's original assets. There may be potential efficiency improvements achieved through combining the outsourcing operation and maintenance contracts when these contracts expire or are re-negotiated or extended.

Long Term Merger Savings

SKM stated that multi-plant economies could be achieved in such a merger, where the merged entity is able to negotiate a reduced price on services or products due to an increase in requirement. The most notable long term economies (5-10 years) that can be achieved are through coordinated purchasing or production.

There is an opportunity to combine the electricity supply contract for the GCDP, the WCRWS and Noosa facility with Seqwater's existing electricity contracts. However, the unpredictability of the demand contract at these two sites would limit the ability to achieve significant savings through pooling these contracts via the competitive electricity market.

The following are examples of areas where SKM considered potential cost savings could be achieved in the next two to five years:

- (a) the termination of the lease to tenants at 240 Margaret Street and relocating all personnel from 95 North Quay to the freed space at 240 Margaret Street, and potentially sub-letting 95 North Quay. Leaving the premises vacant may yield potential direct cost savings from reduced cost of energy, cleaning, maintenance and rates;
- (b) the closure of the WaterSecure data centre and the grouping depots and other facilities, where possible;
- (c) grouping supplier contracts. Seqwater will seek to review all contracts once their terms expire;
- (d) bulking of chemical requirements will only be able to be realised should Seqwater and Veolia Water agree to a joint chemical procurement process. SKM considered that a discounted rate should be achieved by procuring a larger volume of chemicals;
- (e) grouping all sludge and waste disposal into one contract, however only a modest saving was expected here;
- (f) contracting for all power requirements within a single contract (achievable post-2013); and
- (g) streamlining insurances. SKM considered it good practice to have parallel insurances for the first year post merger to enable claims arising under the different insurance policies to be realised. Seqwater indicated that a combined insurance policy for 2012-13 would be sought.

Summary

SKM's potential cost savings are identified in Table 4.63 below, ranging from '\$' - minimal cost savings potential to '\$\$\$' - major cost savings potential.

Table 4.63: Summary of Potential Efficiency Gains from Merger

| <i>Activity</i> | <i>Realisation Period</i> | <i>Cost Savings Potential</i> |
|----------------------------|---------------------------|-------------------------------|
| Systems and Infrastructure | 5-10 years | \$\$\$ |
| Premises | 2-5 years | \$\$ |
| Insurances | 1-2 years | \$\$ |
| Fleet | 2-5 years | \$ |
| Electricity | 2-5 years | \$\$ |
| Chemicals | 2-5 years | \$\$ |
| Sludge and Waste Disposal | 2-5 years | \$ |

Authority's Draft Report Analysis

The high-level nature of SKM's analysis of potential efficiency gains reduced the ability for SKM to provide a quantitative analysis of the merger. Instead, SKM's assessment discussed potential merger efficiency gains in a qualitative manner.

SKM identified future potential improvements and achievable cost savings that were expected to take place in the short, medium and longer terms as a result of the amalgamation of the two utilities.

In particular, SKM stated that major cost savings could be achieved in one area (Systems and Infrastructure), medium cost savings could be realised in four areas (Premises, Insurances, Electricity and Chemicals) and minimal cost savings could be achieved in two areas (Fleet and Sludge and Waste Disposal),

Given the current restrictions that exist for Seqwater to realise cost savings, the Authority did not specifically adjust Seqwater's 2012-13 recommended GSCs. However, consistent with SKM's analysis, the Authority considered that Seqwater should commence realising efficiency savings from 2013-14 onward.

The Authority noted that efficiency incentives are in place for GSPs to make cost savings (see Chapter 7). To date, the GSPs' response to these incentives has been limited. The Authority considered that SKM's conclusions regarding merger efficiencies provides guidance to Seqwater as to where cost savings could be achieved.

The Authority considered that, should its recommended efficiency incentives continue to elicit a limited response from Seqwater, a more direct approach (requiring the application of sampled cost savings to un-sampled items) to ensuring potential efficiency gains are achieved may be required in future regulatory periods.

Final Report

SKM's Analysis

The Authority requested SKM to undertake further assessment of merger efficiencies associated with the Seqwater/WaterSecure merger, with a particular focus on quantifying

these efficiencies. The Authority also sought comment from Seqwater in regard to SKM's conclusions.

The merger of Seqwater and WaterSecure was viewed as a horizontal merger and therefore has limited scope for efficiencies to be realised in the short term. SKM considered that most of the potential efficiencies to be gained were considered to be of a medium to long term nature.

The merger did not require substantial changes to the organisational structure of the pre-merger Seqwater. All of WaterSecure's staff were incorporated within equivalent work groups within Seqwater. An additional group was created (Technical Warranty and Development group) within Seqwater incorporating the equivalent team from WaterSecure and included the Seqwater research resources.

As part of the merger, certain cost savings from reduced staff numbers were realised in the short term subject to the requirement that:

- (a) employees transferred from WaterSecure to Seqwater were to receive the same terms and conditions of employment as they previously had when employed by WaterSecure;
- (b) there were to be no forced redundancies for transferred staff under the terms of their enterprise bargaining agreements (EBA) for the period to the EBA as stipulated by the EBA; and
- (c) Seqwater employees are also protected from forced redundancy under the terms of their EBA.

Under these terms the amount of short term (one to two years) efficiency gains in relation to fixed staff will be limited. However, staff on contracts were not afforded similar protection and were required to apply for their positions where two or more personnel existed for a single position.

Board

The merger led to a direct reduction in the number of Board members resulting in annual savings of around \$200,000.

SKM considers that a further reduction of 2 Board members may be realised when the three-year terms expire. This is estimated to result in a further \$100,000 in annual savings.

Management

The number of FTEs within the executive management pre-merger was 15.3 for Seqwater and 11 for WaterSecure. The total number of FTEs post merger for the executive management is 15.5 a net reduction of 10.8 FTEs.

SKM estimated the reduction in executive staff cost to be about \$1.8 million per year. No further future savings in executive management is expected to be readily achievable in the current structure.

Employees

Prior to the merger, Seqwater employed about 466 FTEs and WaterSecure had about 61 FTEs. These numbers include senior executive staff (but exclude Board members). Hence there was a total of about 527 FTEs between the two organisations.

Post-merger, Seqwater had a total of approximately 521 FTEs, a net decrease of 6.5 FTEs (a decrease of approximately 11% of WaterSecure's FTEs pre-merger). Approximately 17 FTE positions in WaterSecure were not transferred to the post-merger Seqwater (excluding Board members), offset by approximately 10 FTEs in new positions in the post-merger Seqwater. Many of these positions were filled by former WaterSecure staff, transferred to alternative positions in the merged organisation. In addition, it is estimated that 6.4 new FTE positions were created in the new Technical Warranty & Development Group in post-merger Seqwater which was formed to continue to manage the handover, completion and ongoing operations of the WCRWS and the GCDP.

The new FTE positions created in this group was due to an assessed need to acquire the necessary technical skills of consultants previously employed by WaterSecure (and thus not counted as an FTE in WaterSecure's books). Thus if these additional FTEs were discounted (given that they were previously employed by WaterSecure but as contractors and hence not counted within the FTE numbers), a net reduction of 13 FTEs is estimated to have resulted from the merger. This amounts to approximately 21% of WaterSecure's work force.

These changes to the number of FTEs have been estimated to have resulted solely from the merger and do not include changes in the business-as-usual operations of Seqwater caused by assessed need for increased capacities in various parts of the Seqwater organisation. It thus does not include additional resources acquired due to the handing over of various assets including the transfer of Wyaralong Dam and the Hinze Dam Upgrade to Seqwater.

SKM assumed that both Seqwater and WaterSecure were both operating efficiently pre-merger and that post merger efficiencies can lead to a reduction of 50% of staff from the smaller organisation in areas where functional duplications occur. On this basis, SKM estimated that a further 17 FTE may be reduced from the merged Seqwater.

The estimated reduction amounts to approximately 3% of the merged entity's staffing level which SKM believes is achievable over the next three years through natural attrition. Total additional efficiency gains from reduced staff numbers could be \$1.5 million per annum. If the EBA was not in place then these efficiency savings could be realised over a shorter time frame (estimated at six months maximum).

Systems and Infrastructure

SKM stated that it has not identified any further savings over the next three years as software licensing and support contracts have been established for a three year period. Further savings may be achieved through a reduction in FTEs, however SKM believed these to be minor.

Property Leases

SKM suggested that if possible, options for sub-letting surplus office space should be considered. Following the expiration of existing leases, SKM believes that some rationalisation could occur. The potential merger savings from the reduction in 13 FTEs would amount to some \$78,000 per annum in accommodation savings. Should the additional 17 FTE staff reductions occur over the next three years as a result of the merger, a further saving of \$102,000 may be achieved in the cost of premises.

This results in a potential savings of some \$180,000 per annum in property lease costs.

Insurances

With the merger, Seqwater has consolidated its insurance premium for public liability insurance. The cost of this insurance is already incorporated into the 2012-13 budget and has resulted in a saving of around 14% of the annual public liability insurance premium.

The total insurance premium forecast for 2012-13 is \$6.9 million, and consequently the savings by combining premiums could be up to \$0.9 million. There is significant uncertainty about the cost of insurances after renewal, and there is considerable risk that premium costs will be higher than forecast. SKM assumed that the ongoing savings from insurance premiums as a result of the merger is likely to be about \$1 million per annum.

Electricity Cost

SKM stated that savings in electricity costs are difficult to determine due to changes in operating modes and insufficient information regarding load profiles, Seqwater's consultant, ROAM consulting suggested the loads for both Seqwater and WaterSecure are sufficiently large in isolation to obtain economies. Therefore, combining the two loads would unlikely lead to any further economies.

Chemical Cost

SKM has identified that of the 50 different chemicals used by the ex-WaterSecure and Seqwater, there are only eight chemicals that are common. These common chemicals cost Seqwater about \$6.7 million per annum, of which only about \$750,000 are used at the ex-WaterSecure plants. SKM believed that given the limited commonality, there is only likely to be minimal savings as a result of the merger. On the assumption that Seqwater is able to achieve a 10% saving on common chemical purchases, it could be possible to achieve around \$75,000 in savings when the contracts are renegotiated.

SKM indicated that such savings remain uncertain.

Seqwater's Response

In regard to the scope for savings in Board costs, Seqwater responded that this is a matter for Seqwater's shareholder, not Seqwater.

In regard to reduction in employee numbers, Seqwater responded that SKM has not explained or justified the 50% estimated saving that could arise from duplication between Seqwater and WaterSecure and which was used to estimate a further reduction of 17FTEs. There is no reference to actual workload and operating conditions, to provide evidence that such savings are achievable. However, Seqwater noted that 50% reductions have already been achieved in some activities, such as community relations, legal, risk and insurance and research and technology. No savings were achievable in water quality as the scope remained the same before and after the merger. Similarly, the scope of work for property and facilities, ICT and People and Culture also increased relative to the original Seqwater.

Seqwater noted that a process of natural attrition would not occur evenly across all activity areas as assumed by SKM. Seqwater was concerned that SKM's analysis is too high level and should not be used by the Authority to justify reductions in 2012-13 operating charges.

In regard to property leases, Seqwater did not agree with SKM's valuation of potential savings. Opportunities for subletting are limited due to the small size of the space, the limited term of any sub-lease and the costs of portioning the area to be sub-let. Seqwater disagreed that there would be a linear relationship between reduction in FTEs and area to be

sub-let. Instead, Seqwater suggested that savings will arise once the North Quay lease expires, but this saving of \$36,000 would not occur until August 2014.

On chemicals costs, Seqwater noted that the SKM cost estimate was uncertain, and that it would be equivalent to only 0.05% of the total chemical cost. The saving is only \$20,000 given that lime is the only chemical that can be jointly procured in the short term. Seqwater noted that Veolia already has buying power across a range of plants. Seqwater considered that any savings are uncertain and immaterial, at likely around \$20,000.

Authority's Analysis

Seqwater's issues, and the Authority's responses, in regard to specific cost items related to:

- (a) Board costs – the Authority agrees this is a matter for Government. No savings amount has been included in 2012-13 GSCs;
- (b) reductions in staff numbers. The Authority agrees that staff attrition may be uneven, although over a three-year period, this would be less an issue. The Authority emphasises that the estimates provided by SKM are prospective only and are not applied to 2012-13 GSCs;
- (c) property leases – SKM agreed that the scope for savings in property leases is limited for the reasons identified by Seqwater. The actual cost savings will require further investigation; and
- (d) chemicals costs – SKM advised that the larger amount of savings can only be achieved in the longer term and stress that the savings are uncertain.

The Authority accepts that SKM's analysis was high level, but at least provides an indicative range based on limited information that could be used as a starting point. To the extent that any savings are possible in addition to those already achieved, they are in any case not achievable in 2012-13 due to existing constraints or uncertainties. The Authority does not propose to adjust 2012-13 operating charges on the basis of this analysis.

4.9 Duplication of Effort – Seqwater and its Contractors

Seqwater has inherited two contracts, with Veolia Water Australia, from WaterSecure. The two inherited contracts have different terms in that the contractual agreement for the GCDP is one of an alliance arrangement where as the contractual terms for the WCRWS is one of an operate and transfer arrangement. The contracts with Veolia Water are long term contracts and expire as follows:

- (a) GCDP - 2020
- (b) WCRWS - 2028

Draft Report

For the Draft Report, SKM reviewed each entity's roles and responsibilities, their organisational charts and descriptions of objectives for each of the positions in order to identify the common objectives and areas of responsibilities between the different organisations. SKM was then able to identify those areas within these entities where duplication of effort might be expected to exist.

In an assessment across 29 activity areas at Seqwater, its alliance contractors and the WGM, SKM identified 24 areas that potentially contain varying degrees of duplication.

Table 4.64 below provides a summary of each of the areas that SKM has identified where potential duplication exists across the GSPs, their alliance contractors and the WGM. Also included in the table is a guide to potential cost savings that could be achieved ('\$' for minimal cost savings to '\$\$\$' for major cost savings). SKM has not quantified the magnitude of saving expected or associated in defining each category.

SKM's assessment of Seqwater, its alliance contractor and the WGM identified three areas where major cost savings could be expected (Agency Contract Management, Asset Planning Strategic and Asset Planning Capital), 11 areas where reasonable cost savings could be expected and 10 areas where minimal cost savings could be expected.

SKM noted that for functions of a corporate nature (such as finance and human resources) there will be a tendency for some level of duplication and hence inefficiency arising from having multiple organisational support functions within the water grid. Further, that there would be an element of corporate overhead costs arising from this arrangement that would be associated with the areas of functional duplication.

In the Draft Report, SKM identified the following activity areas as likely containing the greatest scope for cost savings between Seqwater and its major service provider, Veolia:

- (a) **Asset Engineering:** Both Seqwater and Veolia Water have engineering support teams. Seqwater has one which deals with the manufactured water assets and another which deals with the "natural" water production assets. Veolia has a functional requirement related to the day-to-day operations of the manufactured water assets, building business cases for equipment changes to improve operations and managing the project delivery of approved projects.

Under this arrangement, Seqwater contractually has the responsibility to provide a management mechanism by which the Veolia proposals are approved, rejected or modified to an acceptable outcome. As such, SKM stated that this activity merits further investigation as in SKM's view there is duplication of effort in this activity;

- (b) Asset planning for capital projects is an area where both organisations have at least one business unit (the Integrated Asset Planning team and Project Delivery Team in Seqwater and the Technical Warranty and Development team in Veolia) performing a number of activities associated with this function;
- (c) While each organisation is responsible for different assets, duplication is likely where the two business processes converge for approval and authorisation to proceed. SKM considers that there is likely to be a high amount of duplication of effort in this activity;
- (d) Corporate functions, such as Administration and Finance exist in both organisations, while in part providing independent functions to their respective entities, similar skills and function duplication would likely exist and therefore contain sufficient numbers of full time equivalents as to merit further investigation;
- (e) **Project Delivery:** Seqwater's project delivery team has primary responsibility for delivery of capital projects, however, Veolia is also responsible for project closures and defects liability periods. Due to the nature of the business process employed in the delivery of projects, it is likely that duplication of effort would occur; and

- (f) **Water Quality Management:** Seqwater and Veolia both have water quality responsibilities. Seqwater has a Water Quality and Environment team, while Veolia has both an Environment Management Team and a Technical Process Laboratory which focuses on the manufactured water assets.

Table 4.64: Activities of Potential Duplication of Effort Identified by SKM

| <i>Activity Area</i> | <i>WGM</i> | <i>Seqwater</i> | <i>Veolia Water</i> | <i>Cost Savings Potential</i> |
|--|------------|-----------------|---------------------|-------------------------------|
| Administration | ✓ | ✓ | ✓ | \$\$ |
| Agency Contract Management | ✓ | ✓ | | \$\$\$ |
| Asset Engineering | | ✓ | ✓ | \$\$ |
| Asset Maintenance EMC | | ✓ | ✓ | \$ |
| Asset Maintenance I&C | ✓ | ✓ | ✓ | \$ |
| Asset Planning Strategic | ✓ | ✓ | | \$\$\$ |
| Asset Planning Capital | | ✓ | ✓ | \$\$\$ |
| Compliance Management and Regulation | ✓ | ✓ | | \$\$ |
| Corporate Governance | ✓ | ✓ | | \$ |
| Corporate Knowledge Management | ✓ | ✓ | | \$\$ |
| Corporate Support | ✓ | ✓ | | \$\$ |
| Environment and Sustainability | | ✓ | ✓ | \$ |
| Finance | ✓ | ✓ | ✓ | \$\$ |
| Human Resource Management | ✓ | ✓ | ✓ | \$ |
| Information and Communication Technology (ICT) | ✓ | ✓ | ✓ | \$\$ |
| Legal Services | ✓ | ✓ | | \$ |
| Operations Pipe Networks | | ✓ | ✓ | \$ |
| Operations Water Treatment Plants | | ✓ | ✓ | \$ |
| Procurement | | ✓ | ✓ | \$ |
| Project Delivery | | ✓ | ✓ | \$\$ |
| Relationship management | ✓ | ✓ | | \$\$ |
| Research | | ✓ | ✓ | \$ |
| Risk Management | ✓ | ✓ | | \$\$ |
| Water Quality Management | ✓ | ✓ | ✓ | \$\$ |
| Workplace Health and Safety | | | | |

Source: SKM 2012

Final Report

SKM was directed by the Authority to further review the potential cost savings from duplication of effort between Seqwater and Veolia.

SKM re-categorised and re-prioritised the activity areas identified in the Draft Report. The activity areas and relevant assessment for capital are as follows:

- (a) Asset planning capital – SKM concluded that at present the requirement for water from the two schemes is not required to meet water demand. No forward capital investment planning is done by either organisation in relation to the two schemes and therefore SKM considered that no duplication of effort exists; and
- (b) Asset engineering – SKM noted that it is apparent that due to the contractual arrangement the majority of effort is required to review the projects that are put forward by Veolia for the WCRWS. Due to demonstrated savings in capital investments, the review process employed by Seqwater demonstrates the commitment of Seqwater to run the plants efficiently and taking a proactive approach in ownership of the plants. While SKM considered that Seqwater has provided sufficient information to demonstrate the requirement for the resources for both the Veolia Water operations and Seqwater, there was scope for an efficiency saving of 30% of Seqwater costs, or about \$166,500.

In relation to corporate overheads, SKM's further analysis indicated, in respect of the various cost components that:

- (a) Administration – Veolia provides 2 FTEs for the site office and reception functions. As these provide a safety function as well, SKM was satisfied that no overlaps exist within administration;
- (b) Finance – SKM considered that duplication of effort is due to the outsourcing model implemented and therefore no potential saving could be made;
- (c) Environmental and sustainability – The 3 FTEs allocated at the Western Corridor Recycled Water Scheme are an Environmental Manager, an Environmental Scientist and a Safety Manager. Seqwater has 2 FTEs allocated, 1 FTE per scheme, to undertake stakeholder engagement and environmental monitoring. SKM considered that Seqwater has provided sufficient evidence to establish that there is no duplication of effort;
- (d) HR - SKM considered that Seqwater has provided sufficient information to establish that there is no duplication of effort;
- (e) Procurement - Veolia Water has allocated 0.3 FTE to the GCDP and 1.2 FTE to the WCRWS. SKM considered that Seqwater has provided sufficient information to establish that there is no duplication of effort;
- (f) Research - Seqwater has indicated that at present no resources are allocated to research for the GCDP. Veolia Water has 0.7 FTE allocated for the Gibson Island Pilot Plant Study. It is expected that the study is nearing completion. SKM considered that Seqwater has provided sufficient information to establish that there is no duplication of effort; and
- (g) ICT - Seqwater has indicated that the contracts do not have a specific item for the systems, i.e. software, which Veolia Water uses. The contracts do make provision for

computer hardware. SKM considered the value of the software that Veolia Water provides to be in the order of \$1.0 million per year, SKM understood this amount to include the development and maintenance of the software and systems. SKM considered that Seqwater has provided sufficient information to establish that there is no duplication of effort in this area.

In relation to operations and maintenance activity areas, SKM's conclusions were as follows:

- (a) Water quality management - Seqwater indicated that they are listed as the operator for the GCDP and therefore the onus lies on them to ensure that the water quality tests are undertaken and reported. At present Veolia Water undertakes the sampling and Seqwater undertakes the reporting and submittal of the information. Veolia Water is listed as the operator for the WCRWS and therefore has the responsibility for water quality monitoring, reporting and submittal. Seqwater has a regulatory requirement as a responsible owner to also undertake water quality testing. Seqwater has identified a potential duplication of effort and has responded by reducing the requirement of Veolia Water to only undertake the sampling and testing part. SKM was satisfied that Seqwater has demonstrated that no duplication of effort exists;
- (b) Asset maintenance – Electrical, mechanical and civil (EMC) - Veolia Water has allocated 1 FTE to the GCDP and 2.7 FTE (Maintenance Engineer Officer, Civil Ops Engineer and Document Controller) to the WCRWS. Based on the information presented by Seqwater, SKM was satisfied that Seqwater has demonstrated that no duplication of effort exists;
- (c) Asset maintenance - Instrumentation and control (I&C) - Veolia Water has no FTEs allocated to the GCDP and have 4 FTE (Controls and Instrumentation Engineer and C&I Technicians) to the WCRWS. SKM did not identify any savings; and
- (d) Operations WTP - as noted in regard to the Seqwater/WaterSecure merger, SKM considered that a maximum of \$75,000 per annum cost saving could be made by combining the chemical contracts. This value is based on a 10% cost saving of the Veolia Water's shared chemical cost.

Seqwater's Response

Seqwater suggested that it is not useful to postulate about savings that could arise if a current binding contract is varied. The contract can only be varied with Veolia's agreement. SKM's analysis should only deal with matters of duplication that exist under current arrangements.

As noted above, Seqwater considered that chemicals costs savings are uncertain and are likely to be a maximum \$20,000.

Authority's Analysis

The Authority accepts Seqwater's view that savings achievable in the near term can only be considered in the context of ongoing contractual arrangements. SKM advised that its estimates for savings were only intended to be indicative, being based on limited analysis from a workshop held with Seqwater and without detailed information. The savings were based on benchmarks only and may in some cases not be achievable.

The Authority proposes that none of the recommended savings can be applied to 2012-13 GSCs as they are indicative estimates that may or may not be achievable in the long term.

4.10 Recommended GSCs

Draft Report

In the Draft Report, the Authority noted that the total GSC is higher than 2011-12 due to:

- (a) higher return on and return of assets due to Seqwater's large capital expenditure additions to the RAB;
- (b) higher fixed operating costs due to a number of extraneous factors, such as works associated with the 2011 floods, new waste levies and the cost of implement the Floods Commission of Inquiry recommendations;
- (c) higher fixed operating costs due to internal factors, including labour cost increases and new initiatives to manage water quality risks; and
- (d) higher variable operating costs, largely due to increased electricity prices, including the expected impact of the carbon tax.

These cost increases were partly offset by an \$11.3 million adjustment to Seqwater's capital charge to account for a lower return on capital during 2011-12.

Final Report

Since the Draft Report, the major changes arising in the GSC reflect the revision in the methodology adopted for modelling cash flows. The adjustment noted in the Draft Report has therefore been reversed.

While the Authority now recommends variable charges on a \$/ML basis, the Authority has calculated indicative total GSCs based on the two alternative demand forecasts for comparative purposes (Table 4.65) as there are no approved forecasts.

In addition, the Authority proposes to apply an efficiency target of a 2.5% (including savings identified for specific items) to fixed operating costs. This adjustment is made to recommended GSCs below. Taken together with specific savings, the Authority is proposing a 2.6% reduction in fixed operating costs. Details of the analysis underlying the efficiency target are provided in Chapter 6.

Table 4.65: Seqwater's Revenue Requirements (\$)

| <i>Revenue Component</i> | <i>Approved Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Seqwater proposed 2012-13</i> | <i>QCA Draft Recommendation 2012-13</i> | <i>QCA Final Recommendation 2012-13</i> |
|--|--------------------------------------|-------------------------------------|--------------------------------------|---|---|
| Return on RAB | 443,235,883 | 419,040,458 | - | 444,671,674 | 432,657,858 / 432,621,963* |
| Depreciation | 149,404,262 | 146,011,075 | - | 154,939,022 | 154,405,750 / 154,390,157* |
| Asset Appreciation | -146,624,899 | -138,175,567 | - | -147,233,717 | -143,704,294 / - 143,695,068 |
| Historic Adjustments | - | - | - | -11,303,239 | -21,369,654 |
| Working Capital | 6,294,536 | 6,006,162 | - | 6,232,386 | 6,098,187 / 6,092,397* |
| Capital Charge | 452,309,782 | 432,882,127 | N/A | 447,306,125 | 428,087,846 / 428,039,794* |
| Fixed Operating Costs | 220,816,533 | 220,816,533 | 235,573,063 | 230,596,933 | 232,990,919 |
| 2.5% Efficiency Target | | | | | -5,889,327 |
| Variable Operating Costs \$/ML | 93.41 | 140.15 | 138.91 | 140.15 | 143.26 / 139.08 |
| Variable Operating Costs total | 25,795,593 | 25,795,593 | 39,344,628 | 39,877,530 | 40,761,974 / 39,414,648* |
| Allowable Costs | 10,329,000 | 6,513,000 | 10,587,225 | 6,771,225 | 10,726,962 |
| Revenue Offset | -3,977,000 | -3,977,000 | -4,497,590 | -4,692,590 | -4,692,590 |
| Total Maximum Allowable Revenue | 705,273,908 | 682,030,253 | N/A | 719,859,223 | 701,985,784 / 700,590,407 * |

*Note: *As described in Chapter 3, the Authority has recommended two alternate GSCs, reflecting the November 2011 / May 2012 Annual Operations Plans. In the event that the May 2012 AOP is approved, the lower values should apply to these items*

4.11 Pricing Structure and Invoicing

The Authority recommends that Seqwater's monthly invoices to the WGM include two components, a fixed and variable charge. As noted above, the Authority recommends that Seqwater present the invoice for the variable charge to the WGM as the Authority's recommended \$/ML variable costs for each asset, multiplied by actual volume supplied.

The Authority recommends that each monthly invoice include a constant fixed charge, as per Table 4.66 below. The Authority has calculated the fixed charge as one-twelfth of the Authority's recommended fixed costs (including Allowable Costs and Revenue Offsets) included in Table 4.65 above.

Moreover, it is noted that the Authority's estimates of prices do not include the cost of carbon which the Authority has recommended be treated as a cost pass through.

Table 4.66: Recommended Monthly Fixed Charges (\$)

| <i>Month</i> | <i>Fixed Charge</i> |
|--------------|----------------------------------|
| January | 58,498,815 / 58,382,534 |
| February | 58,498,815 / 58,382,534 |
| March | 58,498,815 / 58,382,534 |
| April | 58,498,815 / 58,382,534 |
| May | 58,498,815 / 58,382,534 |
| June | 58,498,815 / 58,382,534 |
| July | 58,498,815 / 58,382,534 |
| August | 58,498,815 / 58,382,534 |
| September | 58,498,815 / 58,382,534 |
| October | 58,498,815 / 58,382,534 |
| November | 58,498,815 / 58,382,534 |
| December | 58,498,815 / 58,382,534 |
| Total | 701,985,784 / 700,590,407 |

*Note: *As described in Chapter 3, the Authority has recommended two alternate GSCs, reflecting the November 2011 / May 2012 Annual Operations Plans. In the event that the May 2012 AOP is approved, the lower values should apply to these items*

Table 4.67: Variable Operating Charge \$/ML

| <i>Asset</i> | <i>\$/ML</i> |
|--------------------|--------------|
| Banksia Beach WTP | 227.73 |
| Caboolture WTP | 343.24 |
| Dayboro WTP | 159.54 |
| Enoggera WTP | 468.68 |
| Esk WTP | 355.89 |
| Ewan Maddock WTP | 155.66 |
| Image Flat WTP | 70.89 |
| Jimna WTP | 471.82 |
| Kenilworth WTP | 241.16 |
| Kilcoy WTP | 180.76 |
| Lander's Shute WTP | 59.97 |
| Linville WTP | 194.61 |
| Lowood WTP | 167.86 |

| <i>Asset</i> | <i>\$/ML</i> |
|---|---------------|
| Noosa WTP | 15.98 |
| North Pine WTP | 63.33 |
| Petrie WTP | 94.98 |
| Somerset Dam Township WTP | 278.53 |
| Woodford WTP | 331.46 |
| Amity Point WTP | 138.63 |
| Beaudesert WTP | 298.16 |
| Boonah-Kalbar WTP | 243.35 |
| Canungra WTP | 188.98 |
| Capalaba WTP | 181.86 |
| Dunwich WTP | 165.11 |
| Kooralbyn WTP | 426.04 |
| Molendinar WTP | 80.44 |
| Mt Crosby Eastbank WTP | 103.98 |
| Mt Crosby Westbank WTP | 103.89 |
| Mudgeeraba WTP | 140.60 |
| North Stradbroke Island WTP | 92.96 |
| Point Lookout WTP | 108.05 |
| Rathdowney WTP | 202.25 |
| South Maclean WTP | 412.68 |
| GCDP - 33% Utilisation | 745.22 |
| GCDP - 66% Utilisation | 710.31 |
| GCDP - 100% Utilisation | 696.27 |
| Bundamba AWTP | 593.49 |
| Luggage Point AWTP - Low Flow Days (<10.5ML/day) | 688.16 |
| Luggage Point AWTP - Other | 625.27 |
| PRW Network | 133.94 |
| | <i>\$/Day</i> |
| GCDP - Hot Standby production days | 32,983 |
| GCDP - Hot Standby non-production days | 2,287 |

5. LINKWATER

5.1 Background

LinkWater is a Statutory Authority, owned by the State Government and governed by an independent board.

Since its inception in November 2007, LinkWater has acquired assets that provide bulk water transport services with a regulatory value of more than \$2,038 million (as at 1 July 2011).

LinkWater's assets, as at 1 July 2011 broadly comprise:

- (a) the bulk water transport facilities and pipelines inherited from various local councils in SEQ comprising Brisbane City Council, Gold Coast City Council, Redland City Council, Logan City Council, and Moreton Bay Regional Council; and
- (b) drought assets including:
 - (i) the Southern Regional Water Pipeline (SRWP) – connects the Cameron's Hill Reservoir with the Molendinar WTP. The 95km pipeline provides a two-way flow system that is capable of delivering water from Brisbane to the Gold Coast or from the Gold Coast to Brisbane;
 - (ii) the Network Integration Pipeline (NIP) – links the GCDP at Tugun with the Mudgeeraba and Molendinar WTPs;
 - (iii) the Eastern Pipeline Interconnector (EPI) – is a two-way flow connection between Heinemann Road Reservoir in Redlands to Kimberley Park Reservoir, with a pump station and Water Quality Facility at Gramzow Road, Mt Cotton; and
 - (iv) Stage 1 of the Northern Pipeline Interconnector (NPI Stage 1) – which connects Landers Shute WTP within Sunshine Coast Regional Council to North Pine WTP.

Overall, LinkWater's assets include 534 kilometres of pipelines, 28 reservoirs, 22 pump stations and seven water quality treatment facilities (see Table 5.1).

Table 5.1: LinkWater's Assets (as at 1 July 2011)

| <i>Asset Type</i> | <i>Pipeline Length (km)</i> | <i>Reservoirs (Number)</i> | <i>Pump Stations (Number)</i> | <i>Water Quality Facilities (Number)</i> |
|--|-----------------------------|----------------------------|-------------------------------|--|
| Inherited Assets | 350 | 23 | 15 | 2 |
| Southern Regional Water Pipeline | 94 | 4 | 5 | 2 |
| Eastern Pipeline Interconnector | 8.4 | 0 | 1 | 1 |
| Northern Pipeline Interconnector Stage 1 | 47 | 0 | 0 | 1 |
| Network Integration Pipeline | 35 | 1 | 1 | 1 |
| Total | 534.4 | 28 | 22 | 7 |

LinkWater submitted that following the completion of Stage 2 of the Northern Interconnector Pipeline its asset base has expanded further, as LinkWater assumed ownership of an additional 48 kilometres of bulk water pipelines, at an expected value of \$522 million from an expected commissioning date of 1 April 2012.

5.2 Capital Charge

5.2.1 Opening RAB

LinkWater's Submission

LinkWater proposed an opening RAB as at 1 July 2011 of \$1,455 million for drought assets and \$582 million for non-drought assets.

LinkWater stated that its proposed 2012-13 Capital Charge is based on asset values that were utilised for the purposes of calculating 2011-12 GSCs.

Authority's Analysis

Under the Direction Notice, the Authority is required to accept the 1 July 2011 RAB for LinkWater as provided by the Price Regulator.

The opening RAB includes actual ongoing capital expenditure from 2009-10 and 2010-11, reflecting QWC's approach of adding actual non-drought capital expenditure into the RAB as it occurred.

The RAB provided by the Price Regulator differs slightly from that proposed by LinkWater (and adopted during the 2011-12 investigation). LinkWater's non-drought opening RAB has fallen from \$586 million to \$582.3 million - a fall of \$3.7 million, or 0.6%. The drivers for this fall are that the Mount Crosby realisation project is no longer in LinkWater's RAB, and lower than expected capital expenditure in 2010-11.

The Authority has adopted the RAB provided by the Price Regulator for the purposes of recommending GSCs for the 2012-13 regulatory period as required under the Direction Notice.

LinkWater's opening RAB is provided in Table 5.2 below.

Table 5.2: LinkWater's RAB as at 1 July 2011

| <i>Asset</i> | <i>Value (\$m)</i> | <i>Asset Life (Years)</i> |
|--|------------------------|-------------------------------|
| Southern Regional Water Pipeline (SRWP) | 866.3 | 63 |
| Eastern Pipeline Interconnector (EPI) | 40.3 | 57 |
| Network Integration Pipeline (NIP) | 219.5 | 61 |
| Northern Pipeline Interconnector (NPI) Stage 1 | 329.4 | 61 |
| <i>Total Drought</i> | <i>1,455.4</i> | <i>62</i> |
| Non-Drought | 582.3 | 44 |
| Total | 2,037.7 | 57 |

Note: these figures may not add due to rounding. Asset life totals are weighted averages.

5.2.2 2011-12 Capital Expenditure

The Direction Notice requires the Authority to consider any adjustments required due to an over- or under-recovery of GSCs in 2011-12. The Authority's 2011-12 Review Thresholds committed to allowing GSPs to recover actual (rather than forecast) 2011-12 capital expenditure that was prudent and efficient. The Authority therefore requested LinkWater to provide details of estimated actual 2011-12 capital expenditure⁶.

For 2011-12, LinkWater proposed to spend \$24.4 million on capex, a decrease of 5.8% on the \$25.9 million it proposed in 2010-11. LinkWater's proposed 2011-12 capex according to key asset types is summarised in Table 5.3.

⁶ LinkWater's submission date of 29 February 2012 means it could not possibly provide actual capital expenditure for 2011-12. Instead, LinkWater's submission represents estimated actuals. The Authority proposes a further adjustment for actual 2011-12 capital expenditure as part of a subsequent review.

Table 5.3: LinkWater's Proposed 2011-12 Non-drought Capital Expenditure (\$ million)

| <i>Asset Type</i> | <i>Value (\$m)</i> | <i>Asset Life (Years)</i> |
|--|------------------------|-------------------------------|
| Pump Stations | 1.5 | 45 |
| Reservoirs | 3.0 | 55 |
| Trunk Mains | 10.6 | 75 |
| Water Quality | 0.3 | 50 |
| Land | 2.0 | 0 |
| Supervisory Control and Data Acquisition (SCADA) | 3.5 | 7 |
| Buildings | 0.5 | 50 |
| Non-Infrastructure Capex | 2.9 | 3 |
| Total | 24.4 | 45 |

Note: these figures may not add due to rounding. Asset life totals are weighted averages.

LinkWater's proposed capex is categorised into five investment drivers. The proportion of capex proposed to be spent on each driver is given in Table 5.4 below.

Table 5.4: LinkWater's Proposed Non-Drought Capital Expenditure Program for 2011-12 (\$ million)

| <i>Cost Driver</i> | <i>Value</i> | <i>%</i> |
|----------------------------------|--------------|---------------|
| Maintaining Service | 16.5 | 67.5% |
| Renewals | 7.6 | 31.1% |
| Business Efficiency | 0.3 | 1.2% |
| Growth | 0.04 | 0.2% |
| Compliance | 0.0 | 0.0% |
| Total Capital Expenditure | 24.4 | 100.0% |

Note: these figures may not add due to rounding.

LinkWater submitted:

- (a) 70 projects comprised its Maintaining Service capital expenditure (projects to ensure compliance with service obligations) totalling \$16.5 million. This program represented 68% of LinkWater's total non-drought capital expenditure budget, and included the SCADA project (\$3.2 million), the Tenure Gaps Pilot Land Acquisition Project (\$2 million) and the barrel joints program (\$1.7 million);
- (b) its Renewals program consisted of 21 projects totalling \$7.6 million. The two largest projects accounted for 30% of the total renewals program and 9% of LinkWater's total non-drought capital expenditure budget. These two projects were the above ground

pipe recoating programme (\$1.5 million) and the Ipswich Central (Karana Downs) Pipeline replacement (\$1.1 million);

- (c) eight Business Efficiency capex projects totalling \$0.3 million; and
- (d) one Growth driven capital project for 2011-12 is costed at \$44,884. LinkWater stated that the lack of investment driven by growth reflected the current capacity of its drought assets to meet current and medium term forecast demand.

LinkWater also proposed non-infrastructure capital expenditure of \$2.9 million for projects to support the operational activities of the business, including office equipment, fleet and IT equipment. The majority of the non-infrastructure capital expenditure addresses legacy issues relating to IT systems and asset data inherited by LinkWater from the local governments.

The Authority engaged SKM to review the prudence and efficiency of LinkWater's non-drought capital expenditure. SKM reviewed the cost drivers of the capex as well as the need for, scope and standard of works.

For capex to be included in the RAB, it is required to be prudent (demonstrated need for the expenditure) and efficient (cost effective in scope and standard, using market benchmarks).

5.2.3 2011-12 Capital Expenditure Overspends

On a number of items, LinkWater has spent more than was approved in the 2011-12 GSCs. Subsequent to its initial submission in February 2012, LinkWater provided a revised submission to the Authority on 2011-12 capital expenditure, which is assessed below.

Table 5.5 sets out 2011-12 approved forecast compared with 2011-12 estimated actuals (as of February 2012) for the five broad expenditure categories. A number of projects were re-categorised during 2011-12, such as the SCADA project, which has moved from Business Efficiency to Maintaining Service. LinkWater noted that it also made savings of \$1.8 million on projects, and deferred \$1.5 million in work to future periods.

Table 5.5: 2011-12 Capital Expenditure: Approved vs Estimated Actual by Cost Driver (\$'000)

| <i>Cost Driver</i> | <i>Approved Forecast</i> | <i>Estimated Actuals</i> | <i>Difference</i> |
|---------------------|--------------------------|--------------------------|-------------------|
| Growth | 45 | 52 | 15.6% |
| Maintaining Service | 13,261 | 15,363 | 15.9% |
| Compliance | 0 | 0 | - |
| Renewal | 7,557 | 10,033 | 32.8% |
| Business Efficiency | 3,507 | 798 | -77.3% |
| Total | 24,369 | 26,247 | 7.7% |

Note: these figures may not add due to rounding.

Table 5.5 shows that overall, estimated actual expenditure is \$1.9 million, or 7.7%, higher than approved expenditure. There are some material variations for individual categories, although LinkWater's proposed re-categorisation of projects explains some of the variation.

Table 5.6 below compares 2011-12 approved expenditure and estimated actual expenditure by asset class.

Table 5.6: 2011-12 Capital Expenditure: Approved vs Estimated Actual by Asset Class (\$'000)

| <i>Asset Class</i> | <i>Approved Forecast</i> | <i>Estimated Actuals</i> | <i>Difference</i> |
|--------------------|--------------------------|--------------------------|-------------------|
| Reservoirs | 3,013 | 7,147 | 137.2% |
| Balance Tanks | 0 | 0 | 0% |
| Pump Stations | 1,536 | 2,819 | 83.5% |
| Water Quality | 336 | 1,124 | 234.5% |
| Trunk Mains | 10,608 | 8,248 | -22.2% |
| Buildings | 457 | 873 | 91% |
| Land | 2,005 | 1,063 | -47.0% |
| SCADA | 3,483 | 2,118 | -39.2% |
| Non-System Capex | 2,931 | 2,854 | 2.6% |
| Total | 24,369 | 26,247 | 7.7% |

Note: these figures may not add due to rounding.

Many of LinkWater's estimated actual capital expenditure components have changed and are significantly different from the approved forecast.

Table 5.7 below presents approved projects where the estimated actual expenditure varies by 30% or more from that approved.

Table 5.7: 2011-12 Capital Expenditure Items Varying by More Than 30% (\$'000)

| <i>Project</i> | <i>Approved Forecast</i> | <i>Estimated Actuals</i> | <i>Difference</i> |
|---|--------------------------|--------------------------|-------------------|
| Asset Management Information System Upgrade | 561 | 734 | 30.8% |
| Pump Station Valve Security | 79 | 175 | 121.5% |
| Purchase & Install Online Analysers | - | 271 | - |
| Trunk Main Condition Assessment and Rectification | 209 | 372 | 78.0% |
| Hydraulic Actuators Review and Improvements | 540 | 106 | -80.4% |
| SCADA | 3,226 | 1,579 | -51.1% |
| Tenure Gaps Pilot Land Acquisition Project | 1,999 | 1,063 | -46.8% |
| Valves and Chambers Evaluation and Rehabilitation Program | 1,003 | 501 | -50.0% |

Table 5.7 shows that half of the projects with at least a 30% variance in cost were less than approved and half that were more expensive than approved.

5.2.4 2011-12 Un-Forecast Capital Expenditure Items

A key reason for LinkWater's estimated actual 2011-12 capital expenditure being higher than the approved figure is that there were instances in 2011-12 where LinkWater undertook capital expenditure on items that were not forecast at the time of the 2011-12 investigation. When selecting a sample of items to assess for prudence and efficiency, the Authority has therefore focussed on un-forecast items, as opposed to items which were previously approved but overspent.

The sampled items were selected on the basis of the size of expenditure, to achieve as high a proportion of total capex as possible, while also ensuring a spread across asset types and locations.

Prudence and Efficiency Review

The Authority engaged SKM to assess the prudence and efficiency of four of LinkWater's 11 un-forecast projects. Table 5.8 refers.

Table 5.8: LinkWater's Proposed 2011-12 Capital Expenditure on Non-approved items (\$ million)

| <i>No</i> | <i>Item</i> | <i>Estimated Actual Expenditure (\$m)</i> |
|--|---|---|
| 1 | Kuraby Reservoir Concrete Refurbishment | 0.9 |
| 2 | Bundamba PS Flood Mitigation Work | 1.3 |
| 3 | Reservoir Access Hatch Alarms (Various sites) | 0.2 |
| 4 | Supply & Install Mixers (Various sites) | 1.0 |
| Total Sample | | 3.4 |
| Total Estimated Actual | | 26.2 |
| Sample as a % of Estimated Actual | | 13.0% |

Item 1: Kuraby Reservoir Concrete Refurbishment (\$912,000)

LinkWater's Submission

Draft Report

LinkWater (2012a) submitted that the Kuraby Reservoirs Concrete Refurbishment project involves resealing the roof and repair of roof joints and roof gutters at the Kuraby Hill Reservoir to re-establish the contamination barrier at this facility.

Initial external inspections by Cardno in 2009 revealed relatively minor faults requiring rehabilitation, with an estimated cost of \$100,000. An additional \$250,000 was approved in early 2011 to extend the scope of works to include draining the reservoir, completing an internal inspection and undertaking any repair works that may be revealed.

The internal inspection identified multiple penetrations of the roof, extensive degradation of the surface of reservoir internal walls and additional minor structural problems. The extent of the roof faults means there was not an adequate barrier against contaminants entering the reservoir and this public health risk was considered the highest priority for remediation.

The scope of the roof refurbishment included:

- (a) resealing of roof expansion joints;
- (b) installing a water tight barrier across the entire roof to block entry of contaminants through the roof;
- (c) installation of louvres above vent openings;
- (d) repeat reservoir disinfection; and
- (e) investigating the cause of coating blisters.

The cost driver nominated by LinkWater for this project was Renewal.

LinkWater considered two options to address this problem – to do nothing, and to repair the cracks and joints in 2011-12. LinkWater identified a number of disadvantages to doing nothing, such as:

- (a) the cracks would worsen over time and the underlying reinforcement would continue to corrode, leading to a possible structural failure;
- (b) corrosion/degradation would continue to occur and future repair works would be more significant over time;
- (c) minor contamination issues would continue to occur, and this would worsen over time; and
- (d) leakage from the reservoir could create the perception of an unsafe asset to the public, as well as sending a poor water efficiency message.

LinkWater calculated a negative NPV of \$212,000 for this option.

LinkWater identified the following advantages of repairing the cracks and joints in 2011-12:

- (a) preventing the ingress of potentially contaminated water into the tank;
- (b) prevention of structural failure or more extensive repairs in future;
- (c) prevention of the public being concerned by the appearance of the reservoir with its cracks; and
- (d) repairs could, in all probability, be made while the reservoir remains in service.

LinkWater calculated a negative NPV of \$75,000 for this option.

LinkWater considered that there was a possible consequence of loss of water for an entire suburb for 12-24 hours if it did not undertake the repairs, with an expected loss of income or increase in costs of between \$100,000 and \$500,000. LinkWater considered that by undertaking the repairs in 2011-12 there was an unlikely probability of a limited loss of water supply for 6-12 hours and a loss of income or increase in costs of around \$50,000 to \$100,000.

SKM's Review

SKM considered the project as prudent, as the primary driver of Renewal was demonstrated and an appropriate decision-making process was documented.

SKM assessed the efficiency of the scheme and considered that the scope and standard of the works were appropriate.

LinkWater awarded a contract for the sealing of wall cracks and cleaning of walls and columns for \$0.14 million. No documentation on this procurement process was provided. In May 2011 LinkWater approved a variation to the contract for a value of \$0.28 million, a 191% increase, to undertake additional work. Additional remedial works were identified by the contractor and a select tendering exercise led to the appointment of a contractor at a cost of \$0.56 million.

SKM calculated the cost of the project, as submitted by LinkWater, to be \$1.3 million, as opposed to the \$0.9 million proposed by LinkWater. SKM identified several issues with

these estimates, such as some costs appearing excessive or not easily justifiable. SKM also identified areas where information had not been provided.

SKM concluded that the information made available to it was insufficient to assess the efficiency of the project. SKM deducted \$86,548 for service provider isolations, \$29,887 for telemetry and \$34,395 for future committed expenditure. The expenditure SKM recommended for this project was \$722,000.

To assess LinkWater's proposed expenditure, SKM required the following information:

- (a) details of the procurement process for granting the initial contract;
- (b) justification for the service provider isolation cost; and
- (c) justification for the telemetry cost.

Authority's Analysis

The Authority accepted SKM's recommendations that this expenditure was prudent but required further information to fully assess the proposed costs. The Authority included a revised efficient cost of \$722,000 in its recommended GSCs.

LinkWater's Submission on the Draft Report

LinkWater provided additional information regarding the procurement process undertaken. This information showed that LinkWater released a Request for Tender (RFT) to the open market for the Kuraby Reservoir Remediation. As the extent of the damage within the Kuraby Reservoir could not be accurately determined before the contract was awarded a Schedule of Rates was called for in the RFT. In order to compare the Tender Costs a cost analysis exercise was undertaken utilising a repair scenario based upon the essential repairs as specified by the original Cardno assessment report.

When the tender period closed seven submissions were received. The Tender Evaluation was performed in two stages. Initially the tenders were short-listed to three, and then a preferred tenderer was recommended. The evaluation was undertaken based on cost and non-cost performance criteria. On this basis, Waterstop Solutions were selected as the preferred tenderer by the evaluation panel.

SKM's Review

SKM reviewed the additional information provided by LinkWater. LinkWater's Procurement Management Policy specifies that items of capital expenditure with a contract value in excess of \$250,000 are considered to be significant capital works, and therefore procurement involves inviting a public request for tender, a process which usually takes 60 days. This process was followed for the project.

Due to the limited timeframe available to complete the project prior to the summer peak demand when the Kuraby Reservoir was required to be online, LinkWater sought and received Board approval to directly approach at least three contractors to submit tenders. LinkWater had recently undertaken two reservoir remediation projects, and therefore was familiar with available contractors. Consequently, SKM considered that procurement of the Kuraby Reservoir Concrete Refurbishment is consistent with LinkWater's Procurement Management Policy.

SKM noted that the \$86,548 cost for service provider isolations identified in the Project Justification Report appeared excessive. On review of the costs attributed to the project,

LinkWater identified that a line item for the supply and installation of mixers had been allocated to the project in error and that the costs were to be transferred to the correct project. Otherwise, as the work was carried out under the services contract, with set rates, the costs associated with these tasks appeared to be reasonable to SKM.

SKM also stated that the \$29,887 cost for telemetry was not easily justifiable as being within the scope of the work. This cost was associated with the installation of new level instrumentation at the Kuraby Reservoir. This instrumentation upgrade was not included within the original project scope, however it was identified after an incident occurred at Mount Cotton on 14 July 2011 where a water distribution zone lost supply due to a lack of water in the reservoir.

In a post-incident review meeting held with Allconnex, it was agreed to install dual level transmitters at the Mount Cotton Reservoir. As a result of the incident LinkWater determined that level instrumentation should be upgraded at Aspley, Heinemann Road, Narangba, Kimberley Park and Kuraby reservoirs. The upgrade work was conducted in conjunction with the Kuraby Reservoir Refurbishment project as LinkWater considered it prudent to complete it while the reservoir was offline.

While the installation of new level instrumentation, and associated works, at the Kuraby Reservoir was not included in the original scope of work it appeared reasonable to SKM that the work occur while the reservoir was offline for the refurbishment work. The installation of new level instrumentation is also renewal activity and comprises a low percentage of the total works (approximately 4%, or \$38,296). SKM deemed the project to be efficient as the scope is appropriate, the standards of works are consistent with industry practice and the costs have been market tested.

SKM recommends a revised expenditure of \$853,000. The difference to LinkWater's initial estimate of \$912,000 being due to the removal of some costs incorrectly allocated to the project, partially offset by additional costs of new instrumentation and associated works.

Authority's Analysis

The Authority has accepted SKM's finding that the revised expenditure (\$853,000) is efficient.

Item 2: Bundamba Pump Station Flood Mitigation Work (\$1,267,000)

LinkWater's Submission

The Bundamba Pump Station Flood Mitigation Work project involves works to mitigate future flood damage on the Bundamba Pump Station and offtake. Additionally, the project will return the pump station and offtake to their pre-flood state.

During the January 2011 floods the pump station and offtake were inundated, by approximately one metre and two metres respectively. The floor levels were constructed above the 100 year flood level. The pump station and offtake were rendered non-operational by the flood damage. This resulted in an increase in flood insurance premium and an increase of 1,150% to the flood damage deductible limit until such time that flood mitigation works were undertaken.

SKM's Review

SKM considered the project as prudent, as the primary driver of Renewal was demonstrated and an appropriate decision-making process was documented.

LinkWater's cost estimate spreadsheet indicated the latest cost estimate for the project was around \$1.8 million. An error was discovered in the spreadsheet, which appeared to have arisen when the "Construction Estimated – Accruals" line has been added as the construction Purchase Order and the construction costs were double counted. The cost estimate was recalculated to be around \$1.15 million. This value does not match the sum submitted to the Authority of \$1.267 million, however it is less than that stated in the *Resolution by Board Members* document (\$1.6 million including GST).

Authority's Analysis

The Authority notes the inconsistency in values submitted by LinkWater and provided to SKM, and has adopted LinkWater's lower value of \$1.15 million as the efficient value for the project.

No submissions were received in relation to this project.

Item 3: Reservoir Access Hatch Alarms (\$217,000)

Draft Report

LinkWater's Submission

The Reservoir Access Hatch Alarms project involves a site audit being completed to ascertain the extent of security measures to be implemented. These measures are the installation of reed switches to reservoir access hatches which are alarmed back to SCADA. Unauthorised access has been identified as a significant risk through the water quality risk assessment process and this mitigation measure has been identified. The overall project is to install electrically monitored security to hatches, gates and doors at various water reservoirs.

LinkWater (2012a) assessed two options as a means of addressing the problem of unauthorised access – do nothing, and installing the hatch alarms.

LinkWater considered that the major disadvantage of doing nothing was that unauthorised access into the reservoirs would go unnoticed. It attached a negative NPV of \$147,000 to this option. LinkWater considered that the main advantages of installing the reed switches were that all access to the reservoirs would be logged on SCADA and if a breach occurs, an alarm will be received immediately so an investigation can commence straightaway. It considered that if the reed switches were incorrectly specified or fitted, there would be a risk of a potential false alarm. It attached a negative NPV of \$80,000 to this option.

LinkWater undertook a risk assessment of the identified options. It considered the likelihood as 'Possible' of an incident occurring that would have major consequences in terms of health impacts and negative publicity if someone with malicious intent gained access to the reservoirs. It attached a 'Significant' risk rating to this option. It considered that doing nothing had a significant risk rating.

LinkWater attached a medium risk rating to installing the reed switches. It considered that it was unlikely that a negative outcome would occur as a result of installing the reed switches, and that the risk would be lessened if remote monitoring of the reservoir hatches was provided for.

SKM's Review

SKM considered that this project was prudent. It also noted that an appropriate decision-making process was documented.

SKM assessed the efficiency of the project. It noted differences in LinkWater's estimates of the costs involved. LinkWater's project justification report estimated the project to cost \$80,000 while email correspondence suggested a cost estimate of \$271,459. LinkWater's Procurement and Evaluation Plan for this project details that the project was expected to be completed in June 2011, which may explain why the cost was not entered into the 2011-12 budget.

LinkWater invited tenders from two companies who have a Service Level Agreement with it. Both companies tendered. The work was awarded to a contractor for Stage 1 of the work, with a value of \$34,440. Stage 1 of the works comprised an audit and report on each reservoir to ascertain the exact scope of works required. In the Stage 1 report the contractor submitted costs for the 12 reservoirs that they considered required alarms. LinkWater did not provide SKM with the report. Email correspondence from LinkWater indicated the initial budget of \$80,000 was for Stage 1 of the project.

Stage 2 of the work comprised the supply and installation of the infrastructure in accordance with the Stage 1 report. In order to cover the costs of Stage 2, LinkWater approved an initial contract variation of \$185,819, and a second variation of \$3,696. This increased the total costs of the project to \$223,955, in excess of the 2011-12 estimated value of \$217,000. SKM noted that the Stage 1 works were commissioned in April 2011 but no information regarding them was included in the 2010-11 budget. This disparity was not explained.

SKM considered that the process followed by engaging its contractor was not standard, and that the authority of the Capital Review Committee (CRC) to award a variation of 540% more than the initial contract value was not documented.

SKM also noted that LinkWater had not provided information on the current status of the project.

SKM concluded that the cost information provided was inconsistent and needed to be clarified before the project could be considered efficient. To further assess LinkWater's proposed expenditure SKM requires the following information:

- (a) the contractor's Stage 1 report;
- (b) information detailing the inclusions within the 2010-11 budget; and
- (c) documentation detailing the authority of the CRC to award a 540% variation on the initial contract.

Authority's Analysis

In the Draft Report, the Authority accepted SKM's conclusion that further information was required to demonstrate the efficiency of this project and did not include any allowance for the project in LinkWater's GSCs.

LinkWater Submissions on the Draft Report

In response to the Authority's findings LinkWater provided the requested information to SKM.

LinkWater provided additional information to SKM on the total cost of the project which is summarised below in Table 5.9. LinkWater submitted that the total cost of the project is now \$223,955, plus an allowance of 15% for LinkWater's overhead costs.

Table 5.9: Summary of Project Costs (\$)

| <i>Item</i> | <i>Cost</i> |
|--|----------------|
| J & P Richardson Industries Stage 1 contract | 34,440 |
| J & P Richardson Industries Stage 2 contract – Variation 1 | 185,819 |
| J & P Richardson Industries Stage 2 contract – Variation 2 | 3,696 |
| <i>Sub total</i> | 223,955 |
| LinkWater Overheads | 33,593 |
| Total | 257,548 |

SKM's Review

SKM reviewed the additional information provided by LinkWater. SKM sought information on the role of the CRC and its authority to award a 540% variation on the initial contract cost and this was provided. LinkWater demonstrated that the CRC is a key governance body over the operational development and delivery of the capital works program. The role of the CRC is primarily to provide executive level oversight, facilitate rapid decision-making and promote a clear, unified direction. One of the CRC's responsibilities is to review and approve project variations.

The CRC considered the risks of not undertaking the work, and the consequences of potentially over-spending the program budget and concluded that the project addressed a significant risk and remained a high priority. The project budget was increased to accommodate the direct costs and provisional allowances associated with the full Stage 2 scope of works.

SKM noted that the value outlined in Table 5.9 above exceeds the estimated actual value of \$217,000. LinkWater advised that the Stage 1 of the works was undertaken during June 2011 with reports received through June and July. The balance of allocated project funding, \$33,858, was carried in to 2011-12 with the project for Stage 2 of the works.

Based on the initial budget for Stage 1 of the project being \$80,000, the above statement indicates that \$46,142 was spent in the 2010-11 budget for Stage 1. SKM noted that when the \$46,142 is subtracted from the total budget (\$257,548) the remaining \$211,406 is generally consistent with the 2011-12 estimated actual value (\$217,000). SKM therefore recommended adoption of the original estimate of \$217,000.

In terms of following procedures for Stage 2 of the project, SKM noted that J & P Richardson Industries Pty Ltd was engaged for Stage 1 of the project following a Select Request for Tender process. J & P Richardson Industries Pty Ltd was engaged for Stage 2 of the project by utilising the schedule of rates within the Stage 1 tender.

SKM considered that the appropriate process for the approval of the revised project expenditure was utilised with the CRC reviewing and approving the revised expenditure.

Authority's Analysis

The Authority has accepted SKM's finding that the revised expenditure (\$217,000) is efficient.

Item 4: Supply and Install Mixers (\$971,000)

Draft Report

LinkWater's Submission

This project involved the purchase of 20 water mixers over a three year program (2011 to 2014) to be installed at Aspley, Kuraby and Kimberly Park reservoirs in 2011-12; and at Sparkes Hill 2, Green Hill 1 and 2 reservoirs in 2012-13 and Wellers Hill 1 and 2 reservoirs in 2013-14 to eliminate stratification, uniformly distribute disinfectant and reduce the potential for nitrification. The project was initiated due to issues with loss of disinfectant residuals during the summer.

The 'Business Driver Category' nominated by LinkWater (2012a) for this project is Achieving Required Level of Service, which aligns with the Authority's cost driver of compliance.

The loss of disinfectant residuals was believed to be caused by nitrification of water that is disinfected with chloramine and its occurrence is prevalent during warm weather. Nitrification, if left unresolved for prolonged periods, can generate unpalatable tastes and odours in the water. More importantly it also has the potential to place the health and safety of consumers at risk due to the loss of disinfection residual and the possible occurrence of pathogenic bacteria in the supply. If this occurred LinkWater would not be compliant with the requirements of the Australian Drinking Water Guidelines (ADWG).

A recent study was completed to investigate the existing water quality at Sparkes Hill Reservoir, and the supply from upstream reservoirs at Aspley and Green Hill. It was found that major nitrification events occurred in Sparkes Hill and upstream reservoirs. LinkWater advised that several options were considered within the MWH report (this document has not been provided) however the installation of PAX active submersible water mixers was recommended with the aim of breaking down any stratification occurring in the storage to reduce the loss of disinfectant and limit the conditions that encourage growth of nitrification. Based on these findings mixers were installed in Narangba and Alexander Hills reservoirs with favourable outcomes. As this is specialised equipment there is a preference for continuing with the same mixers across all the reservoirs that need these installations.

LinkWater identified two options to address the identified problem – do nothing or purchase 20 PAX water mixers and install six where they were most needed, in Aspley, Kuraby and Kimberly Park.

LinkWater considered that doing nothing would not resolve the nitrification issue. The size of the reservoirs, summer temperatures and the storage of chloraminated water inevitably results in nitrification events or a high potential for them to occur. Such events severely compromise LinkWater's ability to comply with the ADWG which is one of LinkWater's most fundamental performance obligations. This option will not yield the required outcome and was not considered further. LinkWater has completed its Water Quality Risk Assessment Document in support of its Drinking Water Quality Management Plan. This document identifies the risk associated with "Poor mixing within a storage reservoir or balance tank" in the Brisbane area as 'High (12)'.

The alternative option considered was the installation of mixers in the reservoirs to eliminate stratification and reduce the potential for nitrification. This will require the installation of PAX active submersible water mixers and potential upgrades associated with electrical and control services i.e. power supply, telemetry, level monitoring, etc.

SKM's Review

SKM assessed the project as prudent. The primary driver of compliance was demonstrated. An acceptable decision making process had not been documented.

SKM noted that no documentation was provided that identified alternative methodologies or chemicals to chloramine that could be used for disinfection.

SKM considered that purchasing 20 PAX mixers and installing some of them at Aspley, Kuraby and Kimberly Park Reservoirs was appropriate. It deemed the standard of works adopted as consistent with industry standards.

LinkWater's Project Justification Report estimated the capex for 2010-11 as \$892,000, while email correspondence indicated capex of \$971,170. No explanation for this difference was provided. The Project Justification Report refers to a quote and a study undertaken. These items were not made available to SKM.

LinkWater's Procurement Management Procedure stated that items of capex with a value of between \$250,000 and \$100 million must be tendered publicly. LinkWater did not do this, neither did it gain a waiver to not have to do so.

SKM considered that this expenditure was not efficient until the reason for direct selection of the PAX mixer is provided and assessed as valid, given that alternative options were available. SKM's revised cost for this project is \$0.

Authority's Analysis

In the Draft Report, the Authority accepted SKM's conclusion that this item was prudent but not efficient. The Authority excluded all expenditure related to this item from its GSCs.

LinkWater's Submission on the Draft Report

LinkWater provided the requested information outlined above to SKM to allow it to assess the efficiency of this scheme.

SKM's Review

SKM reviewed the additional information provided by LinkWater. LinkWater provided a study setting out the various options LinkWater had identified to address the nitrification problem. LinkWater also undertook a multi-criteria analysis of the options based on reliability/likelihood of success, capex cost, alignment to budget timeframes, safety, operability, opex cost, site constraints, environmental issues and level of stakeholder interaction. The PAX mixers scored the highest in the multi-criteria analysis and were identified as the preferred option due to simpler installation, more satisfactory dosing arrangement and comparable or lower capital cost.

In addition, the installation of PAX mixers was recommended with the aim of breaking down any stratification occurring in the storage to reduce the loss of disinfectant and limit the conditions that encourage growth of nitrification. Based on these findings, mixers were installed in Narangba and Alexander Hills reservoirs as a trial. The trial resulted in favourable outcomes for the reservoirs.

LinkWater provided a quote obtained from Metaval, the sole suppliers of PAX mixers in Australia, for the supply of up to 20 PAX mixers. The quote included a sliding scale of price depending upon the number of mixers purchased.

A proposal for sole source justification was submitted to, and subsequently endorsed by, the Chief Executive Officer for the purchase of all 20 mixers from Metaval in accordance with the LinkWater Procurement Management Procedure (MGT-095). The proposal stated the justification as:

- (a) simple installation with no structural modifications required;
- (b) more satisfactory dosing arrangement;
- (c) lower capital cost; and
- (d) significantly lower operations and maintenance costs.

In relation to value for money the proposal states that despite the sole source engagement, value for money can be demonstrated by comparing the costs of PAX mixers to other mixers currently available. The MWH report outlines five alternative options. The average costs of alternative mixers range from \$30,000 - \$70,000 each.

The direct engagement of Metaval Consolidated Pty Ltd over a public tender process to deliver the PAX mixers was recommended as follows:

- (a) PAX mixers have been recommended by MWH as the preferred mixer to meet LinkWater's requirements;
- (b) Metaval Consolidated Pty Ltd is the bone fide supplier of PAX mixers in Australia;
- (c) costs have been benchmarked already to other mixers currently available, with the PAX mixer being more effective and lower cost; and
- (d) further market approach is considered unnecessary and would delay the mitigation of nitrification events occurring in reservoirs.

SKM noted that it is typical procedure to enter the capital expenditure into the RAB after it has been commissioned. Consequently SKM recommended that the purchase cost for the mixers be distributed across the years in which they are installed and commissioned.

SKM considered the cost of the scheme to be efficient. On the basis of revised information, SKM recommended total expenditure is \$1.124 million, with \$503,000 incurred in 2011-12, and \$362,000 in 2012-13 (Table 5.10).

Table 5.10: Supply and Install Mixers - Revised Capital Expenditure (\$'000)

| <i>Project</i> | <i>2011-12</i> | <i>2012-13</i> | <i>2013-14</i> |
|---------------------------|----------------|----------------|----------------|
| Supply and Install Mixers | 503 | 362 | 259 |

Authority's Analysis

The Authority has accepted SKM's finding that the revised expenditure is efficient and accepts the revised project cost figures, including an allowance of \$503,000 for 2011-12.

Summary of Prudency and Efficiency Review

Draft Report

In the Draft Report, SKM reviewed four cost items and found all were prudent. It also found that three were not efficient. Across these three items, SKM's recommended cost reductions totalling \$1.5 million. This represented 44% of the sample expenditure or 6% of LinkWater's approved capital expenditure for 2011-12.

Final Report

For the Final Report, SKM conducted further analysis of sampled items based on additional information received from LinkWater. The revised analysis resulted in a total of \$2.7 million of the \$3.4 million in sampled items being accepted as efficient. A major part of the reduction was achieved through deferral of the recognition of the installation of mixers until commissioned.

The above analysis, and the Authority's accepted capital expenditure for 2011-12 on these items, is as summarised in Table 5.11.

As noted in Chapter 3, the Authority considered whether the findings of its consultants, SKM, give a clear indication of a systematic problem with LinkWater's capital expenditure planning and delivery processes that would justify extrapolation of the findings of SKM's sample to the broader un-sampled capital expenditure program.

In total, the Authority has reduced sampled 2011-12 capital expenditure by 19% relative to LinkWater's original submission.

The reductions were for two reasons: deferral of expenditure to later years due to staging of the installation of mixers; and errors in calculation of costs and data input. The Authority considers that reductions due to staging costs of multiple items should not be extrapolated to unsampled items as the issue is not expected to be repeated across other items. The calculation/input errors could be considered to be systemic, and would account for a 5% reduction in capital expenditure.

Nevertheless, as the sample accounted for only 12.8% (less than the 30% by value of capital expenditure that the Authority would normally seek to use as the basis for extrapolation), the Authority considered that extrapolation is inappropriate in this case. In doing so, the Authority has also taken into account its findings relating to proposed capital expenditure for 2012-13 (see further below).

Table 5.11: Prudence and Efficiency of 2011-12 Capital Expenditure (\$'000)

| <i>No</i> | <i>Cost</i> | <i>LinkWater Proposed</i> | <i>Prudence (Final)</i> | <i>Efficiency (Final)</i> | <i>Draft Recommendation</i> | <i>Final Recommendation</i> |
|---|---|---------------------------|-------------------------|--|-----------------------------|-----------------------------|
| 1 | Kuraby Reservoir Concrete Refurbishment | 912 | Prudent | Revised to correct calculation error | 722 | 853 |
| 2 | Bundamba PS Flood Mitigation Work | 1,267 | Prudent | Revised to correct calculation error | 1,150 | 1,150 |
| 3 | Reservoir Access Hatch Alarms (Various sites) | 217 | Prudent | Efficient | 0 | 217 |
| 4 | Supply & Install Mixers (Various sites) | 971 | Prudent | Efficient, but some components deferred to 2012-13 | 0 | 503 |
| Total Sample | | 3,367 | | | 1,872 | 2,723 |
| LinkWater Estimated Actual Total 2011-12 Capital Expenditure | | 26,247 | | | 24,752 | 25,603 |
| Total Sample/Total Capex | | 12.8% | | | | |

5.2.5 2012-13 Capital Expenditure

LinkWater's Submission

LinkWater (2012a) submitted that its forecast capital expenditure was prepared in accordance with the requirements of the Market Rules. Further, LinkWater stated that its forecast was based on the WGM's proposed forecast demand volumes and a program of work that a prudent operator would invest to meet its performance obligations.

LinkWater proposed non-drought capital expenditure of approximately \$21.8 million for the 2012-13 regulatory period. This represented a decrease of 10.7%, compared to LinkWater's approved capital expenditure of \$24.4 million for 2011-12.

The expenditure according to key asset types is summarised in Table 5.12.

Table 5.12: LinkWater's Proposed 2012-13 Non-drought Capital Expenditure

| <i>Asset Type</i> | <i>Value (\$m)</i> | <i>Asset Life (Years)</i> |
|--|--------------------|---------------------------|
| Pump Stations | 1.4 | 45 |
| Reservoirs | 3.1 | 55 |
| Trunk Mains | 7.8 | 75 |
| Water Quality | 0.4 | 50 |
| Land | 3.0 | 0 |
| Supervisory Control and Data Acquisition (SCADA) | 2.8 | 7 |
| Buildings | 0.1 | 50 |
| Non-Infrastructure Capex | 3.1 | 3-5 |
| Total | 21.8 | 40 |

Note: these figures may not add due to rounding. Asset life totals are weighted averages.

LinkWater identified the capital expenditure according to drivers as shown in Table 5.13.

Table 5.13: LinkWater's Proposed Non-Drought Capital Expenditure for 2012-13 (\$ million)

| <i>Cost Driver</i> | <i>Value</i> |
|----------------------------------|--------------|
| Maintaining Service | 13.3 |
| Renewals | 2.5 |
| Business Efficiency | 3.9 |
| Growth | 2.1 |
| Total Capital Expenditure | 21.8 |

Note: these figures may not add due to rounding.

LinkWater submitted that:

- (a) 26 projects comprised its Maintaining Service capital expenditure (projects to ensure compliance with service obligations) totalling \$13.3 million. This program represented 61% of LinkWater's total non-drought capital expenditure budget. These projects accounted for 36.9% of the maintaining service program and 39.0% of the total Capital Works Program. Projects in this category included the land tenure gaps and acquisition program (\$3.0 million), the reservoir refurbishment program (\$2.4 million) and the trunk mains – valve inspection and remediation program (\$2.1 million);
- (b) its Renewals program consisted of seven projects totalling \$2.5 million. This program represented 11.6% of the total Capital Works Program. The two largest projects were

the above-ground pipe recoating program and the trunk mains – valve inspection and remediation program, each for \$0.6 million;

- (c) there are 17 Business Efficiency capex projects totalling \$3.9 million. This represented 17.9% of the Capital Works Program. The two largest projects were the NU SCADA Consolidation (\$2.8 million) and the asset information system (\$0.6 million); and
- (d) one Growth driven capital project for a trunk mains at the Image Flat new Bulk Supply Point (\$2.1 million) to connect to the Northern Pipeline Interconnector – Stage 2 (NPI – Stage 2). LinkWater also proposed a trunk main extension in the Scenic Rim for a cost of \$5.4 million and will seek the Authority’s approval for the project if it is considered the most viable solution to the problem it considers exists.

LinkWater also proposed non-infrastructure capital expenditure of \$3.1 million for projects to support the operational activities of the business, including office equipment, fleet and IT equipment. The majority of the non-infrastructure capital expenditure addressed legacy issues relating to IT systems and asset data inherited by LinkWater from the local governments.

LinkWater reiterated that it has two distinct asset bases, comprising the relatively aged

non-drought assets inherited from the former council water businesses and the newly constructed drought assets. LinkWater submitted that the inherited assets attract the majority of non-drought capex over the short-to-medium term despite representing only 28% of LinkWater’s total assets by regulatory value.

Prudency and Efficiency Review – Sampled Items

The Direction Notice requires the Authority to assess the prudency and efficiency of capital expenditure. For capex to be included in the RAB, it is required to be prudent (demonstrated need for the expenditure) and efficient (cost effective in scope and standard, using market benchmarks).

The Authority engaged SKM to review the prudency and efficiency of a sample of LinkWater’s

non-drought capital expenditure. The sample of five projects (Items 1-5 below) comprises 30% of LinkWater’s proposed 2012-13 capital expenditure.

The sampled items were selected on the basis of size of expenditure, to achieve as high a proportion of total capex as possible, while also ensuring a spread across asset types and locations.

The sample is listed in Table 5.14.

Table 5.14: Capex Projects Reviewed by SKM for 2012-13 (\$ million)

| <i>No</i> | <i>Project Title</i> | <i>Cost Driver</i> | <i>Cost</i> |
|---------------------------------|---|---------------------|-------------|
| 1 | Trunk Mains – Valve and Main Inspection and Remediation Program | Level of Service | 2.1 |
| 2 | Trunk Mains – Image Flat New Bulk Supply Point | Growth | 2.1 |
| 3 | Sparkes Hill Reservoir: Reservoir 2 Refurbishment | Level of Service | 1.3 |
| 4 | Asset Information Management System | Business Efficiency | 0.6 |
| 5 | Surge Compressor and Switchboard Replacement | Renewals | 0.5 |
| Total Sample | | | 6.6 |
| Total Capex | | | 21.8 |
| Total Sample/Total Capex | | | 30% |

Note: These figures may not add due to rounding

Item 1: Trunk Mains – Valve Inspection and Remediation Program (\$2,107,000)

Draft Report

[LinkWater's Submission](#)

LinkWater (2012a) submitted that the valves on the assets it inherited are older than on its drought assets and were subject to inconsistent maintenance regimes under the former council businesses. LinkWater's inspections revealed a significant backlog of required maintenance and renewal. Upon completion LinkWater will have remediated all non-functioning valves and will have produced a prioritised list of future inspections for inclusion in the 2013-14 maintenance plan.

[SKM's Review](#)

SKM concluded that the information submitted to it was insufficient to assess whether the proposed expenditure was prudent. SKM's view was that an appropriate decision-making process had not been documented.

This project involves capital expenditure associated with the replacement and enhancement of an asset that currently meets service performance standards and legislative requirements but faces an unacceptable risk of future non-compliance. The renewal will maintain existing levels of service over the life cycle of the asset. Therefore SKM considered that renewal is considered to be an appropriate driver for the project. However, SKM found that there is insufficient evidence to determine that all infrastructure to be replaced is both used and useful. SKM recommended that the project should integrate more risk and asset management planning at an early stage.

SKM noted that LinkWater had considered a list of broad-brush options, including:

- (a) do nothing;
- (b) repair when discovered; and
- (c) programmed inspection and valve renovation.

LinkWater's preferred option was (c). SKM's view was that there had been no real assessment of options within this program, nor the possibility of using a combination of options. A pilot project in 2011-12 indicated that LinkWater's preferred option would represent a significant amount of work, as many of the valves are in confined spaces and the required works are extensive. SKM suggested that LinkWater considers a study of its existing networks in order to determine whether there are any valves which will no longer be required for LinkWater's operational purposes. SKM also recommended that the inspection and remediation program be assessed in conjunction with LinkWater's other planned capital works to avoid remediation of assets shortly to be decommissioned or replaced as part of separate projects. It might be possible, SKM noted, to incorporate some of the works into other capital projects and planned shutdowns.

SKM noted that 675 – or 17% of all valves – were identified as being at “significant risk”. SKM considered it would be prudent to determine which valves will add value by being inspected and/or remediated in order to establish priority.

SKM considered that a more planned and targeted approach would both decrease the likelihood of high-criticality asset failures and lead to more efficient spending. It recommended that a combination of options one and two could be used based on the criticality of the asset, with higher-criticality assets inspected and remediated on a planned schedule, and lower criticality assets fixed as they break or as issues are found.

SKM noted that it had not been provided with any NPV calculation. There have been no comparative cost estimates completed as LinkWater considers this beyond the scope of its assessment processes due to the complex assumptions involved. Similarly, no information has been provided detailing what was achieved during the six month pilot study. It would be beneficial for both LinkWater and external assessors to see evidence of targets, progress and performance indicators.

SKM did not assess the efficiency of the scheme, as its prudence had not been demonstrated. It proposed a cost of \$0 for this scheme. To enable a complete assessment of the scheme, SKM recommended that LinkWater provide the following information:

- (a) outcomes of the pilot study;
- (b) outcomes of a more extensive decision-making process;
- (c) confirmed scope;
- (d) confirmed standards of works;
- (e) a revised budget including overheads; and
- (f) a revised program

Authority's Analysis

The Authority accepted SKM's recommendation that LinkWater's proposed expenditure on the Trunk Mains – Valve and Main Inspections and Remediation Program was not prudent. The Authority did not include any capex relating to this project in the recommendation of GSCs.

LinkWater's Submission on the Draft Report

LinkWater provided additional information to SKM on the costs of this scheme.

SKM's Review

SKM was advised that in 2010 LinkWater engaged SMEC to conduct a review of their Maintenance Management Plan. This review identified that LinkWater had limited knowledge of their civil assets including pipes, pits, valves and reservoirs.

To rectify this deficiency LinkWater proposed to commence a 'Valve and Main Inspection and Remediation Program'. A pilot project commenced in 2011/-12 indicates that the program will be significant as many of the valves are in confined spaces and the works required are extensive. A desktop study also concluded that a number of pipeline schemes were identified as having extreme or high risk rating and therefore prioritised for inspection and testing.

Although there has been no assessment of options within the proposed 'programmed inspection and valve renovation', or consideration of the possibility of using a combination of the options documented in the Project Justification Report, the manner in which the program has been set up is in effect a combination of the 'repair when discovered' option and the 'programmed inspection and valve renovation' option. Under the program, assets which are identified as having a higher risk rating are inspected and tested first with those identified as having a lower rating inspected and tested later. Correct application of the risk rating to an asset is of significant importance.

No NPV calculation was provided to SKM comparing the two options. There have been no comparative cost estimates completed as LinkWater considered this beyond the scope of its assessment processes due to the complex assumptions involved.

Under a "Repair when Discovered" approach problems are fixed when they are discovered and this will reduce the likelihood of future repeats of the same problem at the same location. Such a program would have a lower expenditure profile than the programmed approach but should also include consideration of the third party effects described under the "Do Nothing" approach.

Only the programmed approach minimises the third party costs associated with valve failures, the associated societal costs and the reputation impacts on LinkWater. Such inspections are normal within the industry to ascertain the initial condition of the asset.

SKM considered that a coarse assessment of the cost of these options can be completed focusing on significant aspects to a degree that is appropriate for the task and that these would inform the decision makers including the Board.

SKM assessed the 2012-13 scope of the project as prudent. The primary driver of renewal has been demonstrated. An acceptable decision making process has been documented, but this decision making process can and should be improved.

LinkWater did not go to market for the engagement of labour services for this project. Instead LinkWater solely approached its current Operations and Maintenance contractor, Transfield Services and United Services (collective known as the Operations and Maintenance Joint Venture (OMJV) or Trility), for a quotation for resources to carry out the scope of works for the project. LinkWater advise that they have previously determined that the benefits of having works undertaken by the Service Contractor outweigh the benefits that might be obtained by tendering the works.

LinkWater's procurement procedure provides thresholds in approaching the market for procurement of goods and service relative to contract value. For contracts between \$20,000 and \$100,000 require a formal process of seeking two or more written quotes; for contracts

between \$100,000 and \$250,000 need a minimum of three tenders, proposals or quotes through a formal invitation to those with special expertise and for contracts between \$250,000 and \$100 million must have a public request for tender.

In addition, approval to use a sole source may be permitted in circumstances where only one supplier has the capability to meet the need or there is genuine urgency. Justification to proceed with a sole supplier, under either circumstance, requires documented justification and approval by the Chief Executive Officer (CEO). No documentation has been provided by LinkWater to show that either of these processes has been followed.

LinkWater's Operations and Maintenance contractor submitted a proposal for the provision of two Critical Asset Inspection Teams (CAIT) with a total price per year of \$931,500 plus an additional service fee of \$77,625 per month based on labour, vehicles and tools and equipment. LinkWater advised that the rates provided in the cost estimate correspond with the current hourly wages agreed within the Operation and Maintenance Deed, with the fixed rates only rising in line with CPI. Further, LinkWater advised that they intend to engage with the market to secure a market tested Operation and Maintenance contract in the 2013-14 financial year.

SKM deemed the 2012-13 project as efficient as the scope is appropriate and the standards of works are consistent with industry practice. The use of a cost estimation database in conjunction with costs from previous year's expenditure is an appropriate method to estimate project costs.

The engagement of the current O&M contractor for the works without going to the market is difficult to substantiate without evidence supporting LinkWater's conclusion that the benefits of having work undertaken under the O&M contract outweigh the benefits of going to the market. In addition, a definitive process regarding how the remediation work proceeds once an asset has been identified should be developed. For these reasons, SKM concluded that this project should be considered for ex-post reviews. Until such reviews are completed, it could not confirm the efficiency of future budget expenditure (2013-14 to 2017-18).

Despite the above deficiencies, SKM considered that the proposed 2012-13 expenditure was efficient.

Authority's Analysis

The Authority accepts SKM's finding that the expenditure on the item is prudent and efficient, and included the expenditure of \$2.105 million. LinkWater has not advised why there is a \$2000 difference from the original cost, and the marginally lower estimate is therefore adopted.

Item 2: Trunk Mains – Image Flat New Bulk Supply Point (\$2,073,000)

LinkWater's Submission

The Image Flat WTP supplies water to the Image Flat reticulation system in the Unitywater water supply zone. The Image Flat WTP has a production capacity of 25 ML/day. The forecast Mean Daily Maximum Month (MDMM) is forecast to exceed this by 2016. There is also currently no contingency for plant failure or water quality issues.

Due to demand being expected to outstrip capacity by 2016, and the lack of security of supply, Unitywater lodged a request for the designation of a new bulk supply point at Nambour with the WGM. LinkWater identified a 500mm flow controlled off-take as the optimal solution. This off-take would allow for the Image Flat WTP to be taken offline for extended periods and still allow for a MDMM of 30 ML/day to be supplied.

The WGM approved the request for a 500mm connection to NPI – Stage 2. LinkWater considers that as this solution has been accepted by Unitywater and the WGM that this proposal is prudent.

WGM's Submission

The WGM (2012a) stated that the connection was needed in its *2010-11 Annual Market Rules Review* and in advice to the QWC. The WGM considered that the connection will improve reliability of supply in the area. The WGM submitted that once the connection is constructed, it will not require supply from Seqwater's Image Flat WTP, deferring the need for capital expenditure on that asset.

SKM's Review

SKM viewed this project as prudent, given that it will allow for increased demand to be met, and will delay the need for capital outlay to upgrade the Image Flat Water Treatment Plant. SKM was also of the view that an appropriate decision-making process had been documented.

SKM considered the project as efficient as the scope of the works were deemed appropriate, the standard of works is expected to be consistent with industry practice and the costs were reasonable and will be tested by public tender.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed expenditure for the Image Flat New Bulk Supply Point is both prudent and efficient.

No submissions were received in relation to this item.

Item 3: Sparkes Hill Reservoir: Reservoir 2 Refurbishment (\$1,305,000)

LinkWater's Submission

LinkWater (2012a) submitted that most of its reservoirs are of concrete construction with either a tin or concrete roof. LinkWater is undertaking condition assessments of its assets to inform future capital and maintenance expenditure plans.

LinkWater's 2011-12 inspection program identified a number of defects at the Green Hill, Sparkes Hill and Wellers Hill reservoirs requiring attention to remove potential entry points for contaminants. The full extent of the works required cannot be determined until the reservoirs are drained, cleaned and further inspected.

Based on the defects identified so far, and works required at other reservoirs, LinkWater estimated the works to cost \$1.3 million at Sparkes Hill Reservoir.

SKM's Review

SKM deemed the project as prudent as it seeks to improve service and an appropriate decision making process has been documented.

SKM considered the project as efficient as the scope was appropriate. LinkWater will first undertake an initial clean and inspection of the reservoir, and will then undertake any additional works as necessary, as advised by an independent engineer. SKM considered that the standards of works would be consistent with industry practice, with LinkWater either

applying a contiguous waterproof seal over the entire roof, or undertaking extensive work on all roof joints. SKM noted that the costs will be market tested by public tender.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed expenditure for the Sparkes Hill Reservoir 2 Refurbishment is both prudent and efficient.

No submissions were received in relation to this item.

Item 4: Asset Information Management System (\$632,000)

LinkWater's Submission

LinkWater (2012a) identified issues with how the asset information inherited from the councils had been programmed into its financial and resource planning software (SAP) which hindered its ability to efficiently access this information. The Authority recommended a spend of \$0.6 million in 2011-12 to remedy this problem. LinkWater was of the view that this budget was insufficient to deliver the proposed improvements.

LinkWater engaged KPMG to advise it on the cost of completing this task. KPMG identified a four-phased solution. LinkWater considers the first three phases as necessary to address the problem identified.

The additional cost to complete these three phases is estimated at \$0.6 million. The fourth phase of KPMG's proposed solution was estimated to cost \$5.0 million. LinkWater submitted that it does not wish to progress this recommendation.

SKM's Review

SKM considered the project to be prudent. LinkWater demonstrated that the project would enhance business efficiency, and that an appropriate decision making process was implemented to arrive at the project deliverables.

SKM judged the project as efficient because the scope was appropriate, the standards of works were consistent with industry practice and the costs were consistent with prevailing market conditions, as LinkWater will publicly tender for a provider. SKM noted that the program of works was logical and leverages off existing organisational tools. The program is staged to take advantage of incremental improvements and reviews future stages to confirm that they provide a benefit to the business. SKM also noted that the SAP program contains current industry practice standards and has optional modules that provide an opportunity to develop best practice.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed expenditure on the Asset Information System is both prudent and efficient.

No submissions were received in relation to this item.

Item 5: North Pine Pump Station Surge Compressor and Switchboard Replacement – (\$516,000)

Draft Report

LinkWater's Submission

This project aims to improve the reliability of the water hammer protection for the trunk water main from North Pine pump station to Aspley reservoir. The project will replace two compressors and a switchboard. LinkWater (2012a) assessed the equipment as being at the end of its life. To protect the equipment, LinkWater had two options, which were:

- (a) to replace the equipment inside a new purpose-built building (\$515,056); or
- (b) to replace the equipment inside the existing building (\$177,672).

LinkWater's preferred option was option (a).

SKM's Review

SKM considered the project to be prudent, as LinkWater demonstrated that it qualifies as a renewal project and an appropriate decision-making process was followed.

SKM did not deem the project to be efficient. SKM noted that a detailed scope and design had not been completed when it undertook its review. SKM also noted that the decision to construct a new building was not supported by the expected documentation, such as:

- (a) a condition assessment of the existing building indicating a deteriorated structure;
- (b) a preliminary design that indicates new equipment would not fit within the existing building; or
- (c) a risk assessment of the different construction methods that would indicate that a new building was required.

SKM compiled a cost estimate based on prices obtained for similar equipment and found its estimates to be very similar to LinkWater's. SKM rejected the need to construct a new building to house the compressors and switchboard. This reduced the estimated cost of the proposal by \$340,000. SKM's assessment of the efficient costs needed to replace the surge compressors and pump station led it to an estimate of \$178,000.

SKM recommended that LinkWater provide more following information to enable a complete assessment of the scheme, which should include:

- (a) a condition assessment of the existing building indicating a deteriorated structure;
- (b) a preliminary design that indicates new equipment would not fit inside the existing building; and
- (c) a risk assessment of the different construction methods that would indicate that a new building was required.

Authority's Analysis

The Authority accepted SKM's recommendation that LinkWater's proposed expenditure was prudent, but required further information before it could be accepted as efficient.

LinkWater's Submission on the Draft Report

LinkWater provided additional information to SKM on the costs of this scheme.

SKM's Review

LinkWater accepted the removal of the cost of constructing a new building from the project cost.

LinkWater submitted that the estimate of \$178,000 used for the work was the base cost for the project. LinkWater submitted that an allowance for Direct CAPEX Program Related Costs needed to be added to this to reflect its full program value and to make it comparable to the cost of \$516,000 as originally proposed. This allowance is 15% of the \$178,000, increasing the cost of the project to \$204,000.

Authority's Analysis

The Authority has accepted SKM's finding that the expenditure on the item is prudent and efficient, and has accepted the revised expenditure of \$204,000.

Prudency and Efficiency Review – Additional Item

In addition to SKM's review of Items 1-5 above, the Authority has made comment on a further item (Item 6 below), which was the subject of a submission from the WGM. This item was not reviewed by SKM in setting draft 2012-13 GSCs, but was reviewed by it when the Authority recommended 2011-12 GSCs.

Item 6: SCADA Upgrade implementation – (\$2,800,000)

LinkWater's Submission

LinkWater (2012a) submitted \$2,800,000 for a SCADA upgrade project in 2012-13.

WGM's Submission

The WGM (2012a) considered that there was a clear need for improved data sharing across Grid Participants. It considered that a well-managed SCADA system was essential to effective grid operation, including in order to optimise the operation of existing assets and to mitigate any risks associated with the deferral of proposed capital upgrades.

The WGM highlighted some problems with participants' existing systems, which were inherited from previous councils and alliances. The WGM submitted that these inherited systems ran diverse SCADA applications, were supplied and maintained by different suppliers, had diverse and inconsistent functionality and were not effectively integrated.

The WGM reiterated LinkWater's previously-identified issues with SCADA, such as that it:

- (a) lacked the security and resilience demanded for the management of critical infrastructure;
- (b) had limited and unsatisfactory functionality to meet contemporary operational, management and regulatory need; and
- (c) had a highly inconsistent and hence inefficient user interface, with significant limitations in its ability to interface with other LinkWater systems and those of LinkWater's Grid Participants.

The WGM noted that the efficiency of the project was a matter for the Authority. It noted that cost savings may be able to be achieved through coordination between the two entities, such as by sharing communication equipment. The WGM noted that there had been good cooperation between the entities and some minor cost savings achieved.

Authority's Analysis

When recommending 2011-12 GSCs, the Authority engaged SKM to assess the prudence and efficiency of this project. At that time, SKM considered the project to be both prudent and efficient. Given that SKM considered the project to be prudent in 2011-12, the Authority has not asked SKM to again assess the prudence of the scheme. The Authority also notes that the project's prudence is supported by the WGM.

In terms of efficiency, the Authority notes that the proposed expenditure for SCADA is more than predicted in 2011-12 but the final actual cost is yet not available but will be reviewed once available.

Summary of Prudence and Efficiency Review

Draft Report

In the Draft Report, SKM reviewed five cost items. It found that four were prudent, with insufficient information to establish prudence for one item, Trunk Mains – Valve and Main Inspection and Remediation Program. SKM was unable to assess the efficiency of this scheme. A further item, North Pine Pump Station Surge Compressor and Switchboard Replacement was deemed to have insufficient information to enable an assessment of efficiency.

Across these five items, SKM's recommended cost reductions totalling \$2,400,000. This represented 36.4% of the proposed capex in the sample, and 11.0% of the total proposed capex.

SKM reviewed projects worth \$6,633,000. As SKM's total proposed capital expenditure was \$21,814,000, the sampled capital expenditure comprised 30.4% of LinkWater's total proposed capital expenditure.

The Authority considered one additional item and found it to be prudent. The Authority's Draft Report recommended capital expenditure was \$19,369,000.

Final Report

For the Final Report, following further analysis by SKM, the Authority found that all sampled items were prudent. The revised total efficient amount of the sampled items was \$6.3 million compared to LinkWater's proposed \$6.6 million.

As noted in Chapter 3, the Authority has considered whether the findings of its consultants, SKM, give a clear indication of a systemic or widespread problem with LinkWater's capital expenditure planning and delivery processes that would justify extrapolation of the findings of SKM's sample to the broader un-sampled capital expenditure program.

In total, the Authority has reduced sampled 2012-13 capital expenditure by 4.7% relative to LinkWater's original submission. While the sample represented 30% of total 2012-13 capex, the Authority noted that only one item was found to be inefficient. The Authority considered that it would be inappropriate to extrapolate savings across un-sampled items on the basis of one inefficient item for which the cost adjustment was due to a change in scope.

Table 5.15 below summarises the analysis above.

Table 5.15: Prudence and Efficiency of 2012-13 Capital Expenditure (\$'000)

| <i>No</i> | <i>Cost</i> | <i>LinkWater proposed</i> | <i>Prudence (Final)</i> | <i>Efficiency (Final)</i> | <i>QCA Draft Recommendation</i> | <i>QCA Final Recommendation</i> |
|---|--|---------------------------|-------------------------|--|---------------------------------|---------------------------------|
| SKM Sampled Items | | | | | | |
| 1 | Trunk Mains - Valve and Main Inspection and Remediation Program | 2,107 | Prudent | Efficient, with immaterial adjustment to cost | 0 | 2,105 |
| 2 | Trunk Mains - Image Flat New Bulk Supply Point | 2,073 | Prudent | Efficient | 2,073 | 2,073 |
| 3 | Sparkes Hill Reservoir: Reservoir 2 Refurbishment | 1,305 | Prudent | Efficient | 1,305 | 1,305 |
| 4 | Asset Information Management System | 632 | Prudent | Efficient | 632 | 632 |
| 5 | North Pine Pump Station - Surge Compressor and Switchboard Replacement | 516 | Prudent | One component not efficient; value then revised to correct calculation error | 178 | 204 |
| <i>Total SKM Sample</i> | | <i>6,633</i> | | | <i>4,188</i> | <i>6,319</i> |
| <i>Total SKM Sample/Total Capex (%)</i> | | <i>30.4%</i> | | | | |
| Item Identified in Submissions | | | | | | |
| 6 | SCADA Upgrade | 2,800 | Prudent | Not Assessed | 2,800 | 2,800 |
| Total Reviewed Items +SCADA | | 9,433 | | | 6,988 | 9,119 |
| 2012-13 Capex items not reviewed | | 12,381 | | | 12,381 | 12,381 |
| Total | | 21,814 | | | 19,369 | 21,500 |

Note: These figures may not add due to rounding.

5.2.6 Return on Capital

Under the Direction Notice, the return on drought assets is to be set to the actual cost of debt incurred by LinkWater for its drought assets.

The cost of debt for drought assets is the book interest rate forecast by QTC for 2012-13 for each asset plus administration and capital market charge. The Authority is required to adopt the QTC rates.

QTC provided actual costs of debt for the first three quarters of 2011-12. In applying these costs of debt, the Authority has adopted a simple average of the three quarters of actual 2011-12 costs of debt as an estimated actual for the 2011-12 year.

QTC submitted the costs of debt for LinkWater's drought assets as shown in Table 5.16.

Table 5.16: Cost of Debt Rates for LinkWater's Drought Assets

| <i>Asset</i> | <i>2011-12 Approved Forecast</i> | <i>2011-12 Estimated Actual¹</i> | <i>Forecast 2012-13</i> |
|--|----------------------------------|---|-------------------------|
| Eastern Pipeline Interconnector (EPI) | 6.62% | 6.62% | 6.49% |
| Network Integration Pipeline (NIP) | 6.59% | 6.59% | 6.47% |
| Southern Regional Water Pipeline (SRWP) | 6.62% | 6.62% | 6.48% |
| Northern Pipeline Interconnector – Stage 1 (NPI – Stage 1) | 6.57% | 6.57% | 6.43% |
| Northern Pipeline Interconnector – Stage 2 (NPI – Stage 2) | 6.09% | 5.98% | 5.91% |

Note: ¹Estimated Actual calculated as a simple average of the actual cost of debt for the first three quarters of 2011-12.

For non-drought assets, the Authority must determine a pre-tax nominal WACC based on parameters detailed in the Direction Notice. The cost of debt used in the WACC is the book interest rate forecast by the QTC for each asset plus an administration and capital market charge and a competitive neutrality fee. The Direction Notice prescribed all other parameters to be used in determining the WACC.

For the non-drought WACC, the QTC provided key parameters as shown in Table 5.17.

Table 5.17: QTC Input Parameters for Calculation of LinkWater's WACC

| <i>Parameter</i> | <i>Approved 2011-12 Forecast</i> | <i>2011-12 Estimated Actual</i> | <i>2012-13 Forecast Value</i> |
|------------------|----------------------------------|---------------------------------|-------------------------------|
| Cost of debt | 8.00% | 8.00% | 7.83% |
| Risk-free rate | 5.95% | 5.89% | 5.71% |
| WACC | 9.90% | 9.87% | 9.68% |

As the Direction Notice requires the GSPs' rate of return to be based on the actual cost of debt, the Authority has retrospectively adjusted LinkWater's 2011-12 recommended GSCs to account for changes in the estimated actual costs of debt and WACC.

Return on Assets Summary

In total, the changes to 2011-12 estimated actual capital expenditure, costs of debt and WACC result in a decrease in estimated actual 2011-12 return on capital. Table 5.18 refers.

Compared to the Draft Report, the return on capital for 2012-13 is reduced mainly due to a correction in the cash flow modelling methodology since the Draft Report. Details are provided in Chapter 3 and further below.

Table 5.18: Return on Capital (\$ million)

| <i>Asset</i> | <i>Approved Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>QCA Draft Recommendation 2012-13</i> | <i>QCA Final Recommendation 2012-13</i> |
|---------------------------------------|--------------------------------------|-------------------------------------|---|---|
| Return on Existing Drought Assets | 100.6 | 93.1 | 125.4 | 122.9 |
| Return on Existing Non-Drought Assets | 55.4 | 54.8 | 57.6 | 55.7 |
| Return on New Capex | 1.1 | 3.8 | 0.8 | 1.0 |
| Total Return on Assets | 157.1 | 151.7 | 183.7 | 179.6 |

Note: These figures may not add due to rounding

5.2.7 Return of Capital

Draft Report

LinkWater's Submission

In its submission, LinkWater (2012a) stated that it applied a straight line method of depreciation to its average remaining asset lives. LinkWater forecast a depreciation allowance of \$21.5 million on its drought RAB and \$15.7 million on its non-drought RAB.

In terms of the depreciation of LinkWater's proposed new commissioned capex for 2011-12, applying asset lives consistent with industry standards provided for a depreciation allowance of \$1.8 million over the 2011-12 regulatory period.

Authority's Analysis

Consistent with 2011-12, the Authority proposed to determine the return of capital based on the written down value of the assets and using a straight line regulatory depreciation based on each asset's estimated useful life. Estimated useful lives along with the written down asset values was provided by the Price Regulator.

The Authority adopted LinkWater's proposed asset lives for 2011-12 and 2012-13 capital expenditure.

Table 5.19 refers.

Table 5.19: Depreciation Summary (\$ million)

| <i>Asset</i> | <i>Approved Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>LinkWater Proposed 2012-13</i> | <i>QCA Draft Recommendation 2012-13</i> | <i>QCA Final Recommendation 2012-13</i> |
|-----------------------------|----------------------------------|---------------------------------|-----------------------------------|---|---|
| Existing Drought Assets | 21.9 | 21.9 | 30.9 | 31.6 | 31.0 |
| Existing Non-Drought Assets | 17.9 | 17.9 | 18.3 | 20.8 | 20.1 |
| New Capex | 2.8 | 1.5 | 2.5 | 0.3 | 0.8 |
| Total Depreciation | 42.6 | 41.3 | 51.7 | 52.7 | 51.9 |

Note: These figures may not add due to rounding.

LinkWater's Submission on the Draft Report

LinkWater indicated that the Authority's estimates for return of capital for new assets differed from LinkWater's proposed values.

Authority's Analysis

Initially, a value of \$319,024 was depreciation of new assets included in the table in the Draft Report. The Authority has confirmed that the correct value is \$792,311.

5.2.8 Asset Appreciation

The Authority's GSC modelling includes an allowance for inflation of the value of LinkWater's RAB. The Authority has adopted an inflation rate of 2.5% (the mid-point of the RBA's target range) in both 2011-12 and 2012-13. The Authority considers that, consistent with standard regulatory practice, the increase in LinkWater's RAB values due to inflation should be removed from LinkWater's annual GSCs to prevent an over-recovery of revenues. The Authority's recommend asset appreciation is included in Table 5.20.

Table 5.20: Asset Appreciation (\$ million)

| <i>Asset</i> | <i>Approved Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>QCA Draft Recommendation 2012-13</i> | <i>QCA Final Recommendation 2012-13</i> |
|--|----------------------------------|---------------------------------|---|---|
| Existing Drought Assets Appreciation | 35.2 | 35.2 | 49.6 | 48.6 |
| Existing Non-Drought Assets Appreciation | 14.0 | 13.9 | 14.9 | 14.4 |
| New Capex Appreciation | 3.4 | 1.4 | 0.2 | 0.3 |
| Total Appreciation | 52.6 | 50.6 | 64.7 | 63.3 |

Note: These figures may not add due to rounding.

5.2.9 RAB Roll-Forward

LinkWater's RAB value has been rolled forward from the 1 July 2011 values provided by the Price Regulator to the closing value as at 30 June 2013, utilising the Authority's recommended capital expenditure, appreciation and depreciation. Table 5.21 refers.

Table 5.21: RAB Roll-forward (\$ million)

| | <i>Drought</i> | <i>Non-drought</i> | <i>Total</i> |
|---|----------------|--------------------|----------------|
| Opening RAB (1 July 2011) | 1,455.4 | 582.3 | 2,037.7 |
| <i>plus</i> 2011-12 Capital Expenditure | 535.4 | 25.6 | 561.0 |
| <i>less</i> Depreciation | 22.6 | 18.7 | 41.3 |
| <i>plus</i> Asset Appreciation | 36.4 | 14.2 | 50.6 |
| Opening RAB (1 July 2012) | 2,004.5 | 603.5 | 2,608.0 |
| <i>plus</i> 2012-13 Capital Expenditure | 0.0 | 21.5 | 21.5 |
| <i>less</i> Depreciation | 31.0 | 20.9 | 51.9 |
| <i>plus</i> Asset Appreciation | 48.6 | 14.7 | 63.3 |
| Closing RAB (30 June 2013) | 2,022.1 | 618.7 | 2,640.9 |

Note: These figures may not add due to rounding.

5.2.10 Financial Sustainability

LinkWater's Submission

In its 2011-12 GSCs submission, LinkWater (2011) noted that the current interim regulatory arrangements required that the Authority should allow LinkWater to recover a sustainable revenue stream over time. However, LinkWater submitted that it had forecast net operating losses over the next 10 years. LinkWater stated that this was due to:

- (a) the cost of debt rate of return on drought assets;
- (b) LinkWater's high debt gearing ratio of 91%;
- (c) straight line depreciation with a high weighted average remaining asset life; and
- (d) the regulatory removal of asset appreciation gains from LinkWater's GSCs.

In order to generate an operating surplus, LinkWater proposed an alternative application of the normal building block model which involved:

- (a) the removal of inflationary gains from annual revenues attributable to drought assets only up to a value equal to the nominal depreciation allowance for drought assets;
- (b) the annual difference between the actual inflationary gain and the value removed from annual revenues to be deducted from the value of the drought asset base; and

- (c) continuation of this approach until the annual depreciation allowance equals the annual inflationary gain for drought assets at which point the calculation of annual revenue would revert back to the conventional nominal building block methodology.

LinkWater submitted that this outcome would result in:

- (a) an increase of approximately \$14.66 million to revenue in 2011-12, which would remove the requirement for LinkWater to seek additional within year debt funding;
- (b) consistency with the Government policy that LinkWater does not earn more than its cost of debt on drought assets; and
- (c) preservation of NPV neutrality with the outcome from application of the conventional nominal building block methodology.

In its 2012-13 submission, LinkWater (2012a) reiterated the points it made in its 2011-12 GSCs submission, stating that it had forecast net operating cash shortfalls for a period in excess of 10 years.

LinkWater cited examples from other jurisdictions, where Ofwat and IPART had made allowances for companies if they did not meet the regulator's financial viability assessment.

LinkWater submitted that the Direction Notice requires the Authority to have regard to allowing the GSPs to recover a sustainable revenue stream from the provision of Declared Water Services, recognising that the time horizon may extend beyond a single regulatory period. LinkWater requested that the Authority express a position on what the Authority considers to be an appropriate time horizon to recover a sustainable revenue stream. LinkWater also noted that the Authority's ability to address many of these issues are constrained by the regulatory framework or are best addressed by the Government, as LinkWater's owner.

Authority's Analysis

The Authority has considered the other jurisdictions submitted by LinkWater and notes that an important consideration for Ofwat and IPART in making allowances for financial viability was the need to maintain good credit ratings for the regulated companies, so they could access debt at low levels. However, this is not a consideration for LinkWater, as it does not have a credit rating, and accesses funding through the Queensland Treasury Corporation.

The Authority again makes the point that the water sector is a long term business, and for companies to be cash-flow negative is not uncommon. Indeed, in the report LinkWater references, Ofwat also makes the point that:

in general, the licensed monopoly companies we regulate are cash negative. In the years following privatisation, it was assumed that capital investment would tail off over time, and the companies would become cash positive. In fact, investment has continued to remain high, which means that the companies are likely to remain cash negative. Page 4.

The privatised water and sewerage companies in England and Wales have been regulated for 23 years and remain, on the whole, cash negative. The Authority considers that such an outcome is not to be unexpected in a monopoly water setting and is not, in and of itself, a cause for concern.

In its report, IPART also noted that, if a company was experiencing cash flow issues, that:

where prices are set to recover the efficient costs of providing regulated services over the life of the assets used to provide the services, responsibility for addressing short-term financeability issues should rest in the first instance with the regulated business and its owners/shareholders. For example, the business may be able to better manage its debt or make savings in other areas
Page 3.

With respect to the issue of an appropriate time horizon for a regulated company to recover a sustainable revenue stream, the Authority considers that monopoly water companies are long-term businesses, and cash shortfalls are not unusual over a period of many years. The Authority considers that LinkWater's revenue stream is sustainable over the life of its assets, by the nature of the regulatory model in place.

The Authority also notes that it has not received any evidence that LinkWater's financial position is such that it is at risk of default or insolvency or that, if LinkWater's position persists, either of these risks become possible. The Authority is not aware of any higher financing costs faced by LinkWater as a result of its operating deficits. The Authority considers that LinkWater's current and projected negative operating results are largely the result of Queensland Government policy decisions that the Authority is required to accept, such as a cost of debt rate of return on drought assets, as well as the Government's decision on LinkWater's gearing. It is therefore more appropriate for the Government than the Authority to address LinkWater's concerns.

5.2.11 Working Capital

Working Capital was included as an allowable cost in 2011-12, but as discussed in section 3.4, it has been re-categorised as a component of the Capital Charge in 2012-13.

2011-12 Working Capital

LinkWater was paid a \$2.2 million working capital allowance in 2011-12.

The Authority notes that the Direction Notice requires that the rate of return earned by LinkWater is based on the actual cost of debt. As the calculation of return on working capital utilises the WACC determined by QTC's submitted actual cost of debt, the Authority recommends that LinkWater's 2011-12 working capital allowance be updated. Table 5.22 refers.

2012-13 Working Capital

LinkWater (2012a) stated that three major components should drive the value of working capital for regulatory purposes:

- (a) inventories which reflect the stores required to be held by a water business in order to operate their network including a holding of critical spares which are necessary to correct critical failures;
- (b) accounts receivable associated with collection of regulated revenue; and
- (c) accounts payable related to the amounts paid for operating costs and capital expenditure.

Consistent with the Direction Notice, LinkWater proposed a working capital allowance determined as accounts receivable less accounts payable. Consistent with the approach taken by Authority in its recent GAWB decision, LinkWater also included inventories.

LinkWater has proposed a working capital allowance determined as accounts receivable less accounts payable applying 45 debtor days and 30 creditor days, consistent with the approach proposed by the Authority in 2011-12.

The Authority notes that LinkWater's proposed approach to calculating working capital is consistent with that applied in 2011-12. The Authority accepts that this approach remains appropriate, and recommends a working capital allowance based on prudent and efficient expenditure, as summarised in Table 5.22.

Table 5.22: LinkWater's Working Capital Requirements (\$ million)

| <i>Working Capital Requirement</i> | <i>Approved Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Draft Recommended 2012-13</i> | <i>Final Recommended 2012-13</i> |
|---|----------------------------------|---------------------------------|----------------------------------|----------------------------------|
| Average Accounts Receivable (\$m) | 25.3 | 24.5 | 28.1 | 27.3 |
| Average Accounts Payable (\$m) | 4.6 | 4.5 | 7.1 | 4.6 |
| Average Debtor Days | 45 | 45 | 45 | 45 |
| Average Creditor Days | 30 | 30 | 30 | 30 |
| Critical Spares and Inventories (\$m) | 2.4 | 2.4 | 1.6 | 2.5 |
| Total Working Capital Requirement (\$m) | 23.1 | 22.4 | 23.4 | 25.2 |
| Return on Working Capital – WACC (\$m) | 2.2 | 2.1 | 2.4 | 2.3 |

Note: these figures may not add due to rounding.

5.2.12 Summary of Capital Charge

Draft Report

LinkWater's recommended capital charge is shown in Table 5.23 below. The increase in Capital Charges in 2012-13 is partly due to the commissioning of NPI – Stage 2 in April 2012.

In its Draft Report, in its review of the 2012-13 GSC modelling, the Authority considered there was a computational error relating to the timing of cash flows comprising the 2011-12 Capital Charge. The Authority added an amount of \$3.9 million to the 2011-12 Capital Charges for LinkWater and included the amount in 2012-13 GSC as an adjustment.

As noted in Chapter 3: Regulatory Framework, following discussions with relevant parties the approach adopted in 2011-12 is considered appropriate and no adjustment is now considered necessary.

However, since the Draft Report, the Authority noted that the commissioning date of the Northern Pipeline Interconnector (NPI) Stage 2 was revised from 1 April 2012 (in the Draft Report) to 30 May 2012. The reduction in return on capital and depreciation for this major asset for a two-month period accounts for \$4.4 million of the adjustment to the 2011-12 GSC revenue shown in Table 5.23.

Table 5.23: Capital Charge Summary (\$ million)

| | <i>Forecast 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|-----------------------------------|-----------------------------|-------------------------------------|---|---|
| Return on Assets | 157.1 | 151.7 | 183.7 | 179.6 |
| <i>plus</i> Depreciation | 42.6 | 41.3 | 52.7 | 51.9 |
| <i>less</i> Asset Appreciation | (52.6) | (50.6) | (64.7) | (63.3) |
| <i>plus</i> Working Capital | 2.2 | 2.1 | 2.4 | 2.3 |
| <i>plus</i> Historic Adjustment | - | - | 3.9 | (5.1) |
| Recommended Capital Charge | 149.2 | 144.5 | 177.9 | 165.5 |

Note: these figures may not add due to rounding.

5.3 Fixed Operating Charge

The Direction Notice requires that the Authority assess the prudence and efficiency of all fixed operating costs proposed by the Grid Service Providers.

LinkWater's Submission

In its submission, LinkWater (2012a) proposed fixed operating costs for 2012-13 of \$43.6 million, including:

- (a) corporate costs - \$14.4 million;
- (b) network operational management - \$10.9 million;
- (c) asset maintenance - \$13.9 million; and
- (d) water quality testing - \$3.0 million.

LinkWater stated that it derived all costs through a bottom-up approach where labour, consultancy, contractor and specific non-capital costs were determined for each activity within the fixed operating cost components.

LinkWater submitted that its proposed fixed operating costs for 2012-13 were 3.1% lower, in real terms, than the 2011-12 figures. It considered that its proposed fixed operating costs represented prudent expenditure to ensure the discharge of its performance obligations.

LinkWater contended that its fixed operating costs for 2012-13 were efficient. LinkWater submitted that its 2011-12 fixed operating costs were deemed efficient, there had been no reduction in the scope of service obligations from 2011-12 to 2012-13, and the 2012-13 proposed costs were lower than 2011-12 in real terms.

LinkWater's proposed fixed operating costs for 2012-13 are outlined below in Table 5.24.

Table 5.24: LinkWater's proposed 2012-13 Fixed Operating Costs (\$ '000)

| | <i>Item</i> | <i>Forecast 2011-12</i> | <i>Estimated actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> | |
|--|--|-------------------------------|---|---|---|---------------|
| Corporate costs | CEO and Board | 1,091 | 992 | 1,105 | 1,105 | |
| | Legal and Governance | 1,384 | 1,730 | 1,731 | 1,731 | |
| | Business Services | 3,738 | 3,324 | 3,635 | 3,635 | |
| | Human Resources | 1,016 | 958 | 908 | 908 | |
| | Corporate Services | 1,903 | 1,923 | 2,435 | 2,435 | |
| | IT and Knowledge Management | 2,536 | 3,037 | 3,084 | 3,084 | |
| | Property Leasing | 1,400 | 1,203 | 1,509 | 1,509 | |
| | | <i>Subtotal</i> | <i>13,068</i> | <i>13,167</i> | <i>14,407</i> | <i>14,407</i> |
| Network Operations Costs | Management and Administration | 424 | 413 | 768 | 768 | |
| | Project Services | 1,112 | 654 | 774 | 774 | |
| | Asset Insurance | 1,453 | 1,502 | 1,784 | 1,784 | |
| | Infrastructure Planning | 1,079 | 231 | 463 | 463 | |
| | System Modelling/Network Information | 734 | 1,075 | 1,005 | 1,005 | |
| | Geographic Information Systems | 413 | 629 | 851 | 851 | |
| | Land & Corridor Management | 631 | 695 | 777 | 777 | |
| | Strategic Asset Management | 1,115 | 961 | 1,315 | 1,315 | |
| | SCADA | 454 | 439 | 535 | 535 | |
| | Network Asset Operations | 1,139 | 1,326 | 1,185 | 1,185 | |
| | Service Delivery | 1,054 | 1,010 | 1,167 | 1,167 | |
| | | <i>Subtotal</i> | <i>9,608</i> | <i>8,935</i> | <i>10,624</i> | <i>10,624</i> |
| | Water Quality Testing | Operational and Compliance | 1,468 | 1,425 | 1,338 | 1,338 |
| Laboratory Testing | | 1,500 | 1,480 | 1,660 | 1,660 | |
| | | <i>Subtotal</i> | <i>2,968</i> | <i>2,905</i> | <i>2,998</i> | <i>2,998</i> |
| Asset Maintenance – Fixed Fee | Reservoirs | 1,890 | 2,177 | 2,515 | 2,515 | |
| | Balance Tanks | 85 | 137 | 202 | 202 | |
| | Pump Stations | 2,936 | 1,660 | 2,428 | 2,428 | |
| | Water Quality Facilities | 3,475 | 2,587 | 2,415 | 2,415 | |
| | Trunk Mains | 344 | 1,101 | 379 | 379 | |
| | Buildings | 0 | 0 | 0 | 0 | |
| | Land | 0 | 0 | 0 | 0 | |
| | SCADA | 0 | 0 | 0 | 0 | |
| | Other (condition based) | 1,827 | 4,383 | 2,159 | 2,159 | |

| | <i>Item</i> | <i>Forecast 2011-12</i> | <i>Estimated actual 2011-12</i> | <i>Draft Recommendation 2012-13</i> | <i>Final Recommendation 2012-13</i> |
|---|---------------------------------------|-----------------------------|---|---|---|
| Asset Maintenance - Unplanned | Mechanical | 1,582 | 322 | 427 | 427 |
| | Electrical | 1,794 | 922 | 231 | 231 |
| | Structural | 0 | 0 | 0 | 0 |
| | Operational | 948 | 504 | 1,167 | 1,167 |
| Asset Maintenance - Other | SLAs | 1,200 | 537 | 1,194 | 1,194 |
| | Tools and Materials | 896 | 1,461 | 818 | 818 |
| | <i>Subtotal</i> | <i>16,977</i> | <i>15,791</i> | <i>13,935</i> | <i>13,935</i> |
| Fixed Electricity Costs | Fixed connection costs | N/A | N/A | 504 | 510 |
| | Constant load costs | N/A | N/A | 0 | 219 |
| | - Security and lighting | N/A | N/A | 27 | 0 |
| | - Air-conditioning of switch rooms | N/A | N/A | 82 | 0 |
| | Variable speed drives | N/A | N/A | 164 | 0 |
| | <i>Subtotal</i> | <i>386</i> | <i>607</i> | <i>777</i> | <i>729</i> |
| Item previously in allowable costs | QCA levy | | | 683 | 683 |
| | Total | 43,007 | 41,405 | 43,424 | 43,376 |

Note: these figures may not add due to rounding.

5.3.1 LinkWater's 2011-12 Asset Insurance costs

In 2011-12 LinkWater obtained a preliminary estimate for its asset insurance of approximately \$1.5 million. It included this figure in its 2011-12 GSCs submission. LinkWater later received a quote for insurance of \$1.8 million, and this was its asset insurance bill. When setting final 2011-12 GSCs, LinkWater asked the Authority to allow it to recover the \$1.8 million. As this request was received well after the deadline for submissions on the Draft Report, and too late for the matter to be received to SKM, the Authority rejected this request. In its 2012-13 GSCs submission, LinkWater again requested that it be allowed to recover this \$0.3 million.

The Authority's view is unchanged from last year. The Authority notes that LinkWater's increased insurance bill did not constitute a Review Event (see Chapter 7). As a result, LinkWater will not be able to recover the \$0.3 million for the 2011-12 year in 2012-13 GSCs.

5.3.2 Electricity Costs

LinkWater's proposed fixed operating costs include \$0.7 million of fixed electricity costs. In the 2011-12 Final Report, the Authority's analysis of variable operating costs indicated that \$0.4 million of costs were fixed connection charges that did not vary according to the amount of electricity used.

The Authority has reviewed LinkWater's proposed fixed electricity costs, and made an adjustment to LinkWater's proposed methodology for forecasting the impost of the Clean

Energy Future Plan. See below for more information. In total, the Authority recommends that \$728,687 of fixed electricity costs should be included in GSCs.

5.3.3 QCA Levy

When setting 2011-12 GSCs, the Authority included the QCA levy in the allowable cost category. As per the Ministerial Direction, allowable costs are costs incurred on a one-off basis, with the exception of the QWC levy. So, in setting draft charges for 2012-13, the Authority included the QWC levy as an allowable cost, while the QCA levy was included under fixed operating costs. For 2012-13, LinkWater estimated the QCA levy to be \$0.7 million, by applying the indexation rate of 5.8%, pursuant to the provisions of the Queensland Competition Authority Regulation 2007 (Qld).

The Authority confirmed LinkWater's estimated QCA levy of \$0.7 million.

The Authority omitted (as noted by LinkWater) the QCA levy in the Draft Report for GSCs in 2012-13. The calculation of GSCs has been revised to include the QCA levy.

Prudency and Efficiency Review

For operating expenditure to be included in GSCs, it is required to be prudent (demonstrated need for the expenditure to meet its requirements) and efficient (least cost and consistent with relevant benchmarks, having regard to prevailing market conditions, historical trends and the potential for efficiency gains or economies of scale).

The Authority engaged SKM to review the adequacy of the data provided by LinkWater and the prudency and efficiency of the proposed fixed operating costs.

SKM undertook a sampling process for reviewing LinkWater's proposed fixed operating costs. The sample of 11 cost items was drawn from the corporate costs, network operational management and asset maintenance cost driver categories, which account for 39.1% of total fixed operating costs. The sample is listed in Table 5.25 below.

Table 5.25: Fixed Operational Costs Reviewed by SKM (\$ million)

| <i>No.</i> | <i>Item</i> | <i>Category</i> | <i>Cost Estimate 2012-13</i> |
|------------|---|--------------------------------|------------------------------|
| 1 | IT and Knowledge Management | Corporate Costs | 3.1 |
| 2 | Corporate Services | Corporate Costs | 2.4 |
| 3 | Property Leasing | Corporate Costs | 1.5 |
| 4 | System Modelling | Network Operational Management | 1.0 |
| 5 | Service Delivery | Network Operational Management | 1.2 |
| 6 | Network Asset Operations | Network Operational Management | 1.4 |
| 7 | GIS | Network Operational Management | 0.9 |
| 8 | Laboratory Testing | Water Quality | 1.7 |
| 9 | Reservoirs | Asset Maintenance | 2.5 |
| 10 | Balance Tanks | Asset Maintenance | 0.2 |
| 11 | Operational Maintenance | Asset Maintenance | 1.2 |
| | Total Sample | | 17.1 |
| | Total Proposed Fixed Operating Costs | | 43.7 |
| | Total Sample/Total Fixed Operating Costs | | 39.1% |

Note: these figures may not add due to rounding.

Item 1: IT and Knowledge Management - \$3,084,000

LinkWater's Submission

LinkWater (2012a) submitted that in terms of IT and Knowledge Management, activities were required to integrate asset data into LinkWater's asset information systems including SAP and the AMF to ensure correct and effective operations and maintenance. Work was also necessary to provide connectivity services to provide for the information transfer between the physical location of the asset and the Network Control Centre and LinkWater's back-up data centre.

SKM's Review

SKM found this expenditure to be prudent because IT and knowledge management services are required for LinkWater to meet its obligations under the Grid Contract.

SKM found that expenditure on IT and knowledge management as a whole was considered to be efficient. LinkWater's costs for this category were close to the median benchmarking value from KPMG's external report. In addition, external services have been procured in such a way that costs will be in line with market rates.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed IT and Knowledge Management expenditure is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Item 2: Corporate Services - \$2,435,000

LinkWater's Submission

LinkWater (2012a) submitted that the expenditure for corporate services comprises government relations; community and stakeholder management; annual reporting; employee communications; risk management; health and safety; and environment and human resources.

SKM's Review

SKM considered that the costs for Corporate Services were prudent. LinkWater provided sufficient information for SKM to review all of the Corporate Service activities and SKM deemed that all the activities were necessary for LinkWater to fulfil its obligations in the Grid Contract, as well as regulatory compliance, social expectations and legal obligations.

SKM considered the cost for Corporate Services to be efficient. SKM reviewed the benchmarking that had been undertaken by KPMG and concluded that even with the increase in effort that the Northern Pipe Interconnector Stage 2 will place on LinkWater, the cost proposed was within reason.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed Corporate Services expenditure is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Item 3: Property Leasing - \$1,509,000

LinkWater's Submission

LinkWater submitted (2012a) that the 2012-13 costs were higher than the 2011-12 figure of \$1.4 million, mainly owing to rent increases and LinkWater leasing a small amount of extra office space.

SKM's Review

SKM concluded that this expenditure was prudent. Linkwater requires an office space due to the type of business structure and need for a designated control room, reception area, office space and board room.

SKM concluded that the expenditure for water Property Leasing was efficient. LinkWater has secured a contract at 2008 market rates with Knight Frank until 30 November 2015. SKM was satisfied that the costs associated with Property leasing are delivered in an effective manner.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed property leasing expenditure is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Item 4: System Modelling - \$1,005,000

LinkWater's Submission

Expenditure under this category relates to LinkWater's hydraulic and water quality model, which is its primary analysis and optimisation tool for network operations. LinkWater submitted (2012a) that the model allows it to continually analyse its network performance to ensure it optimally manages its assets.

SKM's Review

SKM concluded that the expenditure for this item was prudent, as the activities undertaken by the system modelling and network information team are necessary for LinkWater to fulfil its obligations in the Grid Contract. SKM considers that the process of system modelling and network information is an essential part of meeting water demand and quality specifications.

SKM considered the expenditure for system modelling and network information was efficient. Whilst detailed benchmarking information was not available, SKM examined LinkWater's proposed expenditure and considered this to be reasonable given the size of the network and the importance placed on the infrastructure in the Grid Contract.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed System Modelling expenditure is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Item 5: Service Delivery - \$1,167,000

LinkWater's Submission

This function is responsible for the programming of maintenance activities to be issued to the Services Contractor and for monitoring and managing the delivery of the maintenance work program.

SKM's Review

SKM considered this expenditure to be prudent. LinkWater has clear obligations in the Grid Contract to ensure that water transported in its assets meets specific water quality levels. SKM sees the maintenance of its infrastructure as an essential part of meeting water quality demands and quality specifications.

SKM considered the expenditure to be efficient. SKM's view was that, as detailed benchmarking information data was not available to enable comparison, it examined LinkWater's proposed expenditure and considered it to be reasonable based on the priority the grid contract places on water quality.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed Service Delivery expenditure is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Item 6: Network Asset Operations - \$1,426,000

Draft Report

LinkWater's Submission

LinkWater (2012a) stated that network operations are focussed on the day-to-day physical operation of the network to ensure that LinkWater meets its water quality assurance and volume requirements under a Grid Contract Document, the Drinking Water Quality Management Plan (DWQMP) and the WGM Grid Instructions. In particular, network operations are responsible for:

- (a) operating the network control centre;
- (b) creating and reviewing maintenance plans;
- (c) conducting security assessments of LinkWater's assets;
- (d) preparing and maintaining service manuals for reservoir, pumping stations and water quality facilities; and
- (e) assessing asset criticality audits.

LinkWater submitted that to maintain its network, it operates a fully manned 365 day 24-hour continuous real-time control room. The control room has the capacity to monitor the entire network and remotely control certain functions of both inherited and new assets.

LinkWater submitted that the Commission of Inquiry highlighted the importance of the Network Control Centre. The Commission noted that the continuous operation of the Network Control Centre was key in ensuring LinkWater could maintain bulk drinking water supplies during the floods.

SKM's Review

SKM concluded that the expenditure for network asset operations was prudent, as the activities undertaken by the network asset operations team were necessary for LinkWater to fulfil its obligations in the Grid Contract. The continuous operation of LinkWater's network assets is imperative for the supply and quality assurance for SEQ.

SKM's view was that insufficient information had been provided to justify whether an increased expenditure on the last financial year is efficient. As the Enterprise Bargaining Agreement provides for a 4% increase in hourly rates, SKM recommended that unless further justification is provided, the cost for network asset operations for 2012-13 be set at 4% above the 2011-12 cost. This has the effect of reducing the cost for network asset operations to \$1.185 million.

SKM did not include in its recommendation any costs associated with the NPI – Stage 2 implementation. SKM did not receive any detailed cost information specific to this task. SKM noted that if LinkWater were to provide details of the additional costs associated with this project in comparison to last year, this may be included as an additional cost allowance.

Authority's Analysis

The Authority accepted SKM's recommendation that LinkWater's proposed Network Asset Operations expenditure was prudent but could not be considered efficient at this stage. The Authority accepted SKM's revised efficient cost of \$1,185,000, a reduction of 16.9% on LinkWater's proposed costs.

LinkWater's Submission on the Draft Report

LinkWater accepted the recommendation made in the draft report. SKM therefore recommends no change to its previously-recommended figure.

Authority's Analysis

The Authority notes LinkWater's acceptance of the recommendation made in the Draft Report and has accepted SKM's recommendation of \$1.185 million as the efficient amount.

Item 7: Geographic Information System (GIS) - \$851,000

LinkWater's Submission

LinkWater (2012a) proposed to invest in a number of technology upgrades for 2012-13. One upgrade related to increasing functionality following the integration of NPI – Stage 2. This functionality included extensions to information on soil classification, third party assets and the environment in which the asset exists.

LinkWater noted that it is creating a complete set of long section drawings of the trunk main network. This GIS asset location data is utilised by the LinkWater Network Control Centre to manage the transport of water within the network during times of asset failure or water quality issues. For example, technical drawings in GIS are used to identify the most suitable scour locations for draining selected sections of trunk mains to ensure a dry jobsite for maintenance activities. During 2012-13, LinkWater intended to integrate these long section drawings into the GIS.

An allowance has been made for consultancy costs for a project labelled Computer Assisted Drawings (CAD) long sections. It is intended that the mass of both paper and digital data that LinkWater has inherited can be converted into a GIS format. The intention is to provide operations and maintenance with more details on the assets they will encounter to enable better provision for planning before a schedule of works is let.

SKM's Review

SKM concluded that the expenditure for GIS was prudent. The activities undertaken by the GIS team are necessary for LinkWater to fulfil its obligations in the Grid Contract. An effective and reliable GIS requires continual investment in technology upgrades and insuring it is underpinned by relevant information. SKM considered the inclusion of the Near Map inventory system to be prudent for the financial year 2012-13 but that further information will need to be supplied from LinkWater justifying the necessity of future reoccurring subscriptions.

SKM was unable to determine whether the expenditure for CAD long sections is efficient as there is a wide range of variables which comprise the cost. However, SKM considered that the expenditure is prudent. Additionally, LinkWater needs to supply information detailing if the allocated costs for the project were sufficient or whether more funding would be required in the following financial years.

SKM were unable to verify the efficiency of the CAD long section project. However, SKM considered that the financial budget for 2012-13 to be generally efficient overall despite this.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed GIS expenditure is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Item 8: Laboratory Testing - \$1,660,000

LinkWater's Submission

To discharge its water sampling and field testing obligations, LinkWater engaged the Australian Laboratory Group Pty Ltd (ALS) through a competitive tender process. LinkWater forecast a spend of \$1.660 million for 2012-13.

SKM's Review

SKM concluded that the expenditure for water laboratory testing was prudent. All of the water quality and compliance activities are necessary for LinkWater to fulfil its obligations in the Grid Contract, as well as legislation, specifically in regards to the DWQMP.

SKM also found that the expenditure for water laboratory testing was efficient. LinkWater put the contract out to market tender and therefore received competitive tenders which were further analysed through a tender review. SKM was satisfied that LinkWater is delivering this service in a cost-effective manner.

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed Laboratory Testing expenditure is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Items 9, 10 & 11: Asset Maintenance - \$2,515,000; Asset Maintenance - \$202,000; Operational Maintenance - \$1,167,000

LinkWater's Submission

LinkWater contracts out a range of planned asset maintenance activities to ensure it meets its legislated service obligations of maintaining reliability and delivering quality water. These activities are performed by the Services Contractor at the rates specified in the Operations and Maintenance Deed. Some of these activities are performed for a fixed fee. One such activity relates to preventive, routine, monitoring maintenance and testing of LinkWater's reservoirs.

Like reservoirs, balance tanks are another of LinkWater's assets which are subject to routine maintenance for a fixed fee, as specified in the Operations and Maintenance Deed.

In addition to the routine inspections and maintenance captured with the fixed fee, the LinkWater Operations and Maintenance Deed provides for additional services under a variable fee arrangement. One such service undertaken for a variable fee is Operational Maintenance.

SKM's Review

SKM reviewed the prudence of the three items above and concluded that all three were prudent. SKM considered that the planned activities for the reservoirs and balance tanks were prudent as they were required to maintain these facilities to support the Drinking Water Quality Management Plans.

SKM reviewed the efficiency of the three items above. It found the costs for these activities to be efficient given the derivation of the costs by the implementation of a time based maintenance activity plan and the costs contained in the current contract that was competitively tendered. SKM noted that LinkWater will be competitively tendering for this service in the 2012/2013 financial year and will be investing in improvements to their SAP based maintenance information system. The proportion for unplanned operational activities (10% of total maintenance costs) is lower than that used by general industry number (30%).

Authority's Analysis

The Authority accepts SKM's recommendation that LinkWater's proposed expenditure on the above three items is both prudent and efficient.

No submissions were received in response to the Draft Report on this item.

Summary of Prudence and Efficiency Review

In the Draft Report, SKM reviewed 11 cost items and concluded that one item was not completely efficient. SKM's recommended cost reduction was \$241,000. This represented 1.4% of the sample items, or 0.6% of LinkWater's proposed 2012-13 fixed operating costs. Table 5.26 refers.

For the Final Report, the Authority's conclusions remain unchanged in regard to the reviewed items. However, there was a slight adjustment to total fixed operating costs to reflect exclusion of carbon cost from the fixed electricity cost.

The Authority also considered the scope for extrapolation of savings identified in fixed operating costs. The Authority's sample covered 38% of total fixed opex, and the savings identified represented 1.4% of the sampled amount. However, as the cost saving was due to insufficient information, and there was only one such item identified, the Authority considered it inappropriate to extrapolate this saving across unsampled fixed operating costs.

Notwithstanding this, the Authority proposes to apply an efficiency target of an additional 1.5% (in addition to the specific savings identified in the analysis above) to fixed operating costs. This adjustment is incorporated in recommended GSCs. Details of the analysis underlying the efficiency target are provided in Chapter 6.

Taken together, the total efficiency saving in fixed operating costs is 2.2%.

Table 5.26: Prudence and Efficiency of Fixed Operating Costs (\$'000)

| <i>N o</i> | <i>Cost Item</i> | <i>LinkWater proposed</i> | <i>Prudence</i> | <i>Efficiency</i> | <i>QCA Draft Recommendation</i> | <i>QCA Final Recommendation</i> |
|----------------|---|-------------------------------|-----------------|-------------------|-------------------------------------|-------------------------------------|
| 1 | IT & Knowledge Management | 3,084 | Prudent | Efficient | 3,084 | 3,084 |
| 2 | Corporate Services | 2,435 | Prudent | Efficient | 2,435 | 2,435 |
| 3 | Property Leasing | 1,509 | Prudent | Efficient | 1,509 | 1,509 |
| 4 | System Modelling | 1,005 | Prudent | Efficient | 1,005 | 1,005 |
| 5 | Service Delivery | 1,167 | Prudent | Efficient | 1,167 | 1,167 |
| 6 | Network Asset Operations | 1,426 | Prudent | Not efficient | 1,185 | 1,185 |
| 7 | GIS | 851 | Prudent | Efficient | 851 | 851 |
| 8 | Laboratory Testing | 1,660 | Prudent | Efficient | 1,660 | 1,660 |
| 9 | Reservoirs | 2,515 | Prudent | Efficient | 2,515 | 2,515 |
| 10 | Balance Tanks | 202 | Prudent | Efficient | 202 | 202 |
| 11 | Operational Maintenance | 1,167 | Prudent | Efficient | 1,167 | 1,167 |
| | <i>Total</i> | <i>17,021</i> | | | <i>16,780</i> | <i>16,780</i> |
| | <i>Fixed Operating items not reviewed</i> | <i>26,644</i> | | | <i>26,644</i> | <i>26,595</i> |
| | Total | <i>43,665</i> | | | <i>43,424</i> | <i>43,377</i> |

5.4 Variable Operating Charge

In its initial submission, LinkWater (2012a) proposed variable operating costs for 2012-13 of \$2.9 million, comprising \$2.3 million for energy costs associated with water pumping facilities to meet forecast demand and \$0.5 million associated with chemical dosing to ensure the quality of water delivered meets safe drinking standards. This is shown in Table 5.27 below. This equated to a per ML cost of around \$16.25.

Table 5.27: LinkWater's Historic Approved Variable Operating Costs (\$ million)

| Cost Category | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2012-13 |
|---------------|------------|------------|------------|------------|--------------|--------------|
| | | | | | Draft Report | Final Report |
| Energy | N/A | 6.0 | 4.0 | 2.6 | 2.3 | 1.9 |
| Dosing | N/A | 1.1 | 0.4 | 0.3 | 0.5 | 0.5 |
| Other | N/A | N/A | 0.1 | 0 | 0 | 0 |
| Total | 4.4 | 7.1 | 4.5 | 2.9 | 2.9 | 2.4 |

Note: these figures may not add due to rounding.

5.4.1 LinkWater and Electricity Market Contestability

LinkWater's Submission

For its 2011-12 submission, LinkWater was a non-contestable electricity customer. LinkWater's investigations indicated potential benefits from becoming a contestable customer, so LinkWater tendered for the supply of its electricity. It received six responses. LinkWater engaged TRUenergy as its electricity provider for the period 1 November 2011 to 30 June 2013.

LinkWater contended it would save \$1.1 million, or around \$4.80/ML, as a result of becoming a contestable electricity customer in 2012-13. LinkWater anticipated this saving despite it forecasting a 25.5% increase in its pumping volumes.

LinkWater considered it should retain 50% of the saving it will achieve from becoming a contestable electricity customer.

Authority's Analysis

The Authority's 2011-12 Final Report on GSCs discussed the merits of GSPs seeking efficiency improvements, and that allowing GSPs and customers to share in these efficiency improvements was a way of incentivising GSPs to do this, while allowing customers to receive some benefit. Specifically, the Authority said:

Under such an arrangement, GSPs will be permitted to retain 50% of any efficiency gains achieved in 2011-12 in 2012-13 GSCs. However, the efficiency gains must be the result of specific initiatives put in place by the GSPs, and should be submitted for consideration as part of the 2012-13 review. p.155, Final Report, SEQ Grid Service Charges, 2011-12.

The Authority accepts LinkWater's submission. The Authority recommends that LinkWater retain all of the savings it expects to make in 2011-12 and that 50% of the efficiency gains received in 2011-12 should be included in 2012-13 GSCs. The Authority considers it appropriate to include such a payment under LinkWater's Allowable Costs, due to its once-off nature.

The Authority calculates that LinkWater saved \$773,291 in 2011-12 as a result of switching to a market contract. This is calculated as the difference between its forecast cost based on not switching to a market contract, and its estimated actual cost after it did switch. The Authority then deducted \$100,000, which was the cost LinkWater incurred in engaging AECOM to advise it on the potential savings of becoming a contestable customer, meaning a net saving of \$673,291. LinkWater is eligible to receive 50% of this as its efficiency reward.

The Authority therefore recommends that LinkWater receives an efficiency payment of \$336,646. This is summarised in Table 5.28 below.

Table 5.28: LinkWater's Efficiency Incentive Payment (\$)

| <i>Cost Item</i> | <i>Cost</i> |
|---|-------------|
| 2011-12 Forecast Electricity Cost | 2,581,774 |
| 2011-12 Estimated Actual Electricity Cost | 1,808,483 |
| Forecast Savings | 773,291 |
| Cost of Engaging AECOM | 100,000 |
| Net Saving | 673,291 |
| LinkWater Efficiency Payment | 336,646 |

5.4.2 The Clean Energy Future Plan

Draft Report

On 10 July 2011, the Federal Government announced its intention to implement a price on carbon pollution via a Clean Energy Future Plan (CEFP). This will increase LinkWater's electricity costs, and will also increase the price of carbon-intensive goods and services that LinkWater procures, as suppliers pass on some of their increased costs. The CEFP was not in place when LinkWater agreed its contract with TRUenergy. The contract allows for the full pass-through to LinkWater of cost impacts on TRUenergy associated with the introduction of a price on carbon.

In the Draft Report, the Authority noted that LinkWater estimated the total variable cost impact of the carbon tax for 2012-13 to be \$0.4 million. The formula that LinkWater adopted is consistent with:

$$\text{kWh (at each pumping station)} \times 0.9\text{kg/kWh (carbon intensity factor)} \times \$23 \text{ per tonne (Federal Government's mandated cost of carbon)}.$$

The approach adopted by LinkWater is consistent with the generally accepted approach to calculating the cost of the carbon tax on energy use. It also aligns with the methodology adopted by Seqwater.

Given the potential for variability in the carbon intensity index and the energy consumption forecasted at each pumping station for LinkWater's estimate of the cost of carbon each month, the Authority was unconvinced that this approach was the best way forward. Instead, the Authority applied a 10% increase to the relevant components of the fixed and variable charges incurred by LinkWater. This was consistent with the approach adopted for Seqwater. The Authority proposed to give this matter further consideration prior to the Final Report.

Authority's Analysis

Subsequent to the Draft Report, the Authority has undertaken a further assessment of LinkWater's proposed electricity costs, which it submitted for the Draft Report.

Treatment of carbon costs

In its Draft Report, the Authority applied a 10% carbon cost allowance to energy consumption at all pump stations.

The Authority understands that the Australian Energy Market Operator (AEMO) will be responsible for setting a carbon intensity index each month and that this will be determined by the mix of generation supplying electricity to each region within the national electricity market (NEM). Given the mix of generation tends to change each month, this means the index will change and so will the associated carbon costs.

In Queensland, the variation in the carbon intensity factor tends to be between 0.82 and 0.86 tonnes of carbon dioxide per megawatt hour of generation. This will in turn lead to a monthly variation in carbon costs of around 4-5%.

The variability could impose a potential risk to LinkWater if carbon was included in an estimate of variable electricity costs (albeit minor).

The Authority notes that Seqwater has proposed that actual costs of carbon (which incorporate actual adjustments for the carbon intensity index) be passed through in the GSCs as Seqwater has no control over these costs (set by electricity retailer).

The Authority accepts that approach, and proposes to adopt the same approach for LinkWater. That is, the GSCs exclude the cost of carbon in electricity and are therefore lower than estimates in the Draft Report (which included a 10% carbon cost allowance).

Constant Load Costs

Constant load costs vary with energy consumption and therefore attract a carbon cost. They have been treated by LinkWater as fixed costs as they tend not to vary with transported water.

LinkWater's proposed fixed electricity costs of \$0.8m (\$777,419) included a 20% carbon tax allowance to the constant load cost component of \$218,595.

On the basis of the proposed pass through of the costs of carbon, this allowance of 20% is removed from the recommended GSC.

Variable electricity costs

The Authority notes that LinkWater's variable electricity costs of \$2.3 million included 20% carbon tax allowance in addition to the variable base electricity costs of \$1.9 million. As noted the Authority recommends that carbon costs are passed through to the WGM and the 20% allowance is therefore unnecessary.

LinkWater's proposed, and the Authority's recommended, electricity costs are summarised in Table 5.29.

The Authority notes that variable electricity costs are expressed in per ML terms and therefore no volume risk arises. However, the Authority notes that per ML costs of energy need to be reduced and, for that purpose, proposes that any future reviews of the prudence and efficiency of proposed capital expenditure (particularly relating to pumps) take into account the cost of energy.

Table 5.29: LinkWater's Electricity Costs (\$)

| <i>Pumping Station Facility</i> | <i>LinkWater Proposed Variable Charge,(excl carbon)</i> | <i>LinkWater Proposed Variable Charge (incl carbon)</i> | <i>Recommended Variable Charge (\$/ML excl carbon)</i> |
|---------------------------------|---|---|--|
| Drought | | | |
| SRWP – Nth Fl | | | |
| Chamber's Flat | 262,957 | 289,253 | 17.392 |
| Coomera | 189,419 | 208,361 | 11.842 |
| Molendinar | 193,844 | 213,228 | 11.862 |
| SRWP – Sth Fl | | | |
| Bundamba | 0 | 0 | 0 |
| Swanbank | 2,161 | 2,377 | 0 |
| NIP | | | |
| Tarrant Drive | 81,468 | 89,615 | 5.772 |
| EPI – West Fl | | | |
| Gramzow Road | 71,365 | 78,502 | 48.880 |
| NPI - Stage 1 | | | |
| Caloundra St | 0 | 0 | 0 |
| NIP - Stage 2 | | | |
| Narangba | 1,916 | 2,108 | 0 |
| Eudlo | 1,916 | 2,108 | 0 |
| Noosa | 0 | 0 | 0 |
| Non-drought | | | |
| North Pine | 404,892 | 445,381 | 10.858 |
| Aspley | 51,359 | 56,495 | 3.732 |
| Lloyd Street | 59,883 | 65,871 | 7.341 |
| Stones Road | 176,154 | 193,769 | 19.516 |
| Learoyd Road | 274,474 | 301,921 | 30.409 |
| Wellers Hill | 0 | 0 | 0 |
| Trinder Park | 59,022 | 64,924 | 37.859 |
| Daisy Hill | 7,639 | 8,403 | 24.484 |

| <i>Pumping Station Facility</i> | <i>LinkWater Proposed Variable Charge,(excl carbon)</i> | <i>LinkWater Proposed Variable Charge (incl carbon)</i> | <i>Recommended Variable Charge (\$/ML excl carbon)</i> |
|---------------------------------|---|---|--|
| Kimberley Park | 13,061 | 14,367 | 41.862 |
| Alexander Hills | 5,524 | 6,076 | 9.222 |
| Heinemann Road | 52,479 | 57,727 | 9.486 |
| Eprapah Creek | 0 | 0 | 0 |
| Byrnes Road | 0 | 0 | 0 |
| Total | 1,909,535 | 2,100,489 | 12.850 |

Notes

1 Individual estimates may not add due to rounding.

2. Swanbank, Narangba and Eudlo each have 0 ML allocated, but attract annual charges (\$2,161, \$1,917 and \$1,917 respectively), therefore, these have been added to the fixed connection costs.

Prudency and Efficiency Review

As noted above, for opex to be included in prices, it is required to be prudent (demonstrated need for the expenditure to meet its requirements) and efficient (least cost and consistent with relevant benchmarks, having regard to prevailing market conditions, historical trends and the potential for efficiency gains or economies of scale).

The Authority engaged SKM to review the adequacy of the data provided by LinkWater and the prudency and efficiency of the proposed variable operating costs.

SKM undertook a sampling process for reviewing LinkWater's proposed variable operating costs. The sample of one project was drawn from the chemical cost category, which is for \$0.5 million, or 18.7% of total variable operating costs.

Item 1: Chemical Dosing Costs - \$0.5 million

LinkWater's Submission

LinkWater (2012a) submitted that its Grid Contract Document requires the ability to deliver different water quality configurations (i.e. chlorinated versus chloraminated) to the different demand zones.

LinkWater stated that water dosing volumes are impacted by the distance of the demand zone location from the water dosing facility given that the chlorine/chloramine levels decline over time and distance transported. That is, water may require re-dosing to top up chlorine/chloramine levels during transit to the final demand delivery zone.

In developing its forecast costs, LinkWater determined the type and level of dosing required from each water supply source to satisfy the different water quality standards at each Distributor-Retail entity demand zone.

Previously, LinkWater did not have a chemicals contract with a guaranteed delivery time provision. This was identified as a significant risk as it exposed LinkWater to a potential water quality incident by not having the necessary type or quantity of chemical available to guarantee continuity of chemical dosing. For 2012-13, LinkWater will enter into a new contract for the provision of chemicals, following a competitive procurement process. In

gaining guaranteed delivery, the costs for some chemicals have increased materially, as set out in Table 5.30 below.

Table 5.30: LinkWater's Chemical Cost Changes 2011-12 to 2012-13

| <i>Chemical</i> | <i>2011-12 Unit Price (\$/L)</i> | <i>2012-13 Unit Price (\$/L)</i> |
|----------------------|----------------------------------|----------------------------------|
| Sodium Hydrochlorite | 0.18 | 0.30 |
| Aqueous Ammonia | 1.08 | 0.71 |
| Sodium Hydroxide | 0.25 | 0.70 |
| Sulphuric Acid | 0.38 | 0.50 |

Based on its forecast demand and chemical costs, LinkWater's forecast chemical dosing costs for 2012-13 are \$0.5 million, as set out below in Table 5.31.

Table 5.31: 2012-13 Forecast Water Dosing Costs

| <i>Water Quality Facility</i> | <i>Annual Forecast (ML)</i> | <i>Cost (\$)</i> |
|-------------------------------|-----------------------------|------------------|
| Chambers Flat | 15,119 | 256,670 |
| Gramzow Rd | 1,460 | 29,085 |
| Alexandra Hills | 3,941 | 18,915 |
| Stapylton | 0 | 0 |
| Heinemann Rd | 9,490 | 10,253 |
| Caloundra St | 10,946 | 201,269 |
| NPI – Stage 2 | 1,825 | 16,671 |
| Total | 42,781 | 532,863 |

A comparison of 2011-12 and 2012-13 chemical costs is given below in Table 5.32.

Table 5.32: Comparison of 2011-12 and 2012-13 Average Chemical Costs

| <i>Water Quality Facility</i> | <i>2011-12 Average Chemical Costs (\$/ML)</i> | <i>2012-13 Average Chemical Costs (\$/ML)</i> |
|-------------------------------|---|---|
| Chambers Flat | 13.50 | 16.98 |
| Gramzow Rd | 9.96 | 19.92 |
| Alexandra Hills | 3.73 | 4.80 |
| Stapylton | 0 | 0 |
| Heinemann Rd | 0.94 | 1.08 |
| Caloundra St | 9.62 | 18.39 |
| NPI – Stage 2 | N/A | 9.13 |

As Table 5.32 shows, average chemical costs are expected to be higher for all water quality facilities, with costs for Gramzow Rd and Caloundra St are expected to be around 50% higher in 2012-13 than in 2011-12.

LinkWater has identified a number of risks in its existing contract. It has tendered for a new chemicals contract and has included conditions to give it higher levels of service.

SKM's Review

SKM considered it prudent to seek to address the risks LinkWater identified. SKM's view was that by seeking a higher level of service, the cost of the contract would increase. SKM was also of the view that seeking this service improvement was not unreasonable, given the importance of water to the health of SEQ. All three tenders LinkWater received were non-compliant because they could not meet minimum commercial and product requirements. LinkWater is negotiating with its preferred provider to establish the terms for supply and delivery of chemicals.

SKM considered that the proposed costs were generally efficient, as LinkWater had competitively tendered the contract. One issue SKM found with LinkWater's proposed costs was that, despite having reasonable certainty over them, LinkWater had increased them by 5%. SKM deemed this inappropriate, given that they had increased substantially from the previous year, and there were few uncertainties surrounding them. SKM recommended the removal of this 5% uplift. This reduced the cost by \$27,000, to \$506,000.

Authority's Analysis

The Authority accepts SKM's conclusion that the item is prudent. The Authority also accepts SKM's revised figure.

No submissions were received in response to the Draft Report on this item.

Summary of Prudency and Efficiency Review

In the Draft Report, SKM reviewed one cost item and found it to be prudent and generally efficient. SKM found that LinkWater had inappropriately applied a 5% uplift to its proposed costs. SKM recommended removing this uplift reducing the proposed costs by \$27,000.

This reduction represents 5.1% of the proposed expenditure in the sample, and 0.9% of the total proposed expenditure.

As only one item was sampled, the Authority considered it inappropriate to extrapolate cost savings to other cost items.

The Authority proposes no change for the Final Report.

5.4.3 Forecast Demand

Draft Report

The Direction Notice requires the Authority to accept production forecasts for the regulatory period consistent with the WGM's Operating Strategy. As required by the Direction Notice, the WGM provided the approved November 2011 Operating Strategy to the Authority with details of the forecast volumes at pump stations and chemical dosing points in the Water Grid. The November 2011 forecasts are provided in Table 5.33.

LinkWater's Submission

LinkWater's (2012a) submission also includes details of forecast treatment plant volumes to be dispatched. LinkWater's submission corresponds with that of the WGM exactly, save for that LinkWater has included volumes from the Caboolture and Woodford treatment plants. LinkWater's forecast volumes from those plants are as below in Table 5.33.

Table 5.33: LinkWater's Forecasts of WTP Volumes from Caboolture and Woodford WTPs

| <i>Water Treatment Plant</i> | <i>Owner</i> | <i>Forecast ML per annum</i> |
|------------------------------|--------------|------------------------------|
| Caboolture | Seqwater | 613 |
| Woodford | Seqwater | 319 |
| Total | | 932 |

LinkWater submitted that its variable operating costs are largely driven by which assets are defined in the Grid Instructions to transport water to meet demand. Specifically, when the Water Grid is operating in drought mode there is a greater reliance on LinkWater's interconnecting pipes which require greater pumping capacity to transport water from one region to another.

However, when the Water Grid is operating in non-drought mode, the reliance is on regional water supply which does not require the same degree of pumping.

LinkWater stated that prior to 2010, the water grid operated in drought mode. For this reason, LinkWater's historic variable operating costs have been high relative to the costs proposed for 2011-12.

LinkWater submitted pumped volume of 148,607 ML per year, as an estimate of the proportion of total water transported (230,138 ML) that requires assisted pumping rather than gravity feed. This is an increase of 25.5% compared with pumped volumes in 2011-12. The proportion that requires pumping can vary significantly from year to year depending on the operation of the Water Grid.

Similarly, LinkWater submitted that the volume of water requiring chemical dosing is forecast at 42,781 ML for 2012-13.

Authority's Analysis

In the Draft Report, the Authority noted that the WGM listed the Caboolture and Woodford WTPs as infrastructure it did not expect to be needed in the short to medium term, and did not include any transported volumes from these WTPs during 2012-13 in its Annual Operations Plan (WGM 2011).

As the Authority considered it more appropriate to accept the most recent demand forecast in the WGM's submission, the Authority did not include any water transport volumes from the Caboolture and Woodford WTPs.

WGM's Submission on the Draft Report

Subsequent to the Draft Report, the WGM provided the May 2012 Annual Operations Plan, noting that it was currently being assessed by the QWC. The May 2012 Annual Operations Plan includes a small revision to the expected water transport volumes. Table 5.34 refers.

Authority's Analysis

As noted in Chapter 3, the Authority's proposed approach is to recommend the efficient per unit variable operating charge.

These variable charges should be applied by LinkWater at each transfer point.

To provide an indicative estimate for the total GSC, the Authority proposes to estimate a total for both the November 2011 and May 2012 forecasts provided by the WGM. While the November 2011 forecasts may well be considered out of date, they are consistent with the system capacities that have been approved by the QWC, and do not incorporate volumes from Caboolture and Woodford WTPs.

For information purposes, the November 2011 and May 2012 forecasts are compared in Table 5.34.

Table 5.34: Water Grid Manager's Forecasts of WTP Volumes to Transfer, ML/year

| <i>Water Treatment Plant</i> | <i>Owner</i> | <i>November 2011 AOP Forecast</i> | <i>May 2012 AOP Forecasts</i> |
|-------------------------------|--------------|-----------------------------------|-------------------------------|
| Landers Shute | Seqwater | 10,946 | 10,946 |
| Molendinar | Seqwater | 49,813 | 50,707 |
| Mudgeeraba | Seqwater | 18,317 | 17,690 |
| Gold Coast Desalination Plant | Seqwater | 8,110 | 7,078 |
| Mt Crosby | Seqwater | 95,983 | 97,748 |
| North Pine | Seqwater | 33,536 | 34,468 |
| Capalaba | Seqwater | 3,943 | 3,943 |
| North Stradbroke Island | Seqwater | 9,490 | 9,490 |
| Total | | 230,138 | 232,069 |

Note: Figures may not sum due to rounding.

In LinkWater's GSC submission it set out the forecast volumes which would come from each pump station, and how much water would require chemical dosing. There has been a small change to the quantity of water that will require pumping. North Pine Pump Station is now forecast to transfer 34,468ML of water instead of 33,536ML. Molendinar WTP will transfer 50,707ML of water instead of 49,813ML.

The quantity of water requiring chemical dosing remains unchanged from the draft. Table 5.35 below sets out \$/ML dosing costs per water quality facility, and total dosing costs.

Table 5.35: Dosing Costs per Water Quality Facility

| <i>Water Quality Facility</i> | <i>Annual ML</i> | <i>2012-13 \$/ML</i> | <i>2012-13 Cost</i> |
|-------------------------------|------------------|----------------------|---------------------|
| Chambers Flat | 15,119 | 16.98 | 256,670 |
| Gramzow Road | 1,460 | 19.92 | 29,085 |
| Alexandra Hills | 3,941 | 4.80 | 18,915 |
| Stapylton | 0 | 0 | 0 |
| Heinemann Road | 9,490 | 1.08 | 10,253 |
| Caloundra Street | 10,946 | 18.39 | 201,269 |
| NPI – Stage 2 | 1,825 | 9.13 | 16,671 |
| Total | 42,781 | 12.46 | 532,863 |

5.4.4 Summary of Variable Operating Charge

The Authority recommends that LinkWater charge the WGM variable operating charges based on actual volumes pumped and dosed and the Authority's recommended \$/ML variable charges.

A summary of the Authority's recommendations for the Draft and Final Reports are included in full in Table 5.36.

Table 5.36: Summary of Volumetric Charges 2012-13

| | <i>Volume (ML)</i> | <i>Recommended \$/ML Variable Operating Charge</i> | <i>Forecast Cost (\$m)</i> |
|---------------------------------------|--------------------|--|----------------------------|
| Draft Report | | | |
| Pumping (Energy Costs) | 148,607 | 15.61 | 2.3 |
| Chemical Dosing | 42,781 | 12.46 | 0.5 |
| Total | | | 2.8 |
| Final Report (May 2012 demand) | | | |
| Pumping (Energy Costs) | 146,079 | 12.85 | 1.9 |
| Chemical Dosing | 42,781 | 12.46 | 0.5 |
| Total | | | 2.4 |

Note: these figures may not add due to rounding.

The change in the WGM's forecasts of WTP volumes to transfer has meant a small change to the total forecast costs in Table 5.36.

5.5 Duplication of Effort

Following its establishment LinkWater entered into an Alliance agreement with Transfield Services and United Utilities Australia, operating as Trility, for the provision of strategic asset and operational management. The provision of these services was obtained via a competitive tender process.

As LinkWater developed greater internal capacity, an agreement was reached with their Alliance Partners to adopt a specifier-provider arrangement. In March 2010, LinkWater, Transfield Services and United Utilities Australia agreed to an Operations and Maintenance Deed (the Deed) which detailed the provision of operational and maintenance activities. The Deed states that it will end on the 30th June 2013.

Draft Report

For the Draft Report, SKM reviewed each entity's roles and responsibilities, their organisational charts and descriptions of objectives for each of the positions in order to identify the common objectives and areas of responsibilities between the different organisations. SKM was then able to identify those areas within these entities where duplication of effort might be expected to exist.

Of the 25 activity areas assessed at LinkWater, its alliance contractors and the WGM, SKM identified 18 areas that potentially contained varying degrees of duplication.

Table 5.37 below provides a summary of each of the areas that SKM has identified where potential duplication exists between LinkWater, their alliance contractors and the WGM. Also included in the table is a guide to potential cost savings that could be achieved ('\$' for minimal cost savings to '\$\$\$' for major cost savings). SKM has not quantified the magnitude of saving expected or associated in defining each category.

SKM's assessment of LinkWater, its alliance contractors and the WGM found the potential cost savings that could be expected if the duplication of effort was removed to include 11 areas where reasonable cost savings could be expected and seven areas where minimal cost savings could be expected.

SKM noted that for functions of a corporate nature (such as finance and human resources) there will be a tendency for some level of duplication and hence inefficiency arising from having multiple organisational support functions within the water grid. Further, that there would be an element of corporate overhead costs arising from this arrangement that would be associated with the areas of functional duplication.

Table 5.37: Activities of Potential Duplication of Effort Identified by SKM

| <i>Activity Area</i> | <i>WGM</i> | <i>LinkWater</i> | <i>United Utilities & Transfield Services</i> | <i>Cost Savings Potential</i> |
|--|------------|------------------|---|-------------------------------|
| Administration | ✓ | ✓ | ✓ | \$ |
| Agency Contract Management | ✓ | ✓ | | \$\$ |
| Asset Engineering | | | | |
| Asset Maintenance EMC | | | | |
| Asset Maintenance I&C | ✓ | ✓ | | \$ |
| Asset Planning Strategic | ✓ | ✓ | | \$\$ |
| Asset Planning Capital | | ✓ | ✓ | \$\$ |
| Compliance Management and Regulation | ✓ | ✓ | | \$ |
| Corporate Governance | ✓ | ✓ | | \$ |
| Corporate Knowledge Management | ✓ | ✓ | | \$\$ |
| Corporate Support | ✓ | ✓ | ✓ | \$\$ |
| Environment and Sustainability | | | | |
| Finance | ✓ | ✓ | | \$\$ |
| Human Resource Management | ✓ | ✓ | | \$\$ |
| Information and Communication Technology (ICT) | ✓ | ✓ | | \$\$ |
| Legal Services | ✓ | ✓ | | \$ |
| Operations Pipe Networks | | | | |
| Operations Water Treatment Plants | | | | |
| Procurement | | | | |
| Project Delivery | | ✓ | ✓ | \$\$ |
| Relationship management | ✓ | ✓ | | \$\$ |
| Research | | | | |
| Risk Management | ✓ | ✓ | ✓ | \$ |
| Water Quality Management | ✓ | ✓ | | \$\$ |
| Workplace Health and Safety | | ✓ | | \$ |

In the Draft Report, SKM identified the following activity areas as likely containing the greatest scope for cost savings between LinkWater and its major service providers (Transfield Services and United Utilities):

- (a) Asset planning capital: LinkWater provides this activity through the infrastructure planning team in its Operational Services department. United Utilities is required to provide proposals, scopes and pricing for additional works under the Operation and Maintenance deed. The business process for this function has the planning being performed by LinkWater and the result of this planning (depending on value) provided to United Utilities for pricing. A duplication of effort is likely in this area arising from the need for LinkWater to review and verify the proposals for capital works proposed by United Utilities;
- (b) Corporate functions such as Administration, Human Resource Management and Finance exist in both organisations while in part providing independent functions to their respective entities, similar skills and function would exist and contain sufficient numbers of full time equivalents as to expect duplication of effort; and
- (c) Project delivery: the Operations and Maintenance Deed between LinkWater and United Utilities requires United Utilities to undertake similar project delivery activities to those undertaken by LinkWater. In particular, LinkWater's Project Services area provides project management, contracts management, cost control, systems and quality and procurement processes. A clause in the Operations and Maintenance deed requires United Utilities to undertake similar project delivery activities. SKM therefore consider the effort duplication to be worthy of further investigation.

Final Report

SKM's Analysis

The Authority requested SKM undertake further evaluation of areas of potential duplication of effort between LinkWater and its contractors (the issue of overlaps with the WGM are discussed in Chapter 6). SKM re-categorised the activity areas and reviewed potential cost savings as follows:

- (a) Capital – asset planning and project delivery. SKM found that there is a clear delineation of roles and responsibilities between LinkWater and Trility. Under the O&M Deed (section 9.1), the Services Contractor must maintain all of LinkWater's assets at all relevant times fit for their intended purposes and that service failures are corrected as soon as possible. For this reason, minor reactive maintenance and reactive capital works are undertaken by the Services Contractor following approval by LinkWater. LinkWater's Project Services on the other hand are responsible for the delivery of LinkWater annual planned capital expenditure program. SKM was satisfied that, under these arrangements, duplication is minimised and is likely to be negligible, and that no potential efficiency gains in this activity area could be made by disbanding the contract;
- (b) Corporate overhead – SKM was satisfied that LinkWater has minimised duplication under the existing contract conditions in areas such as corporate support, finance, human resource management, administration, risk management and work place health and safety. SKM considers that, within the rate that Trility charges LinkWater, there is an estimated 10% element for corporate support built in. This may be avoided by internalising the functions performed by Trility. Based on the estimated contract value of \$12.5 million this potential efficiency saving equates to approximately \$1.25 million.

SKM is of the opinion that a further saving could be made due to not incurring the profit mark-up added by Trility to the rates. SKM estimates the profit margin to be of the order of 20% of the rates charged. Based on the estimated contract value of \$12.5 million this may equate to approximately \$2.5 million.

In total, potential savings were an indicative \$3.75 million; and

- (c) Operations and maintenance – SKM noted that Trility provide all operations and maintenance activities for LinkWater and therefore no duplication is apparent.

In summary, SKM considered that minimal duplication exists under current contract conditions, and therefore no savings in this area were identified that could be incorporated into GSCs for 2012-13.

The potential future cost saving per year from internalising operations and maintenance equates to a total of approximately \$3.75 million.

LinkWater's Response

LinkWater noted that SKM only estimated savings from in-sourcing of operations and maintenance (\$1.25 million), but did not include the additional costs. LinkWater advised that the costs to in-source operations and maintenance functions were excessive due to the anticipated increased support calls for procurement, HR, finance and administration, as well as the associated accommodation costs. Other costs include recruitment and retention, knowledge retention and additional ICT costs for field staff and additional asset management reporting capability.

In regard to the profit margin, LinkWater considered that the identified savings of \$2.5 million are questionable and in contradiction to SKM's report that no potential efficiency gains could be made by disbanding the existing operations and maintenance contract. Linkwater considered that the savings of \$2.5 million were erroneously attributed to Linkwater corporate overheads costs.

In a further submission to the Authority (3 July 2012), Linkwater indicated that SKM provided no assessment of the efficiency of outsourcing as compared to internalising operations and maintenance activities. LinkWater considered that a thorough examination would be required of the costs and benefits (including risks) of available options. LinkWater suggested the analysis would need to take into account in particular the impact of alternative options on core business activities, staffing flexibility, impact on overhead costs, continuity and risk management implications and the impact on staff development.

Based on its own assessment, LinkWater considered that outsourcing operations and maintenance is the most efficient means of providing services.

In regard to the SKM estimates, LinkWater submitted that SKM failed to identify the basis of the estimated cost savings in terms of corporate costs and the profit margin.

Authority's Analysis

The Authority notes that SKM's analysis was a preliminary analysis completed within a limited time frame and based on benchmarks rather than a full analysis of costs. Hence, the estimates are likely to represent a gross amount of savings and provide an indicative basis for further review. The Authority notes that the basis for SKM's estimates were explained in the report (as noted above) and reflected SKM's views based on past experience rather than any specific analysis of LinkWater's circumstances.

The Authority accepts that any analysis of the benefits and costs of options for outsourcing or internalising operations and maintenance activities requires more refinement and would need to take account of the additional costs and risk factors involved in LinkWater's case. The Authority has not undertaken such an analysis at this time.

Given that SKM's estimated savings were indicative only, did not take into account additional costs, and the contract remains in place for 2012-13, the Authority has not adjusted GSCs by any of the amounts identified by SKM. As noted by Linkwater, the Authority does not consider that the SKM analysis provides a conclusive estimate of net savings. A more thorough analysis of the benefits and costs is required before any change to the current outsourcing model.

5.6 Allowable Costs

Allowable operating costs are intended to capture legitimate business costs not reflected in fixed and variable operating costs.

When setting 2011-12 GSCs, the Authority included the working capital allowance and the QCA levy in the allowable cost category. As per the Ministerial Direction, the Price Regulator states allowable costs are costs incurred on a one-off basis, with the exception of the QWC levy. As a result, the Authority has altered the components of Allowable Costs for the 2012-13 period. The QCA levy has now been included as a component of the Fixed Operating Charge, while the working capital allowance has now been recommended as a component of the Capital Charge.

5.6.1 Treatment of Insurance Excess

The repair and restoration of the Bundamba pump station has been costed at \$2.8 million. However, these repairs are covered under LinkWater's insurance coverage with the exception of an excess of \$0.2 million.

LinkWater has not included the excess in its 2012-13 costs and requests the Authority's direction on the regulatory treatment of this excess.

On the basis that Bundamba pump station is a relatively new asset, is already in the RAB, and the costs are covered by insurance, LinkWater has not included these costs in its Capital Works Program as these capital renewals will have minimal impact on the RAB.

Authority's Analysis

The Authority considers it appropriate that LinkWater recovers the full cost of the repair and restoration of the Bundamba pump station. The Authority notes that the original Bundamba pump station is not individually specified in LinkWater's RAB, and therefore cannot be readily removed.

For expediency, the Authority accepts LinkWater's proposal to avoid adjusting the RAB, and has instead included the insurance excess of \$0.2 million as an Allowable Cost. The Authority considers that this provides the appropriate compensation to LinkWater within the constraint of the level of detail in the RAB.

5.6.2 QWC Levy

The QWC imposed a levy under section 360F of the *Water Act 2000*, which provides that the QWC is to be funded by an annual levy payable by each water service provider.

LinkWater submitted a QWC levy of \$10.6 million, based on a 2.5% increase relative to

2011-12.

In the Draft Report, the Authority noted that QWC had not yet finalised its budgeting for 2012-13, and had not provided an estimate of the 2012-13 QWC levy. The Authority therefore accepted LinkWater's estimate of a 2.5% escalation to the 2011-12 QWC levy.

Subsequent to the Draft Report, the Government has indicated that the QWC will be abolished on 1 July 2012. The Authority considers that a levy payable by LinkWater to the QWC or any successor organisation remains an allowable cost, as required by the Direction Notice and has retained its forecast from the Draft Report of \$10.6 million. However, the Authority notes that it is possible that this cost will not be incurred by LinkWater, dependent on the Government's decisions relating to the QWC.

The Authority's proposed recommended allowable costs are given in Table 5.38 below.

Table 5.38: LinkWater's 2012-13 Allowable Costs (\$ million)

| <i>Allowable Cost</i> | <i>Draft Recommended Value</i> | <i>Final Recommended Value</i> |
|--|--------------------------------|--------------------------------|
| Queensland Water Commission Levy | 10.6 | 10.6 |
| Insurance Excess | 0.2 | 0.2 |
| Efficiency Gain From Moving to a Market Contract for Electricity | 0.3 | 0.3 |
| Total | 11.1 | 11.1 |

Note: these figures may not add due to rounding.

5.7 Revenue offsets

LinkWater submitted that for 2012-13 it expected to receive revenue for non-regulated activities for telephone masts, and easements and other landholder services. As is consistent with the approach outlined in Chapter 3, the Authority recommends that 50% of the revenue (\$73,647) should be offset against water charges while 50% should be retained by LinkWater to provide the incentive to utilise assets. Table 5.39 below presents this expected revenue.

Table 5.39: Revenue offsets

| <i>Item</i> | <i>Total Revenue</i> | <i>Revenue to be offset against GSCs</i> |
|---|----------------------|--|
| Easements and other Landholder Services | 100,000 | 50,000 |
| Phone Masts Income | 47,347 | 23,647 |
| Total | 147,347 | 73,647 |

5.8 Summary of GSCs for 2012-13

Draft Report

LinkWater's proposed notional building block revenue requirement for 2012-13 is shown in Table 5.39.

The Authority's draft recommended GSC was \$234,781,645 compared to LinkWater's proposed \$227,597,742. Despite the Authority's recommended downward revisions to several of LinkWater's proposed costs, LinkWater's recommended capital charge is higher than 2011-12, and higher than that proposed by LinkWater, due to the correction of a computational modelling error in 2011-12.

The Authority's draft recommendation was that LinkWater's Grid Service Charge for 2012-13 is \$234,781,645, summarised in Table 5.39 below.

Final Report

Since the Draft Report, the major changes arising in the GSC reflect the revision in the methodology adopted for modelling cashflows and the inclusion of an ex-post adjustment for the revised later date of the commissioning of the Northern Pipeline Interconnector Stage 2 in 2011-12.

In addition, the Authority proposes to apply an efficiency target of 1.5% (in addition to savings identified for specific items) to fixed operating costs. This adjustment is made to recommended GSCs below. Taken together with specific savings, the Authority is proposing a 2.2% reduction in fixed operating costs. Details of the analysis underlying the efficiency target are provided in Chapter 6.

The Authority provides recommendations in the form of per unit variable charges but has also determined an indicative total Variable Operating Charge as shown in Table 5.40 below.

The Authority has calculated an indicative total Variable Operating Charge based on the two alternative demand forecasts for comparative purposes (Table 5.40) as there are no approved forecasts. The Authority notes that the different demand scenarios do not have a material impact on total GSC for LinkWater.

Table 5.40: LinkWater's Revenue Requirements (\$)

| <i>Revenue Component</i> | <i>Approved 2011-12</i> | <i>Estimated Actual 2011-12</i> | <i>LinkWater Proposed 2012-13</i> | <i>QCA Draft Recommendation 2012-13</i> | <i>QCA Final Recommendation 2012-13</i> |
|--|-------------------------|---------------------------------|-----------------------------------|---|--|
| Return on Drought RAB | \$100,599,218 | \$95,739,215 | \$122,369,214 | \$125,365,834 | \$122,922,805 |
| Return on Non-Drought RAB | \$56,475,071 | \$55,997,865 | \$57,394,146 | \$58,340,347 | \$56,704,438 |
| Depreciation | \$42,564,186 | \$41,256,359 | \$51,700,070 | \$52,746,367 | \$51,910,902 |
| Asset Appreciation | -\$52,624,338 | \$50,556,230 | -\$62,922,855 | -\$64,677,614 | -\$63,265,010 |
| Historic Adjustments | 0 | \$0 | -\$241,202 | \$3,737,426 | -\$5,103,886 |
| Working capital | \$2,181,002 | \$2,112,446 | \$2,191,304 | \$2,430,467 | \$2,328,273 |
| Capital Charge | \$149,195,139 | \$144,549,655 | \$170,731,879 | \$177,942,827 | \$165,497,522 |
| Fixed Operating Costs | \$43,007,592 | \$43,653,592 | \$42,983,452 | \$42,742,204 | 43,377,189 |
| 1.5% Efficiency Target | | - | | | -644,752 |
| Variable Operating Costs | \$2,520,866 | \$2,520,866 | \$2,852,922 | \$2,825,922 | \$2,415,398/ \$2,374,309 |
| Allowable Costs | \$10,975,000 | \$8,421,000 | \$11,270,692 | \$11,270,692 | \$11,123,870 |
| Revenue Offset | 0 | 0 | -\$73,647 | -\$73,647 | -\$73,647 |
| Total GSC - Maximum Allowable Revenue | \$205,698,597 | \$199,145,114 | \$227,597,742 | \$234,781,645 | \$221,695,581/ \$221,654,492* |

*Note: *As described in Chapter 3, the Authority has recommended two alternate GSCs, reflecting the November 2011 / May 2012 Annual Operations Plans. In the event that the May 2012 AOP is approved, the lower values should apply to these items.*

5.9 Pricing Structure and Invoicing

The Authority recommends that LinkWater's monthly invoices to the WGM include two components, a fixed and variable charge. As noted above, the Authority recommends that LinkWater present the invoice for the variable charge to the WGM as the Authority's recommended \$/ML variable costs for each asset, multiplied by actual volume transported.

The Authority recommends that each monthly invoice include a constant fixed charge, as per Table 5.41 below. The Authority has calculated the fixed charge as one-twelfth of the Authority's recommended fixed costs (including Allowable Costs and Revenue Offsets) included in Table 5.40 above.

Table 5.41: Recommended (Fixed) Monthly Charges (\$)

| <i>Month</i> | <i>Fixed Charge</i> |
|--------------|---------------------|
| January | 18,273,349 |
| February | 18,273,349 |
| March | 18,273,349 |
| April | 18,273,349 |
| May | 18,273,349 |
| June | 18,273,349 |
| July | 18,273,349 |
| August | 18,273,349 |
| September | 18,273,349 |
| October | 18,273,349 |
| November | 18,273,349 |
| December | 18,273,349 |
| Total | 219,280,183 |

The variable charges for electricity and chemical dosing are noted in Tables 5.42 and 5.43 below.

Table 5.42: LinkWater's Electricity Charges (\$/ML)

| <i>Pumping Station Facility</i> | <i>Recommended Variable Charge (\$/ML excl carbon)</i> |
|---------------------------------|--|
| Chamber's Flat | 17.392 |
| Coomera | 11.842 |
| Molendinar | 11.862 |
| Tarrant Drive | 5.772 |
| Gramzow Road | 48.880 |
| North Pine | 10.858 |
| Aspley | 3.732 |
| Lloyd Street | 7.341 |
| Stones Road | 19.516 |
| Learoyd Road | 30.409 |
| Wellers Hill | 0 |
| Trinder Park | 37.859 |
| Daisy Hill | 24.484 |
| Kimberley Park | 41.862 |
| Alexander Hills | 9.222 |
| Heinemann Road | 9.486 |
| Total Average | 12.850 |

Table 5.43: Dosing Costs per Water Quality Facility

| <i>Water Quality Facility</i> | <i>2012-13 \$/ML</i> |
|-------------------------------|----------------------|
| Chambers Flat | 16.98 |
| Gramzow Road | 19.92 |
| Alexandra Hills | 4.8 |
| Stapylton | 0 |
| Heinemann Road | 1.08 |
| Caloundra Street | 18.39 |
| NPI – Stage 2 | 9.13 |
| Total Average | 12.46 |

6. PRODUCTIVITY AND EFFICIENCY

6.1 Introduction

In previous chapters, the Authority has calculated its proposed Grid Service Charges for Seqwater and LinkWater based on its reviews of capital and operating costs.

In this chapter, the savings arising from the detailed review of sampled costs are compared with the efficiency targets applied by economic regulators in other jurisdictions and high level cost benchmarks from other water entities. The benchmarking analysis which was included in the Seqwater and LinkWater chapters of the Draft Report is now detailed below.

Potential savings from a merger of bulk entities are not included in the recommended GSCs, consistent with advice from the Minister for Energy and Water Supply (2012) about the scope of the Authority's remit.

6.2 Efficiency Targets

Australian economic regulators have in recent years applied efficiency targets to the total operating costs of bulk water entities of up to 3% per annum (Table 6.1)⁷.

These efficiency targets are generally derived from a combination of detailed engineering and operating reviews and high-level benchmarking.

Targets at the lower end of the range can arise where there have been demonstrable gains in efficiency over the previous regulatory period. For example, efficiency gains of only 0.3% per annum were applied to the Sydney Catchment Authority's (SCA's) operating costs over the 2012-13 to 2015-16 regulatory period. However, this followed a period of significant cuts in full time equivalents (FTEs) by the SCA – from 289 FTEs (in 2007-08) to 246 (in 2010-11), a reduction of 15%.

The Authority's review of SunWater irrigation prices for 2012-17 recommended a combination of specific and generic savings in operating costs. The generic savings included a 1.5% saving in non-direct operating costs, arising from expected productivity gains in labour costs that were also applied to non-labour non-direct costs. The Authority also applied a 0.75% saving in direct costs (as labour comprises about 50% of total direct operating costs and it was not appropriate to apply a 1.5% saving to direct non-labour costs).

Based on regulatory precedents, efficiency targets for the SEQ bulk entities could therefore lie in the range of 0.3% to 3% per year. Applied to Seqwater and LinkWater combined, this implies savings of around \$1 million to \$9 million per year in operating costs.

The level of savings found by the Authority in assessing the prudence and efficiency of fixed opex for 2012-13 GSCs falls within this range and is discussed in section 6.5 below.

⁷ Efficiency targets for retail water entities have ranged up to 3.5% per annum.

Table 6.1: Summary of Selected Regulatory Efficiency Targets

| Jurisdiction and Study/Report | Time Period | Sample/Entity | Approach | Efficiency Target |
|--|------------------------|---|---|---|
| National | | | | |
| National Water Commission (2007) Urban Water Charging Stocktake – Appendix K | Various, prior to 2007 | 8 bulk entities and 8 retail entities | Review of jurisdictional economic regulators' operating efficiency targets | Bulk entities' operating efficiency target ranged from zero to 3.0%. Retail entities' operating efficiency target ranged from zero to 3.5%. |
| New South Wales | | | | |
| IPART – Review of prices for the Sydney Catchment Authority (2012) | 2012-13 to 2015-16 | Sydney Catchment Authority (SCA) | Halcrow review (Feb 2012) | Annual efficiency target of 0.3% applied to SCA's opex based on Halcrow's advice. Previous regulatory period included significant cuts in full time equivalents (FTEs) by the SCA – from 289 FTEs (in 2007-08) to 246 (in 2010-11). |
| IPART – Review of water prices for Sydney Desalination Plant Pty Ltd from 1 July 2012 (Dec 2011) | From 1 July 2012 | Sydney Desalination Plant (SDP) Pty Ltd | [Advice from the] National Centre of Excellence in Desalination and a submission from Degremont Ltd | Opex savings of 2.2% primarily due to energy costs benchmarking undertaken by IPART. Allowed an automatic pass-through of energy network charges determined by the AER. |
| IPART – Review of bulk water charges for State Water Corporation (2010) | 2010-11 to 2013-14 | State Water Corporation | Atkins/Cardno review | Opex savings applied included a: <ul style="list-style-type: none"> • catch-up efficiency target of 0.6% in 2010-11 and 1.2% p.a. for the latter years; and • continuing efficiency gains of 0.8% p.a. |
| IPART – Review of prices for Sydney Water Corporation (2012) | 2008-12 and 2013-16 | Sydney Water Corporation (SWC) | Based on Atkins/Cardno's review (2008-12) and recommendation (2013-16) (see below). | Targets imposed on non-bulk controllable opex of <ul style="list-style-type: none"> • 0.25% continuing efficiency target for 2012-13 to 2015-16; and • 1.5% catch-up efficiency target in 2012-13 and 2% onwards. |
| Atkins/Cardno Report to IPART (January 2012) | 2008-12 and 2013-16 | Sydney Water Corporation (SWC) | Desktop review of Ofwat's 1999, 2004 and 2009 determinations. | 0.75% p.a. catch-up efficiency and 0.25% p.a. continuing efficiency on operating expenditure. |

| Jurisdiction and Study/Report | Time Period | Sample/Entity | Approach | Efficiency Target |
|--|---|--|--|--|
| Victoria | | | | |
| Essential Services Commission (ESC) – Guidance on water plan (Oct 2011). | Third regulatory period (begins on 1 July 2013) | 19 Victorian state-owned water businesses | Internal work (comparison between the rate applied in the second regulatory period and the ABS's data on economy-wide labour productivity gains) | ESC has indicated it will apply a minimum 1% efficiency target on customer growth adjusted business-as-usual (BAU) opex, noting that the latest ABS data suggests that economy-wide labour productivity gains of 1.2 per cent per annum over the 5 years to 2009-10. |
| Western Australia | | | | |
| Economic Regulatory Authority – Inquiry into the efficient costs and tariffs of the Water Corporation, Aqwest and the Busselton Water Board (2012) | 2011-12 | The Water Corporation, Aqwest and the Busselton Water Board. | WA Government's target of efficiency dividend on Government Trading Enterprises for the 2011-12 State Budget. | The Water Corporation is subjected to 5% efficiency dividend (equivalent to \$20.8 million). In the previous inquiry, the Water Corporation was subjected to 1.88% reduction in base real operating costs per connection per annum. |
| Queensland | | | | |
| Queensland Competition Authority – SunWater Irrigation Price Review 2012-17 (2012) | 2012/13 – 2016/17 | SunWater 30 irrigation schemes | Savings targets based on a broad ranging sample of expenditure reviewed by four consultants. | QCA reduced direct opex by an increasing annual amount – by 5.22% (\$1.2m) in 2012-13 to 8.03% (\$1.8m) in 2016-17, in real terms. QCA also applied savings to non-direct opex – 2.7% (\$635,000) in 2012-13 to 8.93% (\$2.2m) in 2016-17, in real terms. |
| QCA – SEQ Interim Price Monitoring for 2010-11 (2011) | 2010-11 to 2012-13 | QUU, Allconnex and Unitywater | High-level benchmarking exercise | QCA indicated a 2% annual compounding efficiency target should apply to controllable (non-bulk) operating costs over the three year interim period. |

6.3 Benchmarking of Operating Costs

Draft Report

In the Draft Report, the Authority supplemented its assessment of specific cost categories for prudence and efficiency with high level benchmarking.

Submissions

Seqwater

Seqwater submitted that benchmarking at an organisational level is problematic due to the lack of peer organisations that may be considered appropriately comparable.

Seqwater considered that, while there were other regulated bulk water service providers around Australia and internationally, none had a similar asset base, including the same mix of drought and non-drought assets, none operated assets similar to Seqwater's desalination plant and the WCRWS, and none had a similar history of development.

LinkWater

LinkWater submitted that to benchmark it against other companies is challenging, as to its knowledge there is only one other company in the world – the Abu Dhabi Transmission and Despatch Company – which operates solely as a bulk water transporter⁸. LinkWater also noted that isolation of the costs associated with bulk water transport for companies which perform a number of activities in the value chain was complex and subject to error.

LinkWater submitted that, to ensure a consistent and accurate benchmarking analysis, there needs to be consistency in the definition and application of costs. LinkWater considered there is no uniform practice across regulated businesses with respect to what is defined as a corporate overhead and what is defined as an operating and maintenance cost. LinkWater noted the importance of understanding the costs included in LinkWater's overhead component and equally what is included in a comparator's costs.

LinkWater also submitted that, if detailed reliable information on overall operating costs were publicly available for a reasonable sample of similar companies, it would be appropriate to assign significant weight to a top down comparison. LinkWater was of the view that such information did not exist.

LinkWater drew a distinction between the choice of either a top down or bottom up approach. LinkWater submitted that the application of a bottom up approach would require intimate knowledge of the operations and management of LinkWater. It submitted that what is relevant from a regulatory perspective is not what LinkWater actually spends, but what an efficient and well-run bulk water transport business would spend. LinkWater submitted that this would require a sound knowledge and understanding of generic cost levels and structures in the industry rather than specific information on LinkWater's expenditure, and finding this information is difficult.

LinkWater submitted that it is still a maturing business, and requested the Authority to consider this carefully when undertaking its benchmarking analysis.

⁸ The Abu Dhabi Transmission and Despatch Company provides both electricity and water transmission services. The costs of water transmission are not separately publicly available.

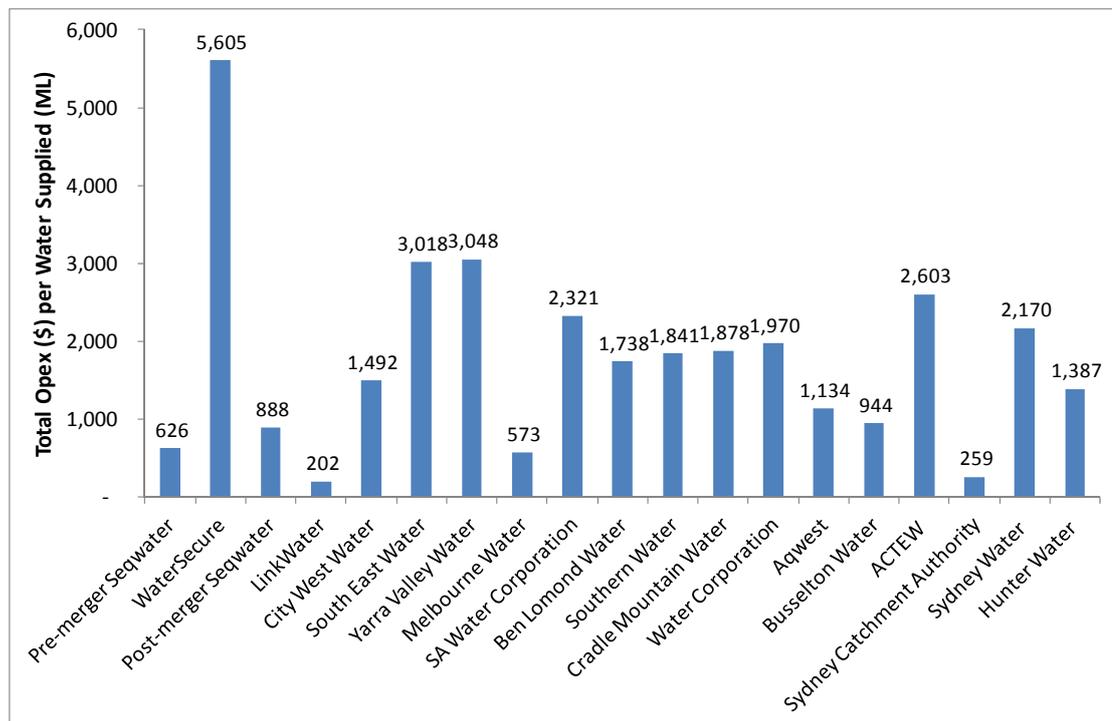
SKM's Review

Due to data and time constraints, SKM's analysis focused mainly at the corporate level. SKM prepared a number of benchmarking metrics to compare the GSPs to other water service providers. While these metrics provide a descriptive comparison of Seqwater's business, many include asset values and total revenues, which are largely outside of the GSP's control.

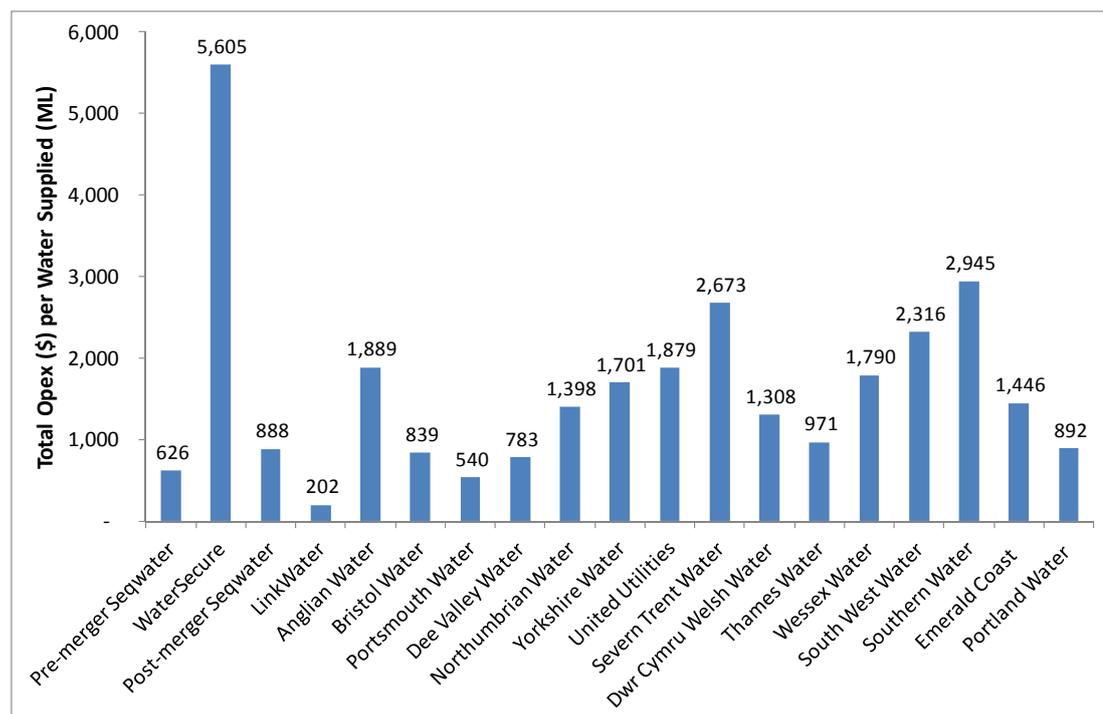
Operating Expenditure per ML

SKM compared 2011-12 total operating costs per ML of water supplied to other water businesses, both nationally (Figure 6.1) and internationally (Figure 6.2).

Figure 6.1: Operating Expenditure per ML Supplied – National (\$/ML)



Note: WaterSecure and LinkWater opex adjusted following the Draft Report – to more closely reflect QCA cost estimates in its 2011-12 Final Report. Note: There are differences in the scope of services provided by these entities. For example, Melbourne Water does not provide desalinated water. SCA provides raw water and does not provide treatment or desalination. Sydney Water provides retail and distribution services. Source: SKM (2012), QCA (2011).

Figure 6.2: Operating Expenditure per ML Supplied – International (\$/ML)

Note: WaterSecure and LinkWater opex adjusted following the Draft Report – to more closely reflect QCA cost estimates in its 2011-12 Final Report. Source: SKM (2012), QCA (2011).

Many differences can be explained by the nature of the business and the quality of water supplied. In many cases, the reference utilities provide a vertically integrated service, including water storage, treatment, transport, distribution and retail. Seqwater, on the other hand is only responsible for storage and treatment, and most supply is sourced from relatively large dams with low operating costs per ML. LinkWater supplies bulk transport services only.

Further, each organisation has unique operating characteristics. For example, SKM suggested that the lower \$/ML ratio for Melbourne Water may be largely explained by the lower energy costs it incurs because most of its water is gravity-fed.

The pre-merger (of Seqwater and WaterSecure) cost per ML for WaterSecure is much higher than those of reference utilities due to the nature of WaterSecure's assets (high cost AWTPs and a desalination plant) and the low quantity of water supplied by WaterSecure over the period (not all of WaterSecure's assets were operational in 2011-12).

Employee Costs per ML

SKM also compared 2011-12 total employee costs per FTE to other water businesses, both nationally (Figure 6.3) and internationally (Figure 6.4). This metric revealed how the GSPs' average salaries and on-costs compare to peer organisations.

Figure 6.3: Employee Cost per Full-Time Equivalents - National

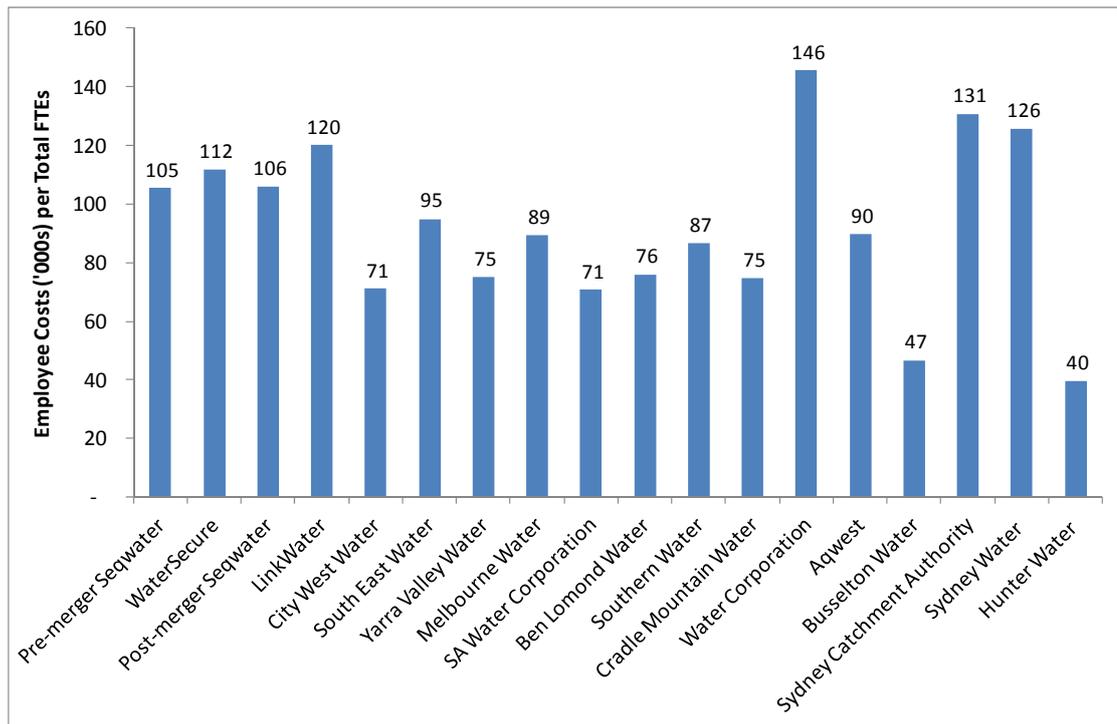
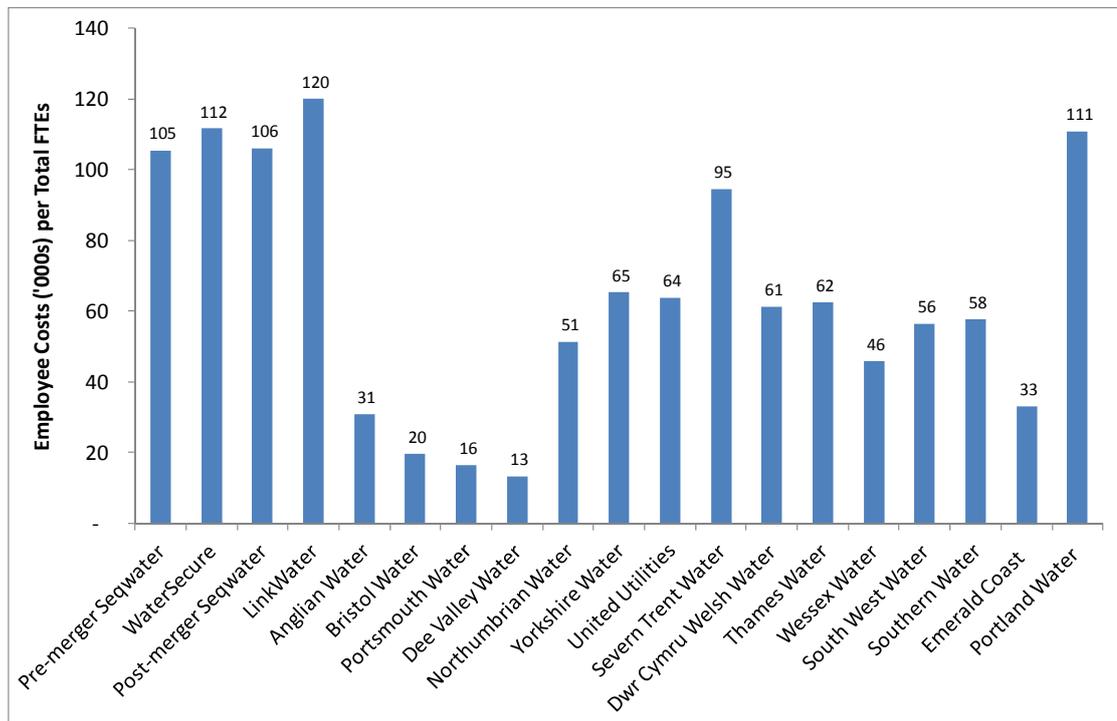


Figure 6.4: Employee Cost per Full-Time Equivalents - International



SKM’s analysis indicated that the GSPs’ employee costs per FTE were higher on average than the majority of reference utilities in Australia. The values for the US and UK water entities were less comparable due to different labour market conditions, however they confirmed that Seqwater’s average employee costs were high relative to international benchmarks.

Authority's Analysis

In the Draft Report, the Authority recognised the limitations of undertaking any benchmarking exercise, particularly in the timeframe available. The Authority considered that comparisons between the GSPs and other water service providers generally, rather than bulk water providers specifically, is unavoidable due to the lack of exact comparators.

The Authority noted data limitations at the time of the Draft Report and proposed to advance its assessment for the Final Report.

The Authority considered that, although definitive conclusions regarding the overall level of operating expenditure cannot be made based on SKM's benchmarking of available data, it appeared as though the GSPs' employee costs are generally higher than benchmark. The Authority noted that average employee costs are largely determined by EBAs, and therefore did not consider it appropriate to recommend adjustments to the GSCs as a result of SKM's benchmarking analysis alone.

The Authority recommended that the GSPs should be working to reduce average employee costs in real terms in 2012-13. The Authority noted that efficiency incentives are available for GSPs to make cost savings (see Chapter 7). To date, the GSPs' response to these incentives has been limited.

The Authority considered that, should its recommended efficiency incentives continue to elicit a limited response from the GSPs, a more direct approach to ensuring potential efficiency gains are achieved may be required in future regulatory periods.

Submissions on the Draft Report

Seqwater

In its submission on the Draft Report, Seqwater recognised the importance of benchmarking to the Authority's review and submitted that it could form a useful longer term exercise, allowing Seqwater's costs to be examined and compared between years (Seqwater 2012). Seqwater considered there was insufficient time between the Draft and Final Reports to conduct a comprehensive benchmarking review.

Seqwater submitted that it remained concerned that there is a lack of suitable comparable peer organisations. Seqwater referred to a range of factors it previously identified that should be taken into account in any benchmarking exercise to moderate outliers and ensure comparability, including: number and size of assets, asset age, asset condition, asset capacity, proximity of assets, forecast population/demand growth, compliance obligations, a range of specific factors relevant to water treatment plants, and mode of operation (for example, mothballed or standby).

LinkWater

LinkWater supported the advancement of appropriate benchmarks and referred to the issues raised in its original submission regarding the challenges associated with undertaking a benchmarking exercise. LinkWater further submitted that it should be consulted on matters not raised in the Draft Report.

WGM

The WGM submitted that the Authority consider setting an efficiency target for GSPs, such as by capping operating costs at or below actual 2011-12 levels (without allowance for inflation).

The WGM submitted that, across the supply chain as a whole, water supply operating costs appear to be higher in South East Queensland than in other capital cities. The WGM noted that this comparison is in part reflected in the benchmarking undertaken by SKM, summarised in the Authority's Draft Report. However, the WGM submitted it is more evident if costs are compared across the water supply chain as a whole [including bulk and retail costs], excluding wastewater and stormwater related costs.

Authority's Analysis

Subsequent to the Draft Report, the Authority sought to advance its benchmarking assessment. The first step was to review the approach to benchmarking. The second step was to review the available data.

Benchmarking Methods

Alternative benchmarking methods (to the partial performance indicators adopted in the Draft Report) were assessed – index-number-based total factor productivity analysis, econometric methods, stochastic frontier analysis, and data envelopment analysis (see AER 2012).

However, these alternative methods require price and quantity data on inputs and outputs for comparable businesses over a sufficiently long time period. Robust and credible data of this kind is not readily available for the bulk water businesses⁹.

Recent benchmarking of retail water and wastewater businesses that adopted these alternative methods used a sample of 54 firms with 409 observations in total (ESC 2012). Bulk water suppliers were specifically excluded from the scope of this analysis, with differences cited in the services provided by Melbourne Water, Sydney Catchment Authority and Seqwater (ESC 2012).

The type of benchmarking analysis adopted in the Authority's Draft Report – that involves the use of partial performance indicators (PPIs) – appears therefore to be the most appropriate method currently able to be applied for the purpose of this review. These indicators have the advantage of being easy to compute and simple to interpret, and widely used. However, they can give misleading information on overall economic performance:

... PPI has been used as an assessment tool in energy regulation in both Australia and a number of other countries such as Ireland. It has provided regulators with information on how the performance (e.g., certain expenditure incurred a particular activity) of a utility compares with others in the industry. The AER has used this as part of its past assessments to determine where greater scrutiny is required of particular types of expenditure.

While useful in the regulatory process, PPI has a number of limitations, particularly relating to data quality and accounting for differing network characteristics and operating environments. It is also difficult to obtain good price deflators (e.g., for labour and/or opex) when comparing utilities over time and across geographical locations. Due to these limitations, PPI-based benchmarking results are best viewed as providing a useful means of comparison and an indication of where certain expenditure may be above efficient levels, but should not be viewed in isolation as a definitive assessment on the efficiency of an energy network business.

⁹ An AEMC review identified a set of pre-conditions for the possible application of TFP (AEMC, 2009, p. 47). The first condition is the availability of robust and credible data. In addition, the TFP measurement must: accurately reflect the industry's productivity growth; be immutable to the behaviour of the regulated businesses and regulator; represent comparable businesses; and reflect stable business performance. Finally, historical TFP performance must be a good indication for future productivity growth; that is, it must be a good predictor.

The Authority notes that benchmarking is not viewed in isolation as a definitive assessment of efficiency and that, as data develops over the normal course of business, more sophisticated benchmarking methods may become available.

Benchmarking Data

Given concerns of comparability raised by stakeholders, the Authority reviewed the data previously used by SKM in its benchmarking.

The Authority considers that the analysis conducted in the Draft Report, showing that average employee costs per FTE were higher on average than the majority of reference utilities in Australia, remains a relevant benchmark for operating performance.

More data on operating and corporate costs was sought from other water entities in other jurisdictions, including Sydney Catchment Authority and Melbourne Water. Data on other bulk water providers from the National Water Commission *National Performance Report for 2010-11* has also been included. Differences in their scale of operation make comparisons less relevant for some of these providers, particularly smaller NSW rural bulk water providers.

Operating Costs

Operating cost data is available for a range of utilities, however many are not comparable to Seqwater. Therefore, the Authority has narrowed its benchmarking of operating costs to domestic bulk water providers only. Further, the Authority has excluded vertically integrated providers, that is, those also providing retail and distribution services.

Reflecting the issues raised by the WGM, the more recent operating cost data from bulk water providers was adjusted and supplemented using available public data from a range of sources in order to provide a more comparable operating cost per ML of bulk water supply for a capital city region, including from desalination. In particular:

- (a) depreciation expenses were removed from operating costs for the Sydney Catchment Authority. Broad estimates of the operating cost of water treatment¹⁰ and desalination¹¹ were added to SCA bulk water supply costs, to form an estimate of Sydney's bulk water costs that is broadly comparable to SEQ bulk water costs (see 'Sydney' in Figure 6.5 below);
- (b) an estimate of the operating costs for providing bulk and recycled water (excluding sewerage) for Melbourne was based on Melbourne Water's Draft 2013 Water Plan. A broad estimate of the operating costs of desalination¹² was added to Melbourne Water's bulk water operating costs (see 'Melbourne' in Figure 6.5 below); and

¹⁰ Sydney Water Corporation estimated operating expense for purchasing treatment services from external providers (2011, p. 39). Note this a maximum estimate of the operating costs of providing treatment services, as external providers would include capital costs in their charges to Sydney Water.

¹¹ Sourced from Sydney Desalination Plant's proposed operating costs in its submission to IPART, assuming full operation mode (IPART 2012, p. 40).

¹² The Victorian desalination project is being delivered as a public private partnership. The Victorian Government has an agreement with AcquaSure to finance, design, build, operate and maintain the desalination plant. The total cost of desalination in 2012-13 is sourced from Melbourne Water's 2013 Water Plan, which assumes commissioning of the desalination plant in February 2013 and four months of fixed costs (pp. 60-61). A share of this total cost is apportioned to operating costs, using information on total project costs and total capital costs (AcquaSure – VDP FAQs and PwC 2011).

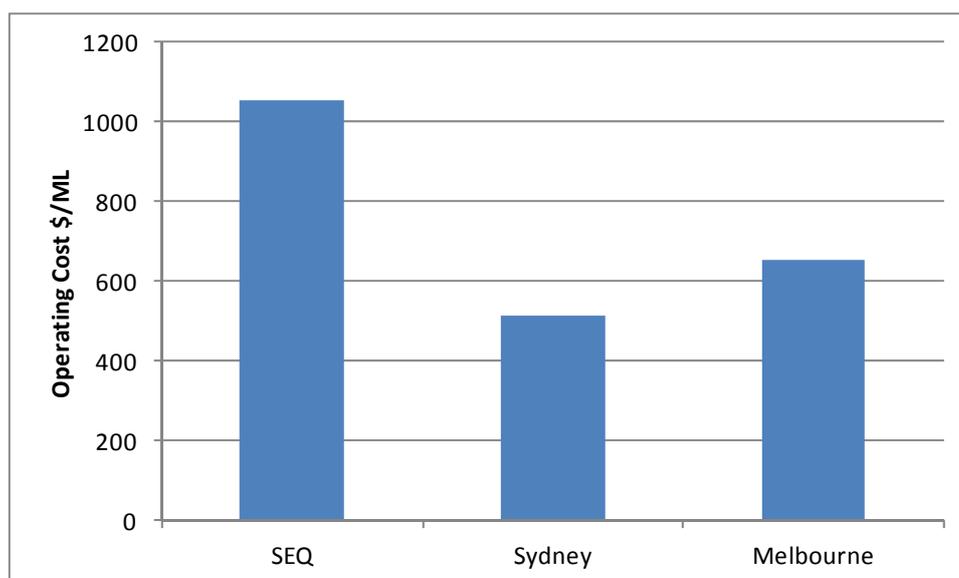
- (c) the operating costs of bulk water supply and transport in SEQ were aggregated for comparison with these benchmarks (see 'SEQ' in Figure 6.5 below).

Not all of the adjustments proposed by stakeholders could be accommodated. Despite the WGM's view, the Authority has not included retail and distribution operating costs, as these costs are not relevant to this review of GSCs – though the Authority acknowledges their relevance to an assessment of overall grid cost efficiency. The Authority considers it would be reasonable to extend the analysis to incorporate the factors identified by Seqwater, when this data is available. The Authority concurs that a longer term exercise is required to develop this information.

The comparisons remain fraught with difficulties. In particular, the costs of desalination are based on 'hot standby' mode for SEQ, full production mode for Sydney, and four months of fixed costs for Melbourne. Further, the share of Melbourne's fixed costs that are operating costs has been broadly estimated based on aggregate project cost data. Data has been compiled from differing sources. However, this is the data that is currently available.

Taking all these factors into account, the operating cost per ML of bulk water in South East Queensland lies above the range of very broadly estimated benchmark outcomes. That is, the SEQ operating cost per ML of bulk water lies above the estimated corresponding cost for Melbourne and Sydney (Figure 6.5).

Figure 6.5 Operating Costs per ML of Bulk Water (including desalination) (\$/ML)



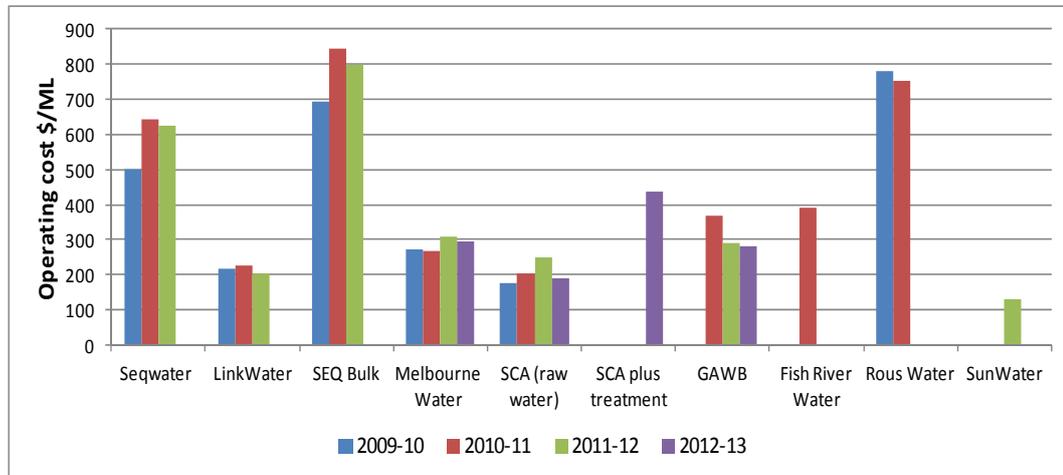
Note: SEQ data relates to 2011-12, Sydney and Melbourne data relates to 2012-13 as this is the only year of data available for desalination costs. \$/ML differs from Figure 6.1 for the reasons outlined in the text. Source: QCA 2012 and 2011, SCA 2011b, SWC 2011 and IPART 2012, Melbourne Water 2012a and 2012b and AquaSure VDP FAQ (nd). Assumes full production mode for Sydney Desalination Plant. Assumes four months of fixed costs of the Victorian desalination project, a share of which is allocated to operating costs using estimates of total project costs.

The Authority considers that this analysis indicates that there are efficiencies to be made in the provision of SEQ bulk. However, no definitive or quantitative assessment can be made using this data in isolation. Nonetheless, it can be compared with and inform other analysis, to support a more definitive outcome.

Operating costs per ML (excluding desalination) are compared across bulk water entities in Figure 6.6 below. The removal of desalination allows for a better comparison with other bulk water providers and other years of data, however the data remains patchy. The SEQ

bulk operating costs per ML appear to be on the high side when compared to the estimated benchmarks drawn from other bulk water providers.

Figure 6.6 Operating Costs per ML of Bulk Water (excluding desalination) (\$/ML)



Note: Seqwater \$/ML = Seqwater cost/Seqwater ML. LinkWater \$/ML = LinkWater cost/LinkWater ML. SEQ Bulk \$/ML = (Seqwater cost + LinkWater cost)/Seqwater ML. Source: QCA 2011 Grid Service Charges Final Report, NWC 2012, Melbourne Water 2012a and 2012b, IPART 2012, SCA 2011, SWC 2011, QCA 2010 GAWB Final Report, QCA 2012 SunWater Final Report.

Cost of Supporting Functions

The Authority’s consultant, Third Horizon, noted there are concerns in benchmarking the GSPs operations against non-bulk water providers.

However, Third Horizon considered it is valid to benchmark the GSPs performance against a range of supporting functions. The Authority supports this view. Third Horizon noted that its comparators for this analysis are asset intensive companies, have large field forces and are supported by a back office function with a broadly similar scope.

Similar to the AER, Third Horizon stated that its benchmarking should not be directly applied as savings targets, but should prompt a conversation about the reasons why some costs are higher than the industry average. Third Horizon stated there may be structural reasons why savings are not achievable (Table 6.2).

Table 6.2: Benchmarking of Supporting Functions

| <i>Function</i> | <i>Benchmark</i> | <i>Seqwater</i> | <i>Industry Average</i> |
|----------------------------|-----------------------------|-----------------|-------------------------|
| Finance | Finance opex/Total opex | 1.4% | 2.7% |
| Procurement | Procurement opex/Total opex | 0.5% | 1.3% |
| Audit, Risk and Governance | AR&G opex/Total FTE's | \$23.7k | \$6.1k |
| Property and Facilities | P&F opex/FTEs | \$20.9k | \$8.7k |
| Human Resources | HR opex/Total FTEs | \$11.7k | \$3.8k |
| Health and Safety | H&S opex/Total FTEs | \$5.4k | \$1.4k |
| IT | IT opex/FTEs | \$22.2k | \$15.8k |

Note: Third Horizon noted that the Seqwater data represents its best estimate of allocation of costs from the Seqwater Operational Cost Report to the functions noted above. Third Horizon noted that a portion of the savings estimates may reflect differences in allocation. Source: Third Horizon 2012.

Again, the Authority notes that this analysis supports a view that there are likely to be efficiencies. Other data available to the Authority on corporate costs also supports this view (see Table 6.3 below).

Table 6.3: Corporate Benchmarks

| <i>Water Entity</i> | <i>Year</i> | <i>Corporate Cost/Total Opex (%)</i> | <i>Corporate Cost/ML (\$/ML)</i> | <i>Corp Employee Cost/Total Employee Cost (%)</i> | <i>Corporate FTEs/Total FTEs (%)</i> |
|----------------------------|-------------|--------------------------------------|----------------------------------|---|--------------------------------------|
| Seqwater | 2011-12 | 26.8% | 238.1 | 33.1% | 32.7% |
| Linkwater | 2011-12 | 33.6% | 68.3 | 51.3% | 45.5% |
| Melbourne Water | 2011-12 | 18.3% | 56.8 | na | na |
| Melbourne Water | 2010-11 | 17.6% | 55.4 | na | na |
| Sydney Catchment Authority | 2010-11 | 25.9% | 53.1 | 36.9% | 33.7% |
| SunWater | 2011-12 | 31.1% | 40.6 | na | 16.7% |
| Wide Bay Water* | 2011-12 | 33.4% | 1173.4 | 26.8% | 24.9% |
| Aqwest* | - | 46.0% | 418.8 | 62.6% | 41.0% |

*Note: Melbourne Water, SCA and Wide Bay Water were provided with a common definition of corporate costs. Seqwater corporate employee costs based on average employee costs. * Wide Bay Water and Aqwest also provide retail and distribution activities. Source: SKM (2012), QCA (2012 and 2011), Melbourne Water (2012a), SCA (2012), QCA SunWater Final Report (2012), Wide Bay Water (2012), Aqwest (2012).*

6.4 Recommended Operating Efficiency Savings for 2012-13 GSCs

As part of normal regulatory practice, consideration is given to whether a general efficiency target should be applied in addition to the specific savings identified through detailed review (section 6.1). This is particularly the case where sample size is relatively small and the items captured were not always representative of other assets employed.

The Authority's analysis identified a specific saving of 0.1% for Seqwater based on a sample of 14% of items, and 0.7% for LinkWater based on a sample of 38% of items. Combined, these amounted to 0.3% of total fixed opex (Chapters 4 and 5).

In considering this issue for the GSCs in 2012-13, the Authority notes that there are a range of factors that combine in favour of the application of a general efficiency target.

First, based on high-level benchmarking analysis (Section 6.3), there appears to be scope for an efficiency target given that the operating costs of the GSPs are higher than their comparators. However, this analysis does not identify the appropriate magnitude of any target efficiency saving given the differences in scope of services and prevailing circumstances.

Based on other regulatory precedents, efficiency targets for the SEQ bulk entities could be justified in the range of 0.3% to 3% per year (section 6.2). Applied to Seqwater and LinkWater combined, this implies savings of around \$1 million to \$9 million per year in operating costs. As the GSPs have only recently been subject to economic regulation, a higher savings target is justified than the savings imposed on entities under more mature regulatory regimes.

In considering the magnitude of such a target, the Authority has taken into account that

- (a) there is less flexibility in achieving a savings target in a one-year review period than over a five year regulatory period as has been applied by other regulators. There may be limited flexibility in the costs of some contracts that have already been subject to market testing. This provides a basis for adopting a target below the 3% upper end of the range;
- (b) the GSPs are better placed to identify efficiencies in their organisations than the Authority or SKM (information asymmetry) and therefore there is a case to apply efficiency incentives and targets (to promote) further innovation; and
- (c) the potential savings from the merger between WaterSecure and Seqwater are still not being realised due to contractual obligations and workplace arrangements (still in place) and there needs to be an incentive for Seqwater to address these as and when the opportunity arises.

Having regard to the above, the Authority considers it appropriate to apply an additional efficiency target to fixed operating costs for each GSP, in addition to the savings already identified.

However, on the basis that Seqwater is a larger organisation, with more diverse assets, and is potentially yet to fully realise savings achieved from the merger with WaterSecure, the Authority proposes a higher target for Seqwater. The Authority also notes that only 14% of Seqwater's fixed opex was reviewed, compared to 38% for LinkWater, in the Authority's review of costs.

The Authority therefore proposes to apply a 2.5% efficiency target to Seqwater (in line with that applied by the Authority for the DRs), and 1.5% for LinkWater. When added to identified savings, the total efficiency gains would be 2.6% for Seqwater and 2.2% for LinkWater. Both these targets lie within the range applied by Australian regulators in recent water regulatory decisions.

Further more detailed review is considered justified to assess further efficiency savings.

7. REVIEW THRESHOLDS

7.1 Introduction

The Review Thresholds define the circumstances and timing under which any review of GSCs recommended for a particular year may be undertaken.

Under the Ministerial Direction, the Authority is required to develop a process, and appropriate review thresholds, for reviewing the 2012-13 GSCs.

7.2 Process

The Market Rules define a process for reviewing GSCs which is consistent with that used in 2011-12. That process was accepted by the Price Regulator. The Authority sees no reason to vary that process, as outlined below.

7.2.1 Review of GSCs

The Market Rules (s. 8.7) state that the Price Regulator may direct the Authority to review GSCs at any time if:

- (a) the Price Regulator is made aware of any change that it considers to be sufficiently material to justify an additional review of GSCs; or
- (b) a GSP or the WGM makes an application to the Authority for a review in accordance with the Market Rules (s. 8.15).

7.2.2 Application for Review of GSCs

Upon receipt of an application for review, the Authority:

- (a) may request information that is required to determine GSCs (s. 8.9). Details of the information to be incorporated in submissions appears further below;
- (b) shall apply such of the principles and procedures in the Market Rules (ss. 8.9–8.14) as it shall consider relevant in determining the merits of such application; and
- (c) upon completion of its investigation, make a recommendation to the Price Regulator as to whether any revisions to the GSCs should be allowed.

7.2.3 Amendment of Review Thresholds

The Market Rules (s. 8.15) also state that the Authority may (and must, if so directed by the Price Regulator), when investigating GSCs determine, vary and notify a Review Threshold for all or some components of GSCs.

When doing so, the Authority must:

- (a) circulate a draft of the proposed Review Threshold; and
- (b) allow GSPs and the WGM an opportunity to comment on the proposed Review Threshold.

The Authority may, in its sole discretion, accept or reject some or all of the comments made by GSPs or the WGM or initiate its own amendments to the draft. The Authority shall notify

its determination of the proposed Review Threshold when it finalises its report to the Price Regulator.

7.3 Review Events and Thresholds (2011-12)

For 2011-12, the nature of the events which could require a review of GSCs (Review Events) and the associated thresholds over which a review might be triggered (Review Thresholds) were defined by the Authority with reference to an earlier version of the Market Rules. These Review Thresholds were developed in consultation with stakeholders.

These were subsequently accepted by the Price Regulator.

The Authority's 2011-12 recommendations are summarised in Table 7.1 below.

Table 7.1: 2011-12 Review Thresholds

| <i>Review Event</i> | <i>Eligible Cost category</i> | <i>Review Threshold</i> |
|---|-------------------------------|--|
| Change in law or policy, or Government specified emergency event | All | Zero, with assessment to be undertaken at end of regulatory period unless cost impact (in combination with impact of other Events) is 5% of GSC in which case assessment will commence on the date of the GSC's request. |
| Change in Demand or Supply Source (applications by GSPs). | Variable Operating Charge | As above |
| Change in Demand or Supply Source (applications by WGM) | Variable Operating Charge | As above |
| Change in Cost of Debt | Capital Charge | As above |
| Change in RAB | Capital Charge | As above |
| Change in actual capex from that initially estimated | Capital Charge | As above |

7.4 Review Events (2012-13)

7.4.1 Nature of Changes from 2011-12

For 2012-13, the Authority has sought to:

- (a) address additional matters raised by stakeholders (clarification);
- (b) remove references to previous Market Rules and an associated Manual (simplification);
- (c) more clearly identify separate categories of review events (specificity); and
- (d) remove unnecessary constraints related to the nature of the costs affected by review events. Essentially, leaving it up to the GSP to identify and justify the nature of the costs affected.

Notwithstanding these changes, the essential nature of the Review Events and their proposed treatment has not changed from 2011-12.

7.4.2 Changes in Law or Government Policy

Changes in law or Government policy are beyond the control of the GSPs, although GSPs are able to ensure that their response is prudent and efficient.

Recent relevant examples of changes in law or government policy include:

- (a) requirements for impact assessments and potential dam upgrades in response to the *Water Supply (Safety and Reliability) Act 2008*; and
- (b) costs relating to the merger of Seqwater and WaterSecure under the *South East Queensland Water (Restructuring) Regulation 2011*.

The Authority considers that, in a competitive market, the prudent and efficient costs arising from such events would apply to all service providers and would be passed through to customers.

7.4.3 Emergency Events

In the 2011-12 investigation, the emergency events and changes in law and government policy were addressed as a single Review Event.

Emergency events, such as the January 2011 floods, have the potential to require responses from GSPs. This may include activation of emergency response plans, staff overtime and rectification costs.

An emergency event is an incident that impacts on water quality, water supply reliability and/or public reassurance, and can have a differential overall severity rating (see SEQ Water Grid Emergency Response Plan¹³) which may affect the need for and nature of a response.

Where the GSP is not at fault for the emergency event, all prudent and efficient costs incurred in response to the emergency event should be recovered by the GSP.

7.4.4 Feedwater Quality Event

In the 2011-12 investigation, the Authority addressed feedwater quality in combination with emergency events. As submitted by Seqwater in 2011-12, feedwater quality is not necessarily correlated with emergency events. In contrast to emergency events, a feedwater quality event may increase treatment costs without affecting the water quality or water security achieved by water users.

The Authority notes that the quality of input water into Seqwater's treatment processes is largely outside of Seqwater's control. Seqwater does manage catchments to varied extents around its storages, but cannot influence other contributing factors to feedwater quality such as weather and topography.

This is primarily relevant to freshwater extracted from rivers and dams which may decline in quality due to rainfall, algal, flooding or run-off events. The Authority considers that this could also possibly apply to seawater input to the Gold Coast Desalination Plant, and the treated wastewater that feeds the WCRWS.

A reduction in the quality of feedwater is expected to impact costs associated with treatment chemicals and sludge disposal. The Authority considers that, to the extent this cost impact is

¹³ http://www.floodcommission.qld.gov.au/__data/assets/file/0019/8038/Seqwater_Supplementary_Submission_Att_13.pdf

outside of Seqwater's control and that Seqwater's response is prudent and efficient, Seqwater should fully recover this cost.

7.4.5 Changes in Forecast Demand or Water Source

Under the Direction Notice, GSPs are not to be subject to volume or source risk whether in total or across production or dispatch points over the regulatory period.

The use of actual (rather than forecast) volumes for billing purposes was employed during the 2011-12 year, and successfully reduced the within-period volume and source risk borne by GSPs. The Authority therefore recommends that 2012-13 variable operating costs are invoiced (monthly in arrears) to the WGM based on actual volumes and recommended \$/ML unit rates.

The Authority also acknowledges that the actual \$/ML unit rates may differ from those recommended by the Authority due to a change in demand or water source. For example, the unit rates of operating the desalination plant vary significantly with throughput rates. Further, higher than anticipated demand may reduce GSPs' ability to rely on gravity feed and cause an increase in per ML pumping costs.

As the volume and source of water demand are established by the WGM and therefore are outside of the GSPs' control, the Authority recommends that prudent and efficient costs arising from a change in demand or source be fully recovered by GSPs.

7.4.6 Changes in the Cost of Debt

Under the Direction Notice, the Authority is required to ensure that asset returns are equal the actual cost of debt in order for the GSPs to be immunised from interest rate exposure. The Authority notes that the cost of debt rate of return applied to drought assets and the cost of debt component of the WACC provided by QTC are forecasts, and may change during the course of 2012-13.

As a consequence, the Authority recommends that any change in the cost of debt be fully reflected in the GSCs recovered by the GSPs. The Authority will seek QTC's assistance in verifying any change in the cost of debt.

7.4.7 Under- or Over-Spend of Capital Expenditure

Stakeholder Submissions

LinkWater (2012a) requested the Authority's advice on when eligible over-spent capital expenditure will be rolled into the RAB. LinkWater noted the timing difference between when capital expenditure was incurred and any ex-post assessment by the Authority.

Authority's Analysis

The Authority's recommended GSCs are based on forecasts for capital expenditure that are likely to vary from actual costs incurred throughout the period. The Authority considers that the capital expenditure risk can be controlled, to a certain extent, by GSPs.

However, the Authority considers that GSPs should receive a Capital Charge consistent with actual prudent and efficient capital expenditure from the date of its inclusion in the RAB. This is likely to require an ex-post review of actual 2012-13 capital expenditure to ensure GSPs recover only prudent and efficient capital expenditure.

In response to LinkWater's submission, the Authority notes it was required to include capital expenditure in the RAB at its commissioning date as part of the 2011-12 investigation. While that particular component of the Ministerial Direction was not included for the 2012-13 investigation, the Authority believes that, for consistency, the actual commissioning date of the asset remains the appropriate date for inclusion of capital expenditure in the RAB. That is, GSCs will be adjusted retrospectively to take account of the actual prudent and efficient capital expenditure from the corresponding actual commissioning date.

7.4.8 Non-Review Events

As for 2011-12, the Authority expects that fixed operating costs will vary from forecast for reasons other than a Review Event. The Authority considers it appropriate that GSPs bear and manage this risk. However, as noted previously, where GSPs can make efficiency savings (including to fixed operating costs) GSPs should be able to retain 100% of their saving in the year it was achieved and 50% in the following year if achieved as a result of specific initiatives put in place by GSPs.

As noted in Chapter 3, the Authority has indicated a preference for the application of assessed cost savings (including extrapolating identifiable systemic savings to other cost items). In doing so the Authority would take into account any proposals relating to the adoption of the efficiency incentive previously proposed.

7.5 Review Thresholds (2012-13)

7.5.1 Framework and Approach

As in 2011-12, the Authority notes the limited magnitude of the risks assumed by the GSPs. In particular:

- (a) the GSCs are currently calculated annually using the latest available estimates of efficient costs. This differs from most regulated entities which have their efficient costs reviewed every three to five years;
- (b) the GSPs do not bear a number of risks normally borne by regulated entities. In this regard:
 - (i) the GSPs are not to bear any volume or source risk;
 - (ii) drought assets are to achieve returns equal to the actual cost of debt for each asset; and
 - (iii) the GSPs are to be immunised from interest rate exposures, through the full recovery of the actual cost of debt in both the rate of interest payable in respect of drought assets and the interest rate incorporated in the WACC applicable to non-drought assets; and
- (c) the 1 July 2011 opening RAB is not to be optimised.

As such, the GSPs' major risks relate to:

- (a) any under- or over-expenditure of fixed operating costs in 2012-13 that is not subsequently addressed in the calculation of GSCs in future reviews;
- (b) the temporary impact on free cash flows due to a cost variation in 2012-13 that is subsequently addressed in the calculation of GSCs in future reviews; and

- (c) capital and operating expenditure that is not considered to be prudent and efficient. This is a risk that should not be compensated for.

7.5.2 End-of-Period Review

As in 2011-12, given the limited magnitude of the risks to be assumed by the GSPs, and having regard to the cost of regulation, the Authority proposes that the most appropriate way to ensure GSPs recover their prudent and efficient costs is to adjust 2012-13 GSCs at the end of the period. The Authority recommends that GSPs submit Review Submissions for the 2012-13 GSCs as part of their regulatory submissions regarding GSCs from 1 July 2013.

To allow GSPs to fully recover prudent and efficient costs related to Review Events, the Authority will consider all submissions, regardless of materiality. In other words, the Authority proposes a zero Review Threshold for all end-of-period reviews.

The changes in costs should be applied from the date the additional costs are incurred (or commissioned in the case of capital expenditure).

7.5.3 Within-Period Review

Stakeholder Submissions

As part of its 2012-13 submission, LinkWater (2012a) argued that the Authority's Review Threshold for within-period adjustment during 2011-12 of 5% was too high. LinkWater submitted that to trigger this level would require an increase in fixed operating costs of over 20% or a capital expenditure impact larger than its entire capital expenditure program. LinkWater submitted that recent decisions by the AER and the Authority's GAWB recommendation have adopted a threshold of 1%. LinkWater proposed that 1% would therefore be a more appropriate Review Threshold.

Authority's Analysis

The Authority notes that the within-period review mechanisms were not triggered in 2011-12.

It is considered that Review Events should only be considered within a regulatory period if a GSC's free cash flows have been materially affected.

The Authority is aware that the GSPs' free cash flows are quite constrained as:

- (a) the return on drought assets is limited to the actual cost of debt;
- (b) drought assets account for 65% of the RAB across the Grid. The proportion of drought assets held by GSPs is 62% for Seqwater and 71% for LinkWater; and
- (c) the GSPs carry a high level of debt as determined by Government (about 90%).

The Authority's modelling estimates free cash flows of the order of 12% of the total GSC for Seqwater and 8% for LinkWater. The Authority therefore considers that a within-period review should only be undertaken if the financial impact of Review Events is likely to account for at least 5% of a GSP's GSCs. This threshold is lower than GSPs' estimated free cash flows and is consistent with that adopted in 2011-12.

In response to LinkWater's submission that a 5% threshold is too high, the Authority notes that the electricity distributors regulated by the AER and the GAWB face a five-year regulatory period, rather than the one-year periods faced by LinkWater. Therefore, the

average length of time that LinkWater will be forced to fund an unexpected cost impact before its charges are adjusted is much shorter.

The Authority also notes that the regulatory cost of a GSCs review is not trivial, and that for the end-of-period review a Review Threshold of 0% is recommended (as discussed in the previous section). Cost changes that qualify as a Review Event will therefore only be borne by GSPs until the end of period.

Further, the Authority recommends that adjustments to GSCs to account for Review Events are neutral in NPV terms, meaning that the timing of any review of GSCs is immaterial. As a result, the Authority considers that a Review Event will only have a detrimental effect on the GSPs' financial sustainability if it exceeds their available cash-flows. The Authority therefore proposes to continue to set one-year Review Thresholds based on an analysis of GSPs' free cash flows.

The Authority considers that a Review Threshold of 5% for a one-year regulatory period is reasonable in all the circumstances.

7.6 Summary of Review Thresholds

A summary of the proposed Review Events and Thresholds appears in Table 7.2 below.

Table 7.2: Summary of 2012-13 Review Thresholds

| <i>Review Event</i> | <i>Review Threshold for end-of-period review</i> | <i>Review Threshold for within-period review</i> |
|---|--|--|
| Change in law or Government policy | Zero | 5% of total GSCs |
| Emergency event | Zero | 5% of total GSCs |
| Feedwater quality event | Zero | 5% of total GSCs |
| Change in demand or source | Zero | 5% of total GSCs |
| Change in cost of debt | Zero | 5% of total GSCs |
| Under- or over-spend of capital expenditure | Zero | 5% of total GSCs |

7.7 Review Submissions

As for 2011-12, in order to facilitate such a review of GSCs, the Authority recommends that GSPs and the WGM provide a Review Submission, with details including:

- (a) demonstration of the business case for expenditure, including justification of the expenditure in terms of the GSP's approved strategic and operational plans;
- (b) demonstration that the expenditure is the most effective means of achieving the required outcome;
- (c) demonstration of compliance with internal governance (including board approvals), business case approvals, procurement, and project management processes and audit;

- (d) where a significant emergency event has occurred, demonstration of how the additional costs are required to meet the requirements of the SEQ Water Grid Emergency Response Plan; and
- (e) detailed supporting documentation enabling independent engineering review or other assessment of the reasonableness of capex or opex (with relevant details as indicated in earlier chapters).

Review Submissions should be certified by the Board of Directors as with any submission relating to the setting of GSCs.

In recommending an adjustment to GSCs, the Authority will seek to ensure that only prudent and efficient costs relating to a Review Event are recovered by GSPs. The Authority may require additional information on a case by case basis in order to properly assess claims by GSPs or the WGM.

7.8 Final Determination

As required under the Market Rules, the Authority provided stakeholders with an opportunity to comment on its proposed Review Thresholds as part of the 2012-13 Grid Service Charges Draft Report.

No submissions were received on this topic.

The Authority therefore has adopted the Review Thresholds for 2012-13, as detailed above.

APPENDIX A: PRICE REGULATOR'S DIRECTION NOTICE



Hon Stephen Robertson MP
Member for Stretton

Ref CTS 17378/11
D/11/046407

Mr Brian Parmenter
Chair
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Parmenter

I am writing to inform you that I have signed a Ministerial Direction to the Queensland Competition Authority (QCA) requesting its investigation of Grid Service Charges (GSCs) for the South East Queensland (SEQ) Grid Service Providers (GSPs).

As you are aware, the increases in water prices at the household level are of significant concern to the Queensland Government. The QCA's thorough review of all capital and operating expenses is therefore vital, as reflected in the attached direction notice.

The Direction Notice explicitly requires the QCA to undertake an operating cost benchmarking review to identify a benchmark level of fixed and variable operating costs appropriate to SEQ's GSPs.

I also request QCA to provide advice on potential efficiency improvements and business savings based on good industry practice. To this end, I encourage the QCA to undertake a consultative process with relevant stakeholders.

Should you have any further queries, please contact Ms Karen Waldman, Chief Executive Officer of the Queensland Water Commission on telephone 3227 8203.

Yours sincerely

STEPHEN ROBERTSON MP

Att

QLD COMPETITION AUTHORITY

24 OCT 2011

DATE RECEIVED



**Queensland
Government**

**Minister for Energy and
Water Utilities**

20 OCT 2011

414933

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SOUTH EAST QUEENSLAND WATER MARKET RULES
Section 8.3 (c)
PRICE REGULATOR'S DIRECTION NOTICE

Direction

As the Price Regulator under the South East Queensland Water Market Rules, I hereby direct the Queensland Competition Authority (the Authority) to investigate and recommend Bulk Water Grid Service Charges for the following south east Queensland bulk water Grid Service Providers (GSPs):

- Queensland Bulk Water Supply Authority (Seqwater); and
- Queensland Bulk Water Transport Authority (LinkWater).

Conduct of the QCA pursuant to this Direction

1. Investigate and recommend Grid Service Charges for 2012-13;
2. Conduct a detailed review of fixed and variable operating costs, including undertaking an appropriate benchmark review to provide advice on potential efficiency improvements and business savings based on good industry practice;
3. Assess the prudence and efficiency of capital expenditure and operating cost estimates submitted by the GSPs;
4. Develop a process, and appropriate Review Thresholds, for reviewing the 2012-13 Grid Service Charges; and
5. Provide a Report to the Price Regulator setting out recommendations for the Grid Service Charges for 2012-13 including identifying opportunities for efficiency improvements in capital and operating costs.

Matters to be accepted

In making its recommendations the Authority is to accept:

- (a) production forecasts for the regulatory period are to be consistent with the grid instructions forecast in the Operating Strategy (or any successor document) and any relevant information provided to the GSPs in accordance with the System Operating Plan;
- (b) the entities are not required to bear volume or source risk, either in total or across production or dispatch points, over the regulatory period;
- (c) the opening Regulated Asset Base (RAB) values and asset lives as advised by the Price Regulator as at 1 July 2011 are not to be reviewed by the Authority or subject to optimisation;

- (d) expenditure on capital projects approved by the Price Regulator prior to 1 July 2011 should be recognised as being prudent;
- (e) major (regionally significant) capital investment for grid capacity augmentation will be determined by the Government as part of the South East Queensland Water Strategy and Regional Water Security Program. Any such capital is to be rolled into the relevant entity's RAB at the project cost;
- (f) for drought assets constructed under the *Water Regulation 2002* (amended 2006) and Table 1 of the Regional Water Security Program, the rate of return should be the actual cost of debt inclusive of administration and capital market charges but exclusive of a Competitive Neutrality Fee as advised by Queensland Treasury Corporation (QTC);
- (g) for non-drought assets and post commissioning expenditure on drought assets, a rate of return equal to Weighted Average Cost of Capital (WACC), calculated on a pre-tax nominal basis, is to be achieved, subject to (i);
- (h) the following parameters are to be used in determining the WACC:
 - (i) a debt/equity gearing of 50:50;
 - (ii) cost of debt equal to the forecast cost of debt (including administration and capital market charges and the Competitive Neutrality Fee) of for each GSP as advised by QTC;
 - (iii) the risk free rate as advised by QTC;
 - (iv) a market risk premium of 6%;
 - (v) an equity beta of 0.68;
 - (vi) a gamma of 0.5; and
 - (vii) a tax rate of 30%.
- (i) In order to fully immunise GSPs from interest rate exposures, the rate of return earned by GSPs for 2012-13 is to be based on the actual cost of debt;
- (j) expenses and revenues associated with Seqwater's irrigation schemes must be taken into account; and
- (k) the current scope of recreation and catchment management activities as prudent.

Matters to be Considered

In making its recommendations the Authority is to:

- (a) consider any adjustments required due to an over- or under-recovery of Grid Service Charges in 2011-12, as described in the Authority's Review Thresholds document;
- (b) allow the entities to recover a sustainable revenue stream from the provision of Declared Water Services determined on the basis of efficient and prudent expenditure forecasts, recognising that the time horizon may extend beyond a single regulatory period;
- (c) provide appropriate incentives for entities to invest, innovate and pursue efficiency improvements consistent with their roles and responsibilities; and
- (d) recognise that Allowable Costs, with the exception of the QWC Levy, are once-off costs which can not be reasonably foreseen, rather than costs that will be incurred on a recurring basis.

Consultation

The Authority must consult with all relevant parties, including the QWC, and consider submissions within the applicable timetable for the investigation.

Timing

In accordance with section 8.4 of the South East Queensland Water Market Rules, the Authority is required to provide the following reports to the Price Regulator, setting out its recommendations on Grid Service Charges and any other information as is reasonably required to support its recommendations as follows:

1. A Draft Report by 30 April 2012; and
2. A Final Report by 30 June 2012.

Other issues

I may, by written notice given to the Authority, withdraw or amend this Direction at any time prior to receiving the Final Report.



STEPHEN ROBERTSON MP
Minister for Energy and Water Utilities

Dated: 20/10/11

APPENDIX B: SEQWATER POST 2012-13 CAPITAL EXPENDITURE

This Appendix summarises multi-period capital expenditure items submitted by Seqwater as not being relevant to 2012-13, a sample of which were reviewed by the Authority.

While some were initially sampled for independent review and findings were incorporated in the Draft Report, due to time constraints, the Authority has not been able to independently assess all the submissions since received on these items.

For future reference, however, the Authority has reported all submissions received in response to the Draft Report and in some instances additional comments and guidance has been provided.

While some items were re-scoped and considered relevant to 2012-13 GSCs, upon review only one project is recommended for inclusion in the 2012-13 RAB.

Prudency and Efficiency Review – Sampled Items

Seqwater (2012a) submitted that the addition of capital expenditure into the RAB at the date of commissioning increased the regulatory risk faced by Seqwater for multi-period capital expenditure. Seqwater submitted that it would appreciate feedback from the Authority relating to the 21 capital expenditure projects that are forecast to cost over \$1 million in total, involve expenditure in 2012-13, but are not due to be commissioned until 2013-14 or later.

The Authority has taken note of Seqwater's submission in preparing a sample of capital expenditure items for review. The Authority engaged SKM to review a sample of 10 capital expenditure items due for completion post 2012-13 (Items 1-10 below), comprising 28% of Seqwater's total proposed post 2012-13 capital expenditure.

The Authority notes that its findings in relation to post 2012-13 capital expenditure will have no impact on the recommended 2012-13 GSCs, as capital expenditure is included in the RAB as at the commissioning date. However, wherever a detailed review of a particular capital expenditure proposal (including independent technical assessment) is undertaken the Authority will be bound by its own findings in any future investigations, subject to an ex post assessment of actual capital expenditure incurred and no further information being available which would suggest otherwise.

Item 1: Molendinar WTP Backwash Pump

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed upgrades to the Molendinar WTP to be undertaken over 2012-13 to 2014-15, at an estimated total cost of \$11.715 million.

Seqwater submitted that the scope of the Molendinar WTP upgrade was a backwash pump.

WGM's Submission

The WGM (2012a) considered that the current treatment capacity of the Molendinar WTP, when considered alongside the neighbouring Mudgeeraba WTP, was adequate. The WGM did not foresee a requirement to increase those capacities at any time in the foreseeable future. The WGM noted that the combined treatment capacity of the two plants exceeded both the entitlement, and average Level of Service contribution from Hinze Dam.

The WGM noted that population growth may cause the capacity of the Molendinar and Mudgeeraba WTPs to be exceeded, as was flagged in the 2010-11 Annual Market Rules Review and advice to the

QWC. However, to the extent that this occurs, the WGM submitted that additional or excess demand would be supplied from alternative supplies operating within their existing capacity.

In relation to water quality, the WGM noted that the Seqwater submission referred to changes to certain water quality parameters. The WGM submitted that these statements referred to a trial of increased disinfectant dosing rates that was requested by Allconnex Water and that the increased dosing rates were being delivered using existing infrastructure. The WGM submitted that the trial had not yet confirmed a need for the change to take place on a permanent basis, or that capital expenditure would be required to maintain the dosing rates that were currently being delivered from existing infrastructure.

Seqwater's Response to the WGM's Submission

Seqwater submitted that the driver for the proposed works was not capacity augmentation, but rather renewals and water quality compliance. Seqwater submitted that the current sub-regional planning work will consider both network and WTP solutions. As such, the backwash pump is considered probable, and has been included in Seqwater's budget.

SKM's Review

SKM was unable to determine that the compliance cost driver identified by Seqwater was appropriate as the scope of the project was yet to be determined. The key document required to demonstrate the appropriateness of the cost driver and prudence as a whole was the Molendinar and Mudgeeraba Issues and Options Development study which was unavailable. Seqwater expected to receive the finished study shortly, and will then prepare a business case to be signed off in September/October 2012. Once these steps are completed, an assessment of the prudence of the expenditure and suitability of the driver can be completed.

With regards to the scope and cost of the project, SKM found that only the two pages of the KBR report were available for review. It was noted that for the Molendinar WTP a minimum capacity upgrade of 45 ML/day was inferred in the report.

Based on the information provided by Seqwater, the SKM review concluded that:

- (a) prudence was yet to be established however it was prudent to conclude the options assessment in order to determine the most appropriate path going forward. An appropriate decision making process had been documented to date, including the commissioning of a comprehensive options study; and
- (b) efficiency was not assessed as prudence was yet to be established.

SKM found that to enable an assessment to be completed the following information was required:

- (a) details of the completion of Options Assessment;
- (b) an Options Report;
- (c) date of approved Business Case; and
- (d) a Business Case.

Authority's Analysis

The Authority accepted SKM's conclusion that this project cannot currently be considered to be prudent.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that at the time of its initial submission in February 2012, the proposed Molendinar WTP Works project was at a very early stage of development. Seqwater's sub-regional planning work for this WTP, along with the Mudgeeraba WTP, had only just commenced. Seqwater prepared an indicative budget, including \$2.0 million in 2012-13, with all proposed expenditure, particularly in the forward years, being conditional on the outcomes of the study and the future of the plants.

At the time of preparing its latest submission, Seqwater noted that the sub-regional planning work, in conjunction with LinkWater, Allconnex and the WGM, has now progressed, and the parties are agreed that plant augmentation is not required, but that renewals to assets within the facilities will be required.

Furthermore, an options study has now been completed by Seqwater and provided to the Authority.

Seqwater submitted that proposed scope of works for Molendinar WTP are now more certain, based on the renewals work required. Seqwater estimated that the budget likely to be required to complete the works is \$1.65 million in 2012-13.

Seqwater considered that this updated information, and the reduction in the 2012-13 budget, reflects the refinement of the scope of works through the normal progression of planning work along the scheduled timeframe. Seqwater also submitted that following this standard process and timeline, it is now preparing its own options analysis and business case, which is likely to be completed from late August 2012. Seqwater noted the schedule for the development of this project means that a business case will not be approved until after the Authority's Final Report is due.

Authority's Analysis

The Authority notes that Seqwater has re-classified this project from a multi-year project to a project to be completed in 2012-13 at a cost of \$1.65 million. However, the need for the renewals expenditure requires further evaluation and the business case is not yet completed, therefore the prudence and efficiency of the Molendinar WTP renewals item remains to be demonstrated.

Item 2: Mudgeeraba WTP Storage

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed upgrades to the Mudgeeraba WTP to be undertaken over 2012-13 to 2014-15, at an estimated total cost of \$11.165 million.

The scope of the Mudgeeraba WTP upgrade is a 20 ML storage.

WGM's Submission

As noted in Item 1 above, the WGM (2012a) considered that the current treatment capacity of the Mudgeeraba WTP, when considered alongside the neighbouring Molendinar WTP, was adequate. The WGM did not foresee a requirement to increase those capacities at any time in the foreseeable future. In relation to water quality, the WGM considered that changes to water quality parameters had not yet been confirmed.

Seqwater's Response to the WGM's Submission

As noted above, Seqwater submitted that that the driver for the proposed works was not capacity augmentation, but rather renewals and water quality compliance. Seqwater submitted that the current

sub-regional planning work will consider both network and WTP solutions. As such, the storage works are considered probable, and have been included in Seqwater's budget.

SKM's Review

As with the Molendinar WTP project above, SKM found that it was unable to determine that the compliance cost driver identified by Seqwater was appropriate as the scope of the project was yet to be determined. The key document required to assess appropriateness of the cost driver and prudence as a whole was the *Molendinar and Mudgeeraba Issues and Options Development study* which was unavailable. Seqwater expected to receive the finished study shortly, and will then prepare a business case to be signed off in September/October 2012. Once these steps are completed, an assessment of the prudence of the expenditure and suitability of the driver can be completed.

Based on the information provided by Seqwater, the SKM review concluded that:

- (a) prudence was yet to be established however it was prudent to conclude the options assessment in order to determine the most appropriate path forward. An appropriate decision making process had been documented to date, including the commissioning of a comprehensive options study; and
- (b) efficiency had not been assessed as prudence was yet to be established.

To enable an assessment to be completed the following information was required:

- (a) details of the completion of Options Assessment;
- (b) an Options Report;
- (c) date of approved Business Case; and
- (d) a Business Case.

Authority's Analysis

The Authority accepted SKM's conclusion that this project cannot currently be considered to be prudent.

Seqwater's Submission on the Draft Report

Similarly to the Molendinar WTP Works above, Seqwater (2012b) submitted that the proposed Mudgeeraba WTP Works project was at a very early stage of development at the time of Seqwater's initial submission in February 2012. Seqwater's sub-regional planning work for this WTP had only just commenced, and as such Seqwater prepared an indicative budget, including \$2.0 million in 2012-13, with all proposed expenditure, particularly in the forward years, being conditional on the outcomes of the study and the future of the plant.

Seqwater noted that at the time of preparing its latest submission, the sub-regional planning work, in conjunction with Linkwater, Allconnex and the WGM, has now progressed, and the parties are agreed that plant augmentation is not required, but that renewals to assets within the facilities will be required.

Seqwater noted that these renewals will guarantee that these assets and facilities can continue to supply water of sufficient quality, into the future, and ensures that Seqwater maintains compliance with the Grid Contract and other obligations.

An options study has now been completed by Seqwater and separately provided to the Authority. Seqwater submitted that the proposed scope of works for Mudgeeraba WTP are now more certain and

based on the renewals work required. Seqwater estimated that the budget likely to be required to complete the works is \$0.50 million in 2012-13. Seqwater considered that this updated information, and the reduction in the 2012-13 budget, reflects the refinement of the scope of works through the normal progression of planning work along the scheduled timeframe.

Seqwater submitted is yet to determine the preferred option and is now preparing a business case, which is likely to be completed in late 2012. Seqwater noted that the schedule for the development of this project means that a business case will not be approved until after the Authority's Final Report is due.

Authority's Analysis

The Authority notes that Seqwater proposes to reclassify this project from a multi-year project to a 2012-13 project, with a cost of \$0.5 million. However, the need for the renewals expenditure requires further evaluation and the business case is yet to be completed, therefore the prudence and efficiency of the Mudgeeraba WTP renewals expenditure remains to be demonstrated.

Item 3: Kilcoy WTP Upgrade

Draft Report

Seqwater's Submission

The Seqwater submission (2012a) reflected that an upgrade of the Kilcoy WTP was underway, at an estimated total cost of \$16.481 million to be commissioned in 2013-14.

WGM's Submission

The WGM (2012a) noted that it had previously provided advice about this project to Seqwater, the Authority and responsible Ministers. The WGM submitted that advice remains extant.

In summary, the WGM:

- (a) agreed that improvements to the existing supply are required in order to meet its contractual obligations;
- (b) noted that the project cost appeared to be high, compared to benchmark rates for similar WTPs;
- (c) noted that the project specifications were more stringent than what is required under its Grid Contract with Seqwater or, to the best of its knowledge, a direction from the Office of the Water Supply Regulator;
- (d) recommended that the upgrades to the Kilcoy WTP be deferred by three months to enable a more fulsome comparison with a pipeline option; and
- (e) requested urgent advice as to the risks associated with such a delay.

The WGM noted that the Authority considered this project in its 2011-12 investigation and encouraged Seqwater to instigate further discussions with the WGM. The WGM submitted that the recommended discussions had not occurred, and no further information or advice was provided about the concerns raised.

Seqwater's Response to the WGM's Submission

Seqwater submitted that a review of the business case was undertaken following assessment of the tenders in order to:

-
- (a) re-estimate the net present value using the 'revised project budget' as the capital cost component for the options considered in the Business Case;
 - (b) re-assess the cost estimated for the grid connection option to improve the level of accuracy for capital cost estimate. The grid connection option capital cost increased from \$30 million to \$35 million with the level of accuracy putting the range between \$25 million and \$55 million;
 - (c) re-evaluate the assumptions and risks associated with the grid connection option to make an improved comparison with the Kilcoy WTP; and
 - (d) re-evaluate the scheduling for the grid connection option to identify the likely programming based on the revised timing.

Seqwater submitted that the Kilcoy WTP was still the prudent and efficient option compared to a pipeline grid connection option involving a 45 km pipeline. Seqwater concluded that a new WTP at the Kilcoy Somerset site remained the best site to treat water from Somerset Dam to supply to Kilcoy.

SKM's Review

Seqwater nominated the cost driver for this project as compliance. SKM found this to be appropriate based on the following:

- (a) the project involved the increase in treated water capacity to allow the WGM to comply with contractual obligations to Queensland Urban Utilities to address water security, quality and reliability issues;
- (b) the existing water supply was vulnerable to both peak demand and asset failure, evidenced by two Level 3 emergencies during 2009 resulting in water supply and quality issues;
- (c) the existing Kilcoy WTP operated in excess of 20 hours per day for 20 out of 27 days in May 2011; and
- (d) Seqwater's risks assessments have identified a number of high risks with the existing treatment process.

SKM found that Seqwater conducted two phases of options analysis which included the review of both a "do nothing" option and a number of pipeline options. Based on its review of the options analysis, SKM found the processes to be appropriate.

In response to the concerns raised by the WGM, SKM reviewed the revised NPV costs for pipeline options contained in the *Kilcoy Pipeline Addendum Report Update*. SKM found that in this report the revised NPV costs for pipeline options were higher than in previous reports.

In its review of the scope of the works SKM found that there had been some significant changes to the scope of works previously proposed which were found not to be efficient by the Authority in its 2011-12 review. These scope changes and their associated costs are outlined in Table B.1 below.

Table B.1: Kilcoy WTP Upgrade Additional Cost Items

| <i>Additional Item</i> | <i>Cost (\$)</i> |
|---|------------------|
| Additional WTP Equipment Required | 600,000 |
| Upgrade to the Access Road | 1,020,000 |
| Lime/CO2 Dosing Facility | 564,000 |
| Raw Water and Treated Water Pipeline Duplications | 512,000 |
| Electricity Supply Increase | 80,000 |
| Increase in the Clear Water Storage Volume (CWS) | 57,000 |

Source: SKM (2012).

SKM reviewed the treated water quality targets adopted by Seqwater and found that the relaxed specification for the plant of 0.3 NTU (95th percentile) and 0.5 NTU (limit) was consistent with current guidelines.

As the costs provided by Seqwater were determined through competitive tender, SKM believed that they accurately represented the current market value of the project. SKM also noted that the preferred tender selected by Seqwater was the second cheapest, with a base price (excluding contingency) of \$11.31 million.

Table B.2 below provides a breakdown of the different elements of the project cost and how each relevant element was priced as part of the tender, i.e. fixed price, pre-agreed variation or contract variation/separate contract.

SKM found the processes followed during the development of the Kilcoy WTP upgrade to be reasonable. A business case, business case review and number of revisions of the business case review have been produced to reflect the changing scope of the project.

SKM found that the outstanding question from its 2011-12 review of the project, is whether these processes were applied at the right time in the development of the project. Based on timeframes being critical to maintaining supply and advised instances of supply shortfall within the last 12 months, SKM concluded that the timing of review activities did not appear unreasonable.

Table B.2: Kilcoy WTP Upgrade Additional Cost

| <i>Description</i> | <i>Amount (\$'000)</i> |
|---|------------------------|
| Original Contract | |
| Design and Construction of WTP | 10,686 |
| Clear Water Storage Upgrade to 400kL (from 200kL) | 57 |
| Lime/CO ₂ Dosing Facility | 564 |
| Contract Contingency | 1,696 |
| <i>Total of Original Contract Budget</i> | <i>13,004</i> |
| Additional Contract Budget | |
| Raw Water Pipeline | 406 |
| Treated Water Pipeline | 106 |
| New Access Road and Existing Road Upgrade | 1,020 |
| <i>Subtotal of Additional Contract Budget</i> | <i>1,532</i> |
| Contingency | 473 |
| <i>Total of Additional Contract Budget</i> | <i>2,005</i> |
| Total Contract Budget | 15,009 |
| Project Delivery | |
| Preliminaries and Tender Phase | 281 |
| WTP D&C Implementation | 1,091 |
| Project Implementation | 668 |
| Contingency | 192 |
| <i>Total of Project Delivery</i> | <i>2,233</i> |
| Total Cost | 17,242 |

Source: SKM (2012).

With regards to the timing of the project SKM noted that Seqwater's key reason for proceeding with the construction of a new WTP at Kilcoy rather than spending more time analysing the viability of a grid supply pipeline, as suggested by the WGM, was the time constraint.

Further, SKM noted that the further development of the pipeline option would have taken additional time and construction of the pipeline option would also have had programme risks, particularly associated with required approvals in a non-drought situation.

SKM also noted that insufficient information on cost breakdowns was provided to make a full assessment of the project's overheads and contingencies but it appeared that there may have been some double counting of contingencies.

SKM concluded the project was prudent, that the primary driver was demonstrated and an acceptable decision making process was documented.

SKM concluded that project was efficient as the scope was appropriate, the standards of works were consistent with industry practice and the costs were consistent with prevailing market conditions.

Authority's Analysis

In the Draft Report, the Authority noted the WGM's submission that further discussions between Seqwater and the WGM regarding this project have not occurred. The Authority noted that these discussions were explicitly recommended in its 2011-12 Final Report (QCA 2011), which was subsequently accepted by the Price Regulator.

The Authority did not consider that Seqwater's obligations regarding customer consultation are particularly onerous, and recommended that it immediately reviews its program of consultation with the WGM to address this shortcoming.

The Authority noted SKM's recommendation that this project is prudent and efficient. The Authority proposed to accept SKM's recommendations, provided that the outcomes of the further discussions between Seqwater and the WGM do not alter SKM's findings.

WGM's Submission

The WGM (2012b) submitted that it continued to be concerned that the project specifications for new WTPs are more stringent than what is required under the Grid Contracts.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that in the Draft Report, the Authority approved the proposed expenditure. However, Seqwater noted that there was expenditure of \$0.506 million spent in 2010-11 which was not required to be included in the submission template but forms part of the total project budget.

Seqwater also determined that an amount of \$1.168 million which was re-phased from 2012-13 to 2011-12 was inadvertently excluded from the anticipated expenditure submitted in its Information Return for 2011-12. However, this amount had been correctly deducted from the 2012-13 amount. Consequently, Seqwater submitted that the anticipated expenditure for 2011-12 was shown in the Information Return as \$6.578 million instead of \$7.746 million. Expenditure for 2012-13 and 2013-14 included in the Information Return was correctly stated.

Seqwater has revised the total project value as follows:

- (a) \$0.506 million expended in 2010-11;
- (b) \$7.746 million to be expended in 2011-12;
- (c) \$8.353 million to be expended in 2012-13; and
- (d) \$1.217 million to be expended in 2013-14.

Seqwater submitted that the total project value is \$17.8 million. This is consistent with the revised budget of \$17.8 million mentioned on page 37 of the Final Report "SEQ Grid Service Charges 2011-12" and the budget investigated by SKM.

Seqwater also acknowledged the Authority's explicit recommendation for further discussions with the Water Grid Manager. Seqwater confirmed that several discussions have already taken place since the

Draft Report was released, and that Seqwater will provide further advice to the Authority when these discussions are finalised.

Authority's Analysis

In response to the WGM's concerns regarding project specification, the Authority has conducted further investigation of water quality requirements. Seqwater has made the Authority aware of potential inconsistencies relating to water quality standards specified in the Grid Contract and the Grid Contract's separate requirement for compliance with the ADWG.

Seqwater's view was that the standards as set out in the Grid Contract were not stringent enough to ensure that the water it supplied to the WGM was safe, and that it would be possible for it to provide water to the WGM that met the standards set out in the Grid Contract, but was potentially unsafe. For this reason, Seqwater chose to exceed the standards set out in the Grid Contract in some areas.

As discussed in Chapter 3, the Authority has accepted the judgement of the GSPs for the purpose of recommending Grid Service Charges insofar as water quality standards are concerned – to do otherwise would require the Authority to establish the appropriate quality/risk standard and expose the service providers to an unacceptable level of risk on a matter of substantive health and safety. This is considered a matter more appropriately determined by Government. The Authority could assist in the future by identifying the various risk/quality cost options or the process that should be adopted for this purpose.

For the purpose of the GSCs, the Authority notes that Seqwater's revised project budget is consistent with that reviewed by SKM for the Draft Report, which was considered prudent and efficient. On this basis, the Authority accepts the amended total project value of \$17.8 million. This project is expected to be commissioned in 2013-14 and therefore has no implications for 2012-13 GSCs.

Item 4: Boonah-Kalbar WTP Upgrade

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to upgrade the Boonah-Kalbar WTP at an estimated total cost of \$9.3 million, to be undertaken from 2012-13 to 2014-15.

WGM's Submission

The WGM (2012a) noted that this project was referred to in the interim statement from Seqwater to the QWC, dated 28 February 2012. That statement included advice that the project will address the key drivers of water quality and supply reliability, and peak capacity demands. The WGM noted that it also stated that total costs were estimated to be \$5.3 million.

The WGM recommended, based on current information, that this capital expenditure was not required at this time.

The WGM considered that existing treatment capacity of 3.5 ML per day exceeded forecast demand over the short to medium term. For comparison, the WGM noted that forecast annual requirement for 2011-12 was about 1.7 ML per day. The WGM submitted that mean day maximum month demand was about 50% of available treatment capacity.

The WGM considered that augmentation options analysis was not expected to be required until 2021 at the earliest, for 2024 implementation.

The WGM was not aware of any water quality or reliability issues at the Boonah-Kalbar WTP.

Seqwater's Response to the WGM's Submission

Seqwater submitted that addressing raw water quality was the primary driver for Stage 1 of these works and involved removal of pathogen risk, rather than capacity. Seqwater submitted that Stage 1 accounted for 80% of the project cost, and would allow for a new raw water intake at the Gorge, with a new pump station and raw water pipeline to Kalbar WTP. A risk analysis of the Kalbar WTP indicated the risk of the raw water being contaminated with pathogens such as bacteria, viruses and protozoa to be very high to extreme. It also indicated that the risk of the plant not having the capacity to manage viruses and protozoa was high to very high, related to chlorination contact time and the filters.

The remaining 20% of stage 1 related to plant automation and dosing system upgrade (\$670,000, 2012-2014) and sludge treatment improvements (\$520,000, 2012-2014), both aimed at ensuring compliance with water quality and quantity requirements. Seqwater submitted that, where demand forecasts proved to be lower than those currently suggesting capacity upgrades by 2019, then Seqwater would take advantage by deferring further capex until needed.

SKM's Review

Seqwater identified a number of cost drivers for this project including; contractual compliance, regulatory compliance, demand growth and renewals. SKM found although Seqwater have identified a number of cost drivers that the project relates to, compliance is the most prominent.

SKM noted that the information provided by Seqwater in its business case was not consistent with the costs within Seqwater's submission to the Authority. Table B.3 shows the costs included in the business case.

Table B.3: Boonah Kalbar WTP Upgrade Business Case

| <i>Component</i> | <i>Description</i> | <i>Cost (\$'000)</i> |
|------------------|---|----------------------|
| 1 | New Raw Water Pump and Pipeline | 5,558 |
| 2 | Improved Control Systems to Allow Unmanned Dosing | 670 |
| 3 | Improvement of Sludge Treatment Facilities | 520 |
| Total | | 6,448 |

Source: SKM (2012).

Regarding the timing of the project, SKM noted that the capacity of the Boonah-Kalbar WTP is likely to be exceeded in two stages:

- (a) approximately 2013-14 – when demand exceeds the capacity based on the current 8-10 hour manned operation of the plant; and
- (b) approximately 2019 – when demand exceeds the capacity of the plant even when operating full time.

However, SKM noted that the justification for component 1 related to raw water quality, rather than production capacity (as queried by the WGM). SKM noted that both upstream and downstream of the extraction point are substantial areas of agricultural and pastoral activities. These activities have been identified as high risks to water quality and compromise the raw water quality through the introduction of pathogens and additional sediment loads. SKM noted that, according to treated water quality

presented in an options study, exceedance of the ADWG guidelines for 2-MIBs and Manganese have been detected.

While SKM found that of the three project components only component 1 was subject to detailed options analysis, SKM concluded that all three components were prudent.

With regards to the scope of the works, SKM found that for component 1 a preliminary design report detailed the scope of the works including the preliminary design, pipe route and cost estimate details. For the remaining components SKM found that there was insufficient information to assess the appropriateness of the works.

Seqwater submitted that cost estimates were based on similar sized projects carried out in SEQ (with Rawlinson construction cost index applied), SKM's internal cost database, industry data and quotations for similar components. The estimates include a 20% contingency for component 1 and 25% for components 2 and 3 and have an accuracy of $\pm 30\%$.

SKM found that the use of similar sized projects carried out in SEQ (with Rawlinson's construction cost index applied), SKM's internal cost database, industry data and quotations for similar components was an appropriate method for determining preliminary cost estimates.

SKM noted that Seqwater indicated that for component 1 a design-then-construct delivery method was to be utilised and that for components 2 and 3 a design-and-construct, delivery method was utilised. SKM found this to be appropriate noting that going to the market during the design-then-construct or design-and-construct process will result in competitive pricing.

Based on the above SKM assessed component 1 to be efficient as the scope was appropriate, the standards of works were consistent with industry practice and the costs were reasonable and will be market tested.

SKM was unable to assess the efficiency of components 2 and 3 as there was insufficient information. SKM noted that the additional information required to allow the efficiency assessment of these components included finalised investigations with costs and timeframes.

Authority's Analysis

In the Draft Report, the Authority considered that Seqwater's submission and SKM's review addressed the WGM's concerns regarding component 1 of this project, and accepted SKM's recommendation that component 1 is prudent and efficient. The Authority noted that further information is required before the Authority can accept that components 2 and 3 are efficient.

The prudent and efficient expenditure for the Boonah Kalbar WTP is detailed in Table B.4 below.

Table B.4: Boonah Kalbar WTP Recommended Capital Expenditure (\$'000)

| | <i>2011-12</i> | <i>2012-13</i> | <i>2013-14</i> | <i>Total</i> |
|--------------|----------------|----------------|----------------|--------------|
| Component 1 | 300 | 2,500 | 2,758 | 5,558 |
| Component 2 | 0 | 0 | 0 | 0 |
| Component 3 | 0 | 0 | 0 | 0 |
| Total | 300 | 2,500 | 2,758 | 5,558 |

Source: SKM (2012).

Submissions in Response to the Draft Report

Seqwater (2012b) acknowledged that additional information is required to be provided in relation to components 2 and 3. While initial scoping has been completed, detailed scoping and timelines are yet to be finalised. Seqwater noted that it intends to provide the Authority with these details and further expenditure justification once completed.

The WGM (2012b) submitted that it remained of the view that proposed improvements to the Boonah-Kalbar WTP are not needed at this time and that it is liaising with Seqwater on the matter.

Authority's Analysis

The Authority has accepted the prudence and efficiency of component 1 but detailed scoping and timelines are to be finalised to enable the prudence and efficiency of components 2 and 3 of the Boonah-Kalbar WTP project to be assessed.

Item 5: Lowood WTP Upgrade

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to undertake sludge handling improvements and other works at the Lowood WTP, at an estimated combined cost of \$3.3 million. The works are proposed to be undertaken for compliance purposes in 2012-13 and 2013-14.

WGM's Submission

The WGM (2012a) recommended that further information was required to demonstrate the need for this expenditure.

The WGM submitted that the treatment capacity of the Lowood WTP exceeds forecast mean day maximum month demand to the year 2031, and potentially beyond. The WGM noted that average day demand was about 7 ML per day, compared to the treatment capacity and entitlement of 20 ML per day.

If sludge handling improvements are shown to be required due to environmental legislation or to maintain supply, the equipment should be sized for no more than the predicted average demand at 2031 of 8.4 ML per day based on medium growth.

There are also no known water quality or reliability issues.

Seqwater's Response to the WGM's Submission

Seqwater submitted that planning work is currently underway on this project, which was not an upgrade of capacity but was due to environmental requirements relating to sludge handling.

Seqwater noted that the plant had been operating at below 50% capacity and had been struggling to deal with sludge at this load. Wet weather created significant issues and there had been a recent overflow incident.

SKM's Review

The cost driver nominated by Seqwater for this project was compliance. SKM found this to be supported by the *Needs Analysis: Lowood WTP Sludge Handling Options Assessment* (Seqwater, October 2011).

SKM found that Seqwater conducted an options analysis for the project. However, SKM noted that this did not include a "do nothing" option and that the final outcome of this analysis will not be completed until May 2012.

Based on the above SKM concluded that the project was prudent and that an appropriate decision making process had been documented to date, including the commissioning of a comprehensive options study.

SKM found that the scope of works for this project was yet to be determined. SKM also noted that no information was provided on the standard of works to which the project will conform.

With regards to efficiency, SKM found that the project was not sufficiently progressed to demonstrate the selection of an efficient option. Similarly, the scope and standard of works were not defined. Consequently, the continued investigation was prudent however the capital expenditure of the solution could not be confirmed as efficient.

Authority's Analysis

In the Draft Report, the Authority accepted SKM's finding that this project is prudent and would require further information before concluding that an efficient option has been selected. Nevertheless, the Authority noted that these findings have no direct impact on 2012-13 GSCs as it would only be recognised upon commissioning.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that recent wet weather created a significant overflow incident which placed the WTP at risk of breaching environmental law. It considered this issue serious given the likelihood of continued breaches of the law if action is not taken. Seqwater noted that the options study for this project is due for completion in the near future and that some of the project will be required by 2012-13.

Seqwater noted that it intends to separate this project into several smaller projects to avoid further risks.

Seqwater water provided additional information including an investigation of options conducted by Hunter Water for an interim solution to sludge handling issues at the site. Seqwater requested the Authority allow \$1,000,000 in the 2012-13 capital charge for this project.

Authority's Analysis

The Authority has reviewed the additional information provided by Seqwater, and notes that the Hunter Water Report found that the most effective interim solution would be to install a Geotube arrangement. The estimated capital cost of this option is listed in the Report at \$139,230 substantially below the \$1,000,000 requested and the initial estimate of \$3.3 million.

It is noted that a detailed business case has yet to be prepared for the interim and longer term solutions to sludge handling issues at the Lowood WTP. Moreover, estimates of the costs vary significantly. The Authority has not incorporated these costs in the 2012-13 RAB and proposes to defer consideration of related capital expenditure until the business case and all relevant costs are available and assessed by its independent consultants.

Item 6: Jimna WTP Upgrade

Seqwater's Submission

Seqwater (2012a) proposed \$1.911 million of upgrades to the Jimna WTP for compliance purposes, in 2012-13 and 2013-14.

WGM's Submission

The WGM (2012a) recommended that further information was required to demonstrate the need for this expenditure.

The WGM understood that this plant has had operational improvements made since Seqwater took ownership of it, resolving many of the initial water quality issues. The WGM stated that it was not aware of any water quality or supply issues since these improvements were undertaken.

In relation to capacity, the WGM noted that current annual demand is about 13 ML (0.04 ML/day). Treatment capacity is 0.2 ML per day.

Seqwater's Response to the WGM's Submission

Seqwater submitted that the main drivers for the work were renewals, compliance and efficiency. Seqwater did not intend to expand the capacity of Jimna WTP, and the capital works did not include fluoridation capability.

SKM's Review

While Seqwater nominated compliance as the key driver of this project it noted that there were a number of different cost drivers including:

- (a) renewal – purchase of the site (the current permit to occupy expires in 2016), and the installation of a new filter cell;
- (b) service – automated de-sludging, intake pump replacements, and raw water main replacement; and
- (c) improvement – upgrade of SCADA system.

SKM found that Seqwater had undertaken a detailed options analysis which included the examination of a “do nothing” option.

Based on its analysis SKM concluded that the project was prudent. SKM reported that the primary driver of compliance was demonstrated, mainly based on their works being the conclusion of

temporary works, for which compliance was the primary driver, along with a number of supporting drivers. An appropriate decision making process was documented although SKM noted that additional information should have been provided.

With regards to the scope of the proposed works, SKM found that the need for the majority of the works was clear from the condition of the treatment plant. However, SKM noted that it was not clear if Seqwater had considered off-site sludge handling or disposal as an alternative to the new sludge handling system.

SKM concluded that scope of the works were appropriate noting that the consultant's brief for the detailed design of the upgrade works had only recently been released and the issues identified above would be addressed through the design process.

SKM reviewed the detailed project cost provided by Seqwater and found that escalation allowance of 9.4% of the total construction cost to be high.

Additionally, SKM noted that the project could be considered to have a disproportionately high cost of treatment per capita given the proposed expenditure and small number of permanent customers. However, SKM noted that Seqwater submitted that it had an obligation to supply water to recreational users as its Grid Contract is simply to supply the area, regardless of the status of the connection.

With regards to contingencies, SKM found that contingencies of 20%, 25% and 30% were used in the preparation of the cost estimate. Overall this resulted in an average contingency of 26%. This was at the upper end of a reasonable range for this stage of the project.

With regards to the WGM's submission, SKM noted that there was still design optimisation works required, which should have been undertaken as part of the detailed design phase, and that additional information needed to be provided to create a complete audit trail.

SKM also reiterated that the basis of its assessment was the assertion by Seqwater that the works were required to complete the temporary works that were undertaken to improve the facility from the non-compliant condition that it was in at the time of transfer. SKM also noted that incomplete works had created poor outcomes in the past as illustrated by several facilities transferred to Seqwater in delivery of the SEQ water reforms.

SKM concluded that the project was efficient as the scope was appropriate, the standards of works should be consistent with industry practice and the costs were consistent with prevailing market conditions.

Authority's Analysis

The Authority accepts SKM's finding that this project is prudent and efficient.

No further submissions were received in regard to this project.

Item 7: North Stradbroke Island WTP Upgrade

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to undertake a \$4.075 million upgrade to the North Stradbroke Island WTP, to be completed in 2013-14, for the lime system and sludge lagoon.

WGM's Submission

The WGM (2012a) endorsed any works required to maintain the ability to consistently access its full entitlement from the borefield. In relation to Herring Lagoon, the WGM recommended that no major expenditure occur until the future role of the supply was agreed by all parties, including both the scope of any required works and the timing of those works. The WGM considered that, based on information provided, this would appear to include the proposed lime system and sludge lagoon.

The WGM considered the North Stradbroke Island WTP was a critical WTP, providing base load supply for use in the Redlands and Cleveland demand zones and for transfer west through the Eastern Pipeline Interconnector.

The WGM noted that the North Stradbroke Island WTP accesses water from a number of bores, as well as surface water from Herring Lagoon. Water from Herring Lagoon is typically high in colour and turbidity due to vegetation tannins leeching into the water, particularly after rainfall events. High colour and turbidity make this water more costly and complicated to treat than water taken from the borefields. Specifically:

- (a) treatment of water from Herring Lagoon typically involves the use of the dissolved air flotation unit. Water sourced from the borefields generally only requires pH correction and disinfection; and
- (b) the Herring Lagoon WTP has two sludge pools to dry the sludge that comes from the treatment process when sourcing water from Herring Lagoon, which requires the use of a coagulant. This sludge, once dried, needs to be transported off the island for disposal with associated operational costs and environmental impacts. Sludge volumes increase with production.

The WGM noted that it, the QWC and Seqwater are currently reviewing the future role and function of the Herring Lagoon source, in consultation with DERM.

Seqwater's Response to the WGM's Submission

Seqwater submitted that DERM recently delayed its decision regarding Herring Lagoon water allocations and source extraction delaying works until 2013-14.

Due to DERM's delayed decision, Seqwater will now delay capital expenditure on North Stradbroke Island WTP in its budget until 2013-14. This project will be included in Seqwater's 2013-14 submission to the Authority.

Consequentially, Seqwater has budgeted \$1.1 million for the North Stradbroke Island WTP in 2012-13.

SKM's Review

In conducting its review of the prudence of the project, SKM found that Seqwater proposed that in order to efficiently meet future demands, it required a transfer of water entitlements and extraction capacities from Herring Lagoon to bore fields to create a more reliable and consistent source of water.

Both the WGM and Seqwater have been in communication with DERM regarding the benefits and efficiencies associated with the transfer of extraction entitlements. However, DERM has indicated that it will not address the issues of the transfer of extraction entitlements until February 2013.

As the primary source of water will be a key determinant to the decision making process and the scope of the proposed works, SKM concluded that in the absence of advice from DERM it is unable to determine the prudence of the project. However SKM noted that the intent to source higher quality raw water was appropriate.

As the scope, standard and project design had not been documented it was unable to assess the efficiency of the project.

SKM recommended that additional information be provided by Seqwater to enable a complete assessment. This information should include:

- (a) confirmation from DERM regarding the ability to transfer existing water extraction licences;
- (b) information regarding the choice of pH correction chemical compound;
- (c) a detailed scope of works;
- (d) information indicating the capacity of the sludge lagoon with accompanying justification and preliminary drawings; and
- (e) a cost breakdown of Seqwater's supply and install costs for the lime dosing configuration.

SKM recommended all expenditure on this project be excluded.

Authority's Analysis

The Authority accepted SKM's recommendation that further information is required before it can be determined that the project is prudent and efficient.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that after its initial submission of February 2012, new information was provided by DERM (now DEWS) advising that its policy decision regarding water allocations and source extraction on North Stradbroke Island would be delayed until 2013-14.

Given DEWS' new timeframe, Seqwater submitted that it has now decided to postpone the proposed capital expenditure at the North Stradbroke Island WTP in its budget until 2013-14.

Seqwater has therefore proposed not to incur capital expenditure on the North Stradbroke Island WTP in 2012-13, and the \$1.1 million originally budgeted will be delayed until 2013-14. This will be addressed in Seqwater's submission to next year's review, dependent on DEWS' final policy decision.

Authority's Analysis

As Seqwater proposes to postpone capital expenditure on the North Stradbroke Island WTP in 2012-13, and the \$1.1 million originally budgeted will be delayed until 2013-14, the Authority has not further investigated the prudence and efficiency of the expenditure related to this project.

Item 8: Maroon Dam - Stage 1 Safety Upgrade

Draft Report

Seqwater's Submission

In its submission Seqwater (2012a) proposed a total expenditure of \$7.25 million, to be completed in 2013-14, to raise the crest of the Maroon Dam by 1.5 metres to comply with the *Acceptable Flood Capacity Guidelines* issued in February 2007 by the DERM.

SKM's Review

SKM reviewed the decision-making process adopted by Seqwater for this project and noted that a detailed multiphase options analysis was undertaken including the consideration of a “do nothing” option and the commissioning of independent advice. SKM found this decision-making process to be appropriate.

SKM found the project to be prudent.

SKM found that the scope of the works included in the budget estimate included the detailed design of the works and their construction and found that these were appropriate for the project.

SKM developed cost estimates for the project using the unit rates within the SunWater (the owner of the Dam prior to its transfer to Seqwater in 2008) 2005 Spillway Adequacy Assessment which were escalated to current industry rates using a 4% annual escalation over seven years. SKM calculated the expected budget value to be \$3.75 million for the 2011-12 financial year. Where possible, Rawlinson's 2011 Australian Construction Handbook was used by SKM for comparison. In support of SKM's calculation, a cost estimate for the 2010-11 financial year of \$3.5 million was considered by Project Support Pty Ltd.

Notwithstanding the above, Seqwater's project business case showed an estimated capital expenditure of \$7.9 million whilst the Grid Service Charges Information Return Spreadsheet listed a total cost of \$7.25 million. Both these values are significantly larger than the SKM cost estimate of \$3.8 million. SKM found that the reason for the different values in the business case and Grid Service Charges Information Return Spreadsheet was unclear. However, SKM noted that all cost estimates included project management, construction management and design costs, as well as contingency.

Utilising the information available, SKM considered that an allowance of \$3.8 million inclusive of design costs was acceptable for the Stage 1 upgrade. SKM noted that more information was required detailing why Seqwater requested at least \$7.25 million for Stage 1.

Furthermore, SKM noted that in the project business case it was stated that “DERM advised that funding of \$12 million has been made available to Seqwater for the Maroon and Moogerah Dam spillway upgrades during 2011-12”. Of this, \$6 million was allocated to Seqwater for Maroon Dam in the form of a grant. It was not apparent to SKM how this funding fitted into the spending timetable.

SKM found \$3.8 million of expenditure to be efficient for 2012-13. With regards to the remaining expenditure SKM recommended that additional information be provided by Seqwater including:

- (a) confirmation of the scope of the project that was being implemented in Stage 1;
- (b) justification of the budget allowance of \$4 million and \$3 million in 2012-13 and 2013-14 respectively to implement Stage 1, when compared to the other estimates, which indicated a substantially lower amount; and
- (c) explanation of why the project business case and the grid service charges information return spreadsheet showed capital expenditure which differ (\$7.9 million and \$7.25 million respectively).

Authority's Analysis

In the Draft Report, the Authority accepted SKM's finding that this project is prudent. The Authority recommended that all expenditure to be funded via the DERM grant be removed from GSCs. In this regard, the Authority noted the disparity between Seqwater's proposed business case (\$7.9 million), Seqwater's submission (\$7.25 million), SKM's recommendation of efficient capital expenditure (\$3.8 million) and DERM's grant (\$6 million). The Authority considered that it cannot provide an opinion

on the efficient cost of this project to be recovered from water users until these disparities are reconciled.

Seqwater's Submission on the Draft Report

Seqwater (2012b) has submitted additional information to the Authority regarding the scope and costing of this project. In particular, Seqwater has provided cost estimates prepared by GHD in September 2011 and used to underpin Seqwater's business case. Seqwater acknowledged that the valued contained in its submission incorrectly excluded 50% of the project contingency of \$1.4 million and the full amount of the contingency should have been included.

Consequently, Seqwater submitted that the total budget be increased from \$7.2 million to \$7.9 million with the additional \$0.7 million being added to the budget for 2013-14, increasing the budget for that year from \$3.0 million to \$3.7 million.

In addition, Seqwater submitted that the status of the subsidy for the dam safety works relating to the Maroon Dam is currently still subject to confirmation. Seqwater noted that it has been in contact with DEWS about this issue and has requested additional information as soon as possible. As additional information becomes available, Seqwater noted that it will advise the Authority on the nature of the subsidy and its appropriate treatment in relation to its 2012-13 capital expenditure program.

However, in the meantime, Seqwater submits that it would be appropriate and consistent with regulatory precedent to include the total cost of the upgrade in the RAB. The implications of the subsidy, in terms of the effect on GSCs, should be determined after receiving specific advice from the grantee about the intended price consequences. Seqwater notes that the Authority's 2000 Statement of Regulatory Pricing Principles (QCA 2000) states that:

The appropriate approach to regulatory recognition of capital subsidies depends, largely, on the purpose of the grant. In this regard, the purpose may include employment generation, assisting local government to meet funding shortfalls or reducing the service costs to a particular consumer or group of consumers. In the absence of any specific agreement or agreed purpose, or evidence to suggest that a particular outcome was intended, the treatment of past and future grants should be at the asset owner's discretion.

Seqwater submits that this approach accords with the Authority's treatment of capital contributions generally, such as its consideration of federal government grants to the Burdekin Dam in the review of Burdekin-Haughton water charges.

Authority's Analysis

The Authority has reviewed the additional information provided by SEQ water and notes that the variance between the submitted cost and the business case has been reconciled. But a difference remains with SKM's estimated efficient cost.

The Authority notes that Seqwater has not received a clear indication from DEWS that water users should bear the entire cost of the Maroon Dam Safety Upgrade despite receipt of grant funding. The Authority understands, from its SunWater 2012-17 irrigation prices investigation, that Government funding of dam safety upgrades is typically provided in place of user funding.

The Authority would only include prudent and efficient expenditure that is in excess of the grant.

Unless other relevant information is forthcoming, the Authority would only propose to admit SKM's efficient cost into the asset base (in the year the project is commissioned) and this would still need to be adjusted for any subsidy.

Item 9: Beaudesert WTP Upgrade

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to upgrade the Beaudesert WTP at an estimated cost of \$9.0 million to be commissioned in 2014-15, with \$2.5 million to be expended in 2012-13. The capital expenditure relates to an upgrade of the plant for compliance purposes, including raw water infrastructure.

WGM's Submission

As with the Canungra WTP and off-stream storage above, the WGM (2012a) submitted that proposed capital expenditure presupposed the outcomes of a planning study that was being undertaken for Canungra and Beaudesert, led by the QWC and involving all relevant stakeholders. The WGM considered that planning investigations in relation to whether the preferred option was either a pipeline connection to the grid or a local WTP should be concluded, and a preferred strategy for servicing the Canungra and Beaudesert townships agreed by all parties, prior to any significant capital expenditure being undertaken.

The WGM noted that its previous assessments identified the potential for raw water quality risks. The WGM understood that some limited capital expenditure may be required in 2012-13 to reduce those risks until the planning study was concluded, without increasing treatment capacity to more than 4 ML per day. However, the WGM also noted that those risks have not been reflected in subsequent planning reports or in the results from water quality testing undertaken over the last 18 months - including during the major flooding events of January 2011.

Seqwater's Response to the WGM's Submission

Seqwater submitted that should the Scenic Rim Regional Planning study not demonstrate the need for this project, it would not proceed. Seqwater considered that, at the time of budgeting, the Beaudesert WTP upgrade was perceived as a component of the most likely options. Seqwater submitted that works may still be required based on other drivers such as Environmental and Water Quality compliance and renewals.

Seqwater acknowledged the more recent information provided by the WGM that the forecast demand figures were suggesting a lower than expected rebound in demand following the severe drought.

SKM's Review

SKM was unable to establish whether the cost driver nominated by Seqwater for this project (growth) was appropriate as the need for and the scope of the project was yet to be documented or provided to SKM.

It was noted by SKM that Seqwater had engaged an external consultant (Hunter Water Australia) to undertake a study to determine what options are available for the future of the Beaudesert WTP.

Given the lack of available information, SKM concluded that the prudence of the total investment was yet to be established; however it was prudent to complete the options assessment in order to determine the most appropriate path forward.

SKM was unable to conduct an assessment of the efficiency of this project as the project was not at a stage where the scope, cost and standards had been determined.

Authority's Analysis

In the Draft Report, the Authority accepted SKM's finding that there is insufficient information to assess the prudence or efficiency of this project. Nevertheless, the Authority noted that these findings have no direct impact on 2012-13 GSCs as it would only be recognised upon commissioning.

Seqwater's Submission on the Draft Report

In response to the Draft Report, Seqwater (2012b) submitted that the final report for the Scenic Rim Regional Planning Study is currently with the QWC. Seqwater noted that the findings of this report include:

the preferred direction for the supply to Beaudesert is to undertake the initial 4ML/d "Stage" upgrade of the Beaudesert WTP. This upgrade will delay the need for the construction of a pipeline or major upgrade at Beaudesert WTP for a number of years. During this time, improved understanding will be available on the projected growth in bulk water demand and the preferred implementation of other regional bulk water sources (eg. Wyaralong WTP).

Seqwater submitted that the October 2011 Beaudesert WTP Upgrade Concept Design Report (CDR) states that major capital investment was not critical at Beaudesert WTP is not desired (Hunter Water 2012a). The report noted that, in terms of water quality, Beaudesert WTP meets the requirements of the ADWG and Seqwater's bulk water contract.

Seqwater however noted that it seeks to enhance treated water quality at its sites beyond these levels. Seqwater submitted that it targets these higher water quality levels to ensure appropriate risk mitigation – the use of such a risk-based approach for water treatment activities is mandated by the ADWG.

Seqwater submitted that a design report prepared on its behalf lists the key issues at this WTP as ageing assets and equipment, and ensuring production of water that meets Seqwater's specification, particularly in terms of pathogen reduction. The report notes that the recent asset condition assessment has concluded that considering the age and the operational issues reported, most of the Beaudesert WTP will require replacement within the next five years (some equipment has been recently replaced). It also identified raw water quality risk are mainly turbidity and colour events, ammonia, pathogens, potential taste and odour and algal toxins. (Hunter Water 2012a)

Seqwater submitted that the cost estimate for the upgrade to the existing plant was \$740,000. This proposed refurbishment of existing plant would see the following work undertaken within the next two years:

- (a) the raw water inlet screen system will be modified to operate under high river flow conditions;
- (b) raw water on-line instrumentation including UV254 and turbidity;
- (c) the existing filters will be retained in their current arrangement. It has been identified that there are a number of spare parts, 4-way valves, limit switches etc, that can be obtained from the Capalaba WTP should there be a mechanical failure of these items;
- (d) the existing clarifier mechanism will be replaced with a new unit; and
- (e) UV disinfection will be installed at the combined outlet of the existing filters.

In response to comments made by the WGM, Seqwater submitted that it has undertaken analysis around the various demand scenarios and the timing for additional capacity. On the demand side, Seqwater notes that the base estimate demand series put forward by the WGM in the specification study appear to over-estimate future demand, with the source of this attributable to a rebound factor

during 2011-2016. As pointed out in the WGM's recent submission to the Authority, the rebound is expected to be lower than originally anticipated.

Seqwater submitted that this project also has a compliance driver, in order to ensure a reliable supply in terms of both quality and quantity of water. It noted that the CDR report found that two key factors prevent the ability to produce the capacity amount of 4.3ML/day. Firstly the clearwater tank is not baffled, resulting in bypassing of filtered water through the tanks and reduced disinfection capability. As a result, treated water production is restricted to 3.25ML/day. Secondly, during periods of increased flow in the Logan River, the intake screens at the raw water pump station restrict the flow into the pump well.

Seqwater also submitted that a process improvement is also needed to increase pathogen treatment at the plant due to the type and condition of the filters at Beaudesert, given a catchment risk assessment which shows that the water source is compromised.

Seqwater submitted that it had budgeted \$2.5 million for the Beaudesert WTP in 2012-13. However, given the recent developments and planning work, the budget for 2012-13 has now been revised to reflect the proposed expenditure associated with the above refurbishments to the Beaudesert WTP, estimated at \$740,000.

SKM's Review

SKM assessed the additional information provided by Seqwater and noted that Seqwater had performed a 30 year Net Present Value assessment of the three options evaluated in that Hunter Water's options analysis. Options assessed included an upgrade to the WTP, or fully supply from the Southern Regional Water Pipeline (owned by LinkWater). SKM recommended that the primary driver of Growth has been demonstrated and an appropriate decision making process has been followed.

SKM noted that LinkWater and Seqwater have jointly formed the view that the preferred option for water supply to Beaudesert is an initial 4 ML/day water quality and reliability upgrade of the Beaudesert WTP. As a consequence, SKM recommended that the project is prudent.

SKM reviewed the revised scope of works, including project components and allowance for engineering design, project management and contractor margin. SKM considered that the revised scope of works is appropriate. SKM noted that the individual cost items are calculated as either engineering estimates or quotes with the estimates being lump sum items or occasionally a quantity multiplied by a rate to produce an item amount. SKM concluded that the cost estimates appear reasonable and that the project is efficient.

Authority's Analysis

While it is apparent that cost forecasts are being refined, the Authority accepts SKM's finding that the project is prudent and efficient.

Item 10: Flood Damage Assessment and Repairs

Draft Report

Seqwater's submission

In its submission Seqwater (2012a) proposed \$19.4 million of expenditure for the Flood Damage Assessment and Remediation Works, expected to be completed in 2013-14. Of this, Seqwater forecast that \$9.8 million will be expended in 2012-13. These works involve remediation work at six sites to repair damage caused by the January 2011 flood event. Table B.5 below summarises the scope of works to be conducted at each of the sites.

Table B.5: Scope of Flood Repairs

| | <i>Removal of Debris</i> | <i>Spillway remediation works</i> | <i>Embankment works</i> | <i>Road repair works</i> |
|----------------|--------------------------|-----------------------------------|-------------------------|--------------------------|
| Borumba Dam | ✓ | ✓ | | |
| Mt Crosby Weir | | | ✓ | |
| Somerset Dam | | | ✓ | ✓ |
| Wilson Weir | | | ✓ | |
| Wivenhoe Dam | ✓ | ✓ | | ✓ |

Source: SKM (2012).

SKM's Review

Seqwater nominated renewal as the cost driver for this project. SKM found that although not specifically mentioned, the cost driver of renewals was supported by the *Dams and Weirs – Overall Seqwater Flood Damage Assessment and Remediation Works Design and Summary Report (Undated)*. SKM noted that damage sustained by the assets included in this project presented a risk of future non-compliance of the assets, especially in the event of another significant flood.

SKM concluded that the nature of the works and the justifications provided supported renewals as the relevant cost driver.

With regards to the decision-making process, SKM found that an options assessment was undertaken for each of the sub-projects, and these all included numerous options (ranging from 3 to 13 in number) with each one considering a “do nothing” option. Capital cost estimates were provided for each of the options.

In light of the above, SKM concluded that the expenditure was prudent.

SKM noted that the scope of works was developed from a shortlist of options for each sub-project. These shortlists were then assessed based on cost and non-cost criteria and a preferred option was recommended for each sub project. The options assessment process was conducted in consultation with the relevant stakeholders, and a structured and quantitative assessment process was used.

Seqwater provided SKM with detailed capital cost estimates for five of the six project components. SKM noted that the method used for the estimate of cost varied by project as a result of different consultants working on the different projects. SKM reviewed costing data across the sub-projects and found there was consistency across the sub-projects. Where a comparison was possible the variance of costs was not unreasonable.

Crucially, SKM also found that Seqwater submitted a total of approximately \$19.4 million for the Flood Damage Assessment and Remediation Works, whereas the information provided for the repair of each individual dam or weir equated to a total expenditure of approximately \$14.9 million, as outlined below in Table B.6 below. Information to resolve this difference was not provided.

Table B.6: Flood Repair Costs by Site

| <i>Location</i> | <i>Total cost (\$)</i> |
|-----------------|------------------------|
| Borumba Dam | 1,939,200 |
| Mt Crosby Weir | 3,905,250 |
| Somerset Dam | 3,356,735 |
| Wilson Weir | 904,600 |
| Wivenhoe Dam | 4,779,000 |
| Lake Manchester | Not Provided |
| Total | 14,884,785 |

Source: SKM (2012).

SKM also noted that approximately \$6.6 million had been included in the budget for 2011-12 and no information was provided to SKM to reconcile this expenditure. However SKM suggested this expenditure may be associated with urgent repairs required after the flood event.

With regards to efficiency, SKM concluded that the scope of the works was appropriate, the standards of works were consistent with industry practice and the costs appeared to be reasonable and should be market tested. However, SKM stated that due to the significant discrepancy in costs between the *GSC Information Return Capex 2012-13* and the detailed supporting documentation, it could not find the expenditure to be efficient at this time.

SKM noted that in order to complete its assessment of the efficiency of this project Seqwater must supply a complete breakdown of the costs associated with the project across the three years to 2013-14.

Authority's Analysis

In the Draft Report, the Authority accepted the SKM finding that the expenditure is prudent. The Authority was unable to establish a view on the efficiency of the project until such time that Seqwater provides a full reconciliation of the costs associated with this project.

Seqwater's Submission on the Draft Report

Seqwater submitted that the information request by SKM has now been compiled and provided to the Authority.

Seqwater noted that the original \$6.6 million of expenditure for 2011-12 was budgeted to cover damage assessments, remediation design work, and any preliminary, minor or early works that could be completed in 2011-12, particularly at Wivenhoe Dam where significant channel clearing was required. Seqwater now estimates that the actual expenditure in 2011-12 will total only \$3.5 million, including \$1.7 million relating to the first stage of work and channel clearing at Wivenhoe Dam, and other preliminary and minor works across other asset locations.

The difference between the budgeted amount and the estimated actual expenditure in 2011-12 is unlikely to be incurred now that the total scope of works is established. Seqwater submitted that the total budget for this project is now \$16.76 million, with \$3.37 million of estimated actual expenditure in 2011-12, \$10.44 million proposed in 2012-13 and \$2.95 million proposed in 2013-14.

The additional information needed to complete the analysis of estimated actual costs in 2011-12 has been included in the information provided by Seqwater to the Authority.

Authority's Analysis

The Authority notes that in the Draft Report, SKM was unable to reconcile different amounts submitted by Seqwater. The Authority has reviewed the additional information provided by Seqwater and is able to reconcile the new total cost of \$16.76 million with actual expenditure and forecast project costs. SKM previously concluded that the scope of the works was appropriate, the standards of works were consistent with industry practice and the costs appeared to be reasonable and should be market tested. As the revised total now aligns with the actual costs of the component projects reviewed by SKM and additional information on minor works the Authority has found the project to be efficient.

While the project (due for commissioning in 2013-14) was previously accepted as prudent, the Authority can now confirm that the revised amount is efficient.

Prudency and Efficiency Review – Un-sampled items

In addition to SKM's review of Items 1-10 above, the Authority commented on seven other capital expenditure projects that were the subject of a submission from the WGM (Items 11-17 below).

These items were not subject to prudency and efficiency review by SKM and the Authority's findings are therefore of the nature of preliminary observations, based on readily available information.

Item 11: South Maclean WTP Upgrade Works

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed an upgrade to the South Maclean WTP, at an estimated cost of \$4.375 million, to be commissioned in 2013-14.

WGM's Submission

The WGM submitted (2012a) that supply from the South Maclean WTP was no longer required.

Instead, the WGM submitted that the forthcoming Annual Operations Plans and all subsequent Grid Instructions will direct that the South Maclean Demand Zone be supplied from the Southern Regional Water Pipeline. The WGM submitted that, given that no supply is required, the WTP could be permanently decommissioned, avoiding the need for any future capital expenditure.

The WGM submitted that it does not need the water supply yield from the South Maclean Weir to comply with its obligations under the System Operating Plan and noted that, on an annualised cost basis, the South Maclean WTP is one of the highest cost WTPs in the Water Grid.

The WGM stated that it had previously provided advice to this effect to Seqwater, Allconnex Water (the relevant DR) and the QWC.

Seqwater's Response to the WGM's Submission

Seqwater submitted that, while the South Maclean WTP was not included in the option analysis for the Scenic Rim planning study, this does not, in and of itself, suggest that the South Maclean WTP is no longer required. Seqwater submitted that there were a myriad of factors to be considered before

proceeding with decommissioning of the asset. For example, pump capacities and reservoir capacities in the region would need to be confirmed with the DR entity.

Seqwater also submitted that decommissioning the plant would result in loss of water allocations and notes that the South Maclean WTP is not necessarily a high cost WTP when compared to other WTPs in the regional areas adjacent to Scenic Rim.

Seqwater considered that any decision would best be made after a collaborative review by the QWC, the WGM, LinkWater and Seqwater, following the completion of the Final Report for the Scenic Rim Regional Study.

Authority's Analysis

In the Draft Report, the Authority noted that the Direction Notice requires it to accept production forecasts that are consistent with Grid Instructions forecast in the WGM's Annual Operations Plan and any relevant information provided to GSPs in accordance with the SOP. The Annual Operations Plan forecast supply from the South Maclean WTP in 2012-13, in contradiction to the WGM's submission that supply was no longer required. However, the Authority noted that the Annual Operations Plan (November 2011) pre-dates the WGM's submission (February 2012). Furthermore, the Authority considered that the WGM's submission to the Authority constitutes relevant information provided to Seqwater in accordance with the SOP.

The Authority agreed with Seqwater's submission that there are factors that need to be confirmed with the DR before decommissioning a WTP. The Authority also considered that Seqwater's concerns regarding unutilised water allocations are a matter for the WGM, as holder of the water entitlements. Finally, the Authority agreed with Seqwater's submission that the outcome of the Scenic Rim Regional Study should be considered, but was not prepared to recommend \$4.4 million of capital expenditure on a WTP that the WGM will not be requiring in its Grid Instructions.

Subject to the receipt of further information and assessment, the Authority accepted that the WGM's submission that supply from the South Maclean WTP is no longer required to meet its obligations under the SOP (QWC 2011). That is, the Authority concluded that the proposed capital expenditure on the South Maclean WTP is not prudent.

Seqwater's Submission on the Draft Report

Seqwater submitted that the recently released Annual Operating Plan (May 2012) was the first instance of Seqwater being formally advised that supply from this plant is not required. On this basis, Seqwater is willing to concede that the proposed capital expenditure may no longer be required, subject to a formal review of this WTP and alternate options for supply to the area.

Seqwater therefore submitted that it is not currently proposing to pursue Authority's endorsement of an upgrade to South Maclean WTP in the 2012-13 regulatory process.

Authority's Analysis

The Authority notes that Seqwater is not proposing to pursue approval for this project (to be commissioned in 2013-14).

Item 12: Image Flat WTP Upgrade

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to upgrade the Image Flat WTP at an estimated cost of \$11.5 million, to be undertaken over 2012-13 to 2015-16. The purpose of the upgrade is for sludge handling and chemical dosing.

WGM's Submission

The WGM (2012a) submitted that, once the connection to the Northern Pipeline Interconnector (being proposed by LinkWater – see Chapter 5) was constructed, the WGM will not require supply from the Image Flat WTP.

From that time, the WGM intended that the Sunshine Coast be primarily supplied from the Landers Shute and Noosa WTPs. The WGM submitted that these supplies will be augmented by supply from the Ewen Maddock WTP and Northern Pipeline Interconnector during peak demand periods and when supply from the other plants was constrained, including due to maintenance or poor raw water quality.

The WGM considered that, once supply was no longer required, the Image Flat WTP could be decommissioned until the year 2025, avoiding fixed operating costs and deferring the need for the proposed capital expenditure.

The WGM noted that a decision to decommission the Image Flat WTP will have no material impact on water security over the short or long term and that system reliability would increase following the connection to the Northern Pipeline Interconnector.

The WGM submitted that this advice has been provided to Seqwater during planning discussions for the Image Flat WTP during 2011.

Seqwater's Response to the WGM's Submission

Seqwater submitted that it was only proposing to spend \$1.0 million in 2012-13 and the expenditure in the forward years would be conditional on the future of the plant. Seqwater considered that the work identified for 2012-13 would remain necessary, even if supply was only to continue for two to three years longer. The 2012-13 proposed works were for sludge handling and chemical dosing, much of which was required in order to maintain compliance with other legislative drivers, including environmental obligations.

Seqwater reported that decommissioning would lead to a potential loss of water allocation of 16,500ML and recommended further planning be undertaken to determine the impact of decommissioning.

Seqwater submitted that the planning study *Options Study for Bulk Supply to the Image Flat Sub-Region (2011)* recommended augmenting Image Flat with a grid supply, but rejected using the grid as a sole source of supply.

Authority's Analysis

In the Draft Report, the Authority noted capital expenditure relating to a new connection is being proposed by LinkWater that, once complete, the WGM submitted will remove the need for supply from Image Flat WTP. The new connection is expected to be completed in 2012-13, while Seqwater's proposed upgrade will be commissioned in 2015-16. Further, the Authority noted that LinkWater's project is estimated to cost \$2.1 million, compared to \$11.6 million proposed by Seqwater.

The Authority noted Seqwater's submission that a planning study recommended that using grid supply as a sole source of supply to Image Flat was not recommended. The Authority reviewed the report and found that the option of a grid connection was not shortlisted due, in part, to its expected cost. However, the Authority noted that LinkWater's proposed grid connection is expected to be substantially cheaper than Seqwater's proposed WTP works.

Subject to the receipt of further information and assessment, the Authority considered that the timing, cost and WGM endorsement of the grid connection option implies that Seqwater's proposed capital expenditure is not prudent.

Seqwater's Submission on the Draft Report

Seqwater (2012b) noted that the WGM submitted that supply from alternative sources including the Northern Pipeline Interconnection (NPI) would mean that supply from the Image Flat WTP was no longer required and that the asset could be decommissioned until 2025 deferring the need for the proposed capital expenditure.

In response, Seqwater submitted that it believes that even though sub-regional planning has further progressed with involvement from all Grid Partners, the view regarding Image Flat WTP is still somewhat uncertain, and certainly not agreed. For instance, Seqwater holds that the NPI should be developed as an augmentation to ongoing supply from Image Flat WTP – hence these projects are not necessarily mutually exclusive, as was highlighted in the commissioned planning report Options for Bulk Supply to the Image Flat Sub-Region (2011).

Seqwater noted that it will continue engaging with the other grid participants on the future of Image Flat WTP, and are confident options are being thoroughly assessed through the grid planning forums.

The 2012-13 proposed works submitted by Seqwater were for sludge handling and chemical dosing. Seqwater submitted that this work is required to maintain Seqwater's legislative compliance, and are required even if Image Flat WTP is to provide supply for only another few years.

Seqwater noted that it is currently bearing the risk of unauthorised discharges of sludge to the environment, during high rainfall or other dirty raw water quality events. Further, due to the condition of the existing chemical dosing equipment, Seqwater stated it is also at risk of being unable to meet its Grid Contract obligations as the capacity of the plant is severely restricted during such high rainfall or other dirty raw water quality events.

As the draft Annual Operating Plan (Grid Instructions) still requires supply from Image Flat WTP, Seqwater contends that the estimated \$1.0 million expenditure for 2012-13 is considered prudent given the associated legislative requirements, and requests the Authority to reconsider the draft finding for this item in the final report.

Authority's Analysis

The Authority notes Seqwater's submission that the planning study for supply options to the Image Flat sub-region is not complete. The Authority considers that, if the planning study was completed with the conclusion that the Image Flat WTP should be maintained as a critical source of water supply, Seqwater's proposed capital expenditure would be considered prudent.

Given the WGM's submission and the incomplete nature of the planning study, the Authority considers that there is considerable doubt as to whether the proposed capital expenditure is required.

The Authority notes that Seqwater has proposed that an amount of \$1 million should be considered to address sludge issues for 2012-13.

The Authority also notes Seqwater's submission that, as the WTP is scheduled to produce water during 2012-13 regardless of the outcomes of the planning study, it is bearing the risk of non-compliance with its legislative obligations. The Authority acknowledges Seqwater's legislative obligations, particularly the breaches of licence conditions resulting from the discharge of supernatant discharge into Poona Dam. To address the licence conditions breach, Seqwater could continue to operate the installed portable chemical dosing system and temporary solids handling facility until such time as the future of the WTP finalised.

Moreover, the Authority has not been able to reconcile the proposed expenditure of \$1.0 million in 2012-13 with the supporting documentation provided by Seqwater.

On this basis, the Authority maintains its Draft Report finding and does not consider that Seqwater has established the prudence of the proposed works.

Item 13: Canungra WTP Upgrade and Off-Stream Storage

Draft Report

Seqwater's submission

Seqwater (2012a) proposed to construct off-stream storage at Canungra, at an estimated cost of \$4.3 million, and to upgrade the Canungra WTP, at an estimated cost of \$1.2 million. The works were proposed to be undertaken between 2011-12 and 2015-16, with expenditure of \$1.4 million in 2012-13. Seqwater submitted that the project was due to population growth in the Canungra area, more high priority water from Canungra Creek, and required an off-stream storage.

WGM's Submission

The WGM (2012a) submitted that the proposed capital expenditure presupposed the outcomes of a planning study that was being undertaken for Canungra and Beaudesert, led by the QWC and involving all relevant stakeholders. The WGM considered that planning investigations in relation to whether the preferred option was either a pipeline connection to the Water Grid or a local WTP should have been concluded, and a preferred strategy for servicing the Canungra and Beaudesert townships agreed by all parties, prior to any significant capital expenditure being undertaken.

The WGM noted that the interim statement from Seqwater to the QWC, dated 28 February 2012, stated that Seqwater would await the outcome of the planning process before then making appropriate determinations regarding its assets. However, Seqwater also stated that it may determine that expenditure was required due to issues associated with asset condition or the meeting of peak demand capacities as differentiated from average demand.

The WGM indicated that it had undertaken a demand assessment for the purposes of the planning study, including of peak demand. The WGM noted that the assessment highlighted that demand at Canungra was highly uncertain, with annual growth projections of between 5-15% from a base population of 740 people, or approximately 300 connections. To achieve these growth rates, in the order of 15 to 50 new connections would be required each year. However, recent consumption trends have been negative, with the actual number of new connections closer to zero. While a subdivision had been approved with the potential to almost double the population, construction work had not commenced and as such the take up rate was unknown. The results of that assessment were provided in previous advice to Seqwater and the QWC.

On that basis, the WGM submitted that that it would be prudent to adopt a staged approach to any upgrade of the WTP, with the initial upgrade triggered by:

- (a) demand being consistently above 0.22 ML per day on a rolling year average; and

- (b) the number of new connections in a rolling year average exceeding 10 per year.

Seqwater's Response to the WGM's Submission

Seqwater submitted that should the Scenic Rim Regional Planning study not demonstrate the need for this project, it would not proceed. Seqwater considered that, at the time of budgeting, the Canungra WTP upgrade was perceived as a component of the most likely options. Seqwater submitted that works may still be required based on other drivers such as Environmental and Water Quality compliance and renewals.

Seqwater acknowledged the more recent information provided by the WGM that the forecast demand figures are suggesting a lower than expected rebound in demand following the severe drought.

Authority's Analysis

In the Draft Report, the Authority noted the considerable uncertainty related to this project and did not consider that Seqwater's submission that work may still be required based on other drivers has been substantiated.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that the final report for the Scenic Rim Regional Planning Study is currently with the QWC and is due to be finalised in the very near future and that LinkWater released the results of their modelling. This modelling suggests that the preferred solution for the long-term supply to the Canungra township is an upgrade to the existing WTP in lieu of a pipeline connection to the Water Grid as it is the most cost effective option.

However, Seqwater also noted that there is some uncertainty around the construction of the project as it is generally thought that this would be an expensive option relative to tankering in the water and is thus regarded as not prudent. Seqwater has provided the Authority with the business planning around these options.

Seqwater submitted that reports prepared for it by Hunter Water Australia (HWA) state that the most pressing issue facing the Canungra plant is its limited treatment capacity due to whole of plant limitations, including the clarifier and filter. HWA estimate that the plant will be unable to meet projected water demand by 2013. Ageing assets and equipment are also a major issue for ensuring production of water that meets Seqwater's specification, particularly in terms of pathogen reduction.

Seqwater submitted that the reports concluded that considering the age and the operational issues reported, most of this plant will require replacement within the next five years. Risks identified in these studies include turbidity and colour events, pathogen risks and potential taste and odour and algal toxins. The reports state that refurbishing the existing plant or recommissioning the Cedar Grove WTP asset may turn out to be a 'band-aid' solution. A new treatment plant should be considered as the only reliable long-term solution for Canungra. As a result, this Preliminary Design has focused on the new plant design.

In response to comments made by the WGM, Seqwater submitted that it has undertaken analysis around the various demand scenarios and the timing for additional capacity. Seqwater notes that the base estimate demand series put forward by the WGM in the specification study appears to overestimate future demand, with the source of this attributable to a rebound factor during 2011-2016. Seqwater indicated that in the WGM's recent submission the rebound is expected to be lower than originally anticipated. On adjusting the estimated demand series for this, there could be scope to make savings from deferring CAPEX until forecast demand triggers a need for increased capacity.

Seqwater stated that while the base estimate suggests that additional capacity will be required during the first five years, the sensitivity test results suggest that capacity is not required to be increased until

the period 2016 to 2021. However, Seqwater states that its analysis of recent demand for Canungra WTP indicates that the demand is increasing rapidly towards pre-drought levels.

Seqwater noted that it had budgeted \$900,000 for the Canungra WTP and \$500,000 for the off-stream storage in 2012-13. However, this has since been revised to \$1,251,000 for the Canungra WTP, with no proposed spend for the Canungra off-stream storage. The revised Canungra WTP upgrade project has an estimated total project cost of \$4 million, with commissioning expected in 2013-14.

Authority's Analysis

The Authority notes that the sensitivity tests conducted by Seqwater suggest that additional capacity will not be required at the plant until at least 2016. Given the uncertainty around the construction of the project and demand as identified by Seqwater, the Authority has not been able to confirm the prudence and efficiency of the proposed expenditure at this stage.

Item 14: Kooralbyn WTP Sludge Handling Upgrade

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to undertake \$1.15 million of upgrades for sludge handling at the Kooralbyn WTP, to be commissioned in 2013-14.

WGM's Submission

The WGM (2012a) recommended that further information was required to demonstrate the need for this expenditure.

The WGM considered that if improvements were shown to be required due to environmental legislation or to maintain supply, then the equipment should be sized for no more than the predicted average demand by 2031 of 1.2ML per day (based on medium growth). For comparison, the WGM's forecast production requirement for 2011-12 was 168 ML (less than 0.5 ML per day). The WGM noted that the stated capacity of the existing WTP was 1.9 ML per day.

Seqwater's Response to the WGM's Submission

Seqwater submitted that it was in the planning stage for the Kooralbyn WTP and had not completed its evaluation of the possible options. Seqwater submitted that the works on the sludge handling were intrinsically related to clarifier works (Item 9 in the review of 2012-13 items above) and should occur together. Seqwater considered that water quality risks will be identified and investigated through the planning study and later stages of development.

Seqwater submitted that it had not planned to increase the capacity of Kooralbyn WTP and indicated that the project will not proceed if the planning study shows that it would not be required.

Authority's Analysis

In the Draft Report, the Authority noted Seqwater's submission that the planning study has yet to indicate whether these works are required. The Authority therefore did not consider that it is appropriate to accept the proposal for the purpose of the GSCs.

Seqwater's Submission on the Draft Report

Seqwater noted that the WGM recommended that further information was required to demonstrate the need for this expenditure.

Seqwater's investigations show that supernatant now overflows from the drying lagoon to a property across the road. This problem is caused by poor sludge management and design creating the need to drain the clarifier regularly. Seqwater noted that this is a breach of its general statutory environmental duty, which requires that it must not carry out any activity that causes, or is likely to cause, environmental harm unless the person takes all reasonable and practicable measures to prevent or minimise the harm.

Seqwater considers this investment is reasonable considering it is required to meet Government legislation and given that penalties for breaching the environmental duty are substantial fines.

Authority's Analysis

The Authority notes the findings of Seqwater's investigation. However in the absence of completed detailed planning studies and costings for this project the Authority has retained its finding from the Draft Report that there is insufficient information to assess the prudence and efficiency of this project at this stage.

Item 15: Wyaralong WTP Design and Capitalised Interest

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to undertake a preliminary design for the Wyaralong WTP of \$2.0 million over 2012-13 and 2013-14. The WTP would connect the recently constructed Wyaralong Dam to the Water Grid.

Seqwater's capital expenditure program also included an amount of between \$672,000 and \$752,000 per annum relating to capitalised interest on \$10 million of costs incurred on Wyaralong WTP to date. Seqwater estimated total capitalised interest expense of \$3.6 million over five years.

WGM's Submission

The WGM (2012a) submitted that the Government announced that the Wyaralong WTP will be constructed from 2014-15.

On this basis, the WGM recommended that Seqwater and LinkWater seek clarification of project timing from the Government prior to undertaking any further planning for the Wyaralong WTP or Kuraby Interconnector.

The WGM considered that the Wyaralong WTP and associated infrastructure would not be required over the short to medium term, due to ongoing water use efficiency and other storages being full or near full. The WGM considered that it could be deferred until around 2024-25, depending upon actual demand growth.

Seqwater's response to WGM's Submission

Seqwater submitted that it was complying with Government instructions relating to drought projects and reported that there had not been any formal notification to Seqwater that planning and design work for this treatment plant was not to continue. Seqwater noted that if Seqwater were to receive formal contrary instructions this work will not proceed.

Authority's Analysis

In the Draft Report, the Authority noted that the Wyaralong WTP is required under the RWSP and is therefore a drought asset. The Authority therefore did not assess the Wyaralong WTP for prudence and efficiency, and would include the project in the RAB at its total cost on its commissioning date.

The Authority noted the submission from the QWC to its 2011-12 GSC investigation that stated that construction of the Wyaralong WTP was not expected to begin until 2013-14 at the very earliest. The Authority was not made aware of any Government instructions that require Seqwater to complete the Wyaralong WTP in the coming years. The guidance provided by the QWC and the WGM's submission warrants a delay to the design of the Wyaralong WTP.

The Authority considered that if the WGM's submission that the Wyaralong WTP is not required until 2024-25 is agreed to by the Government, Seqwater's proposed design work is premature and should be delayed until construction of the WTP is imminent.

The Authority noted that Seqwater has proposed to include the design costs of the Wyaralong WTP in the RAB upon completion of the design in 2013-14. The Authority recommended that all costs relating to the Wyaralong WTP, including design work and capitalised interest, are included in the RAB at the commissioning date of the WTP, not at the completion of the design work.

This is consistent with the Authority's recommendations regarding land acquisition costs and design work at Wyaralong WTP in 2011-12, and mirrors the approach adopted for other drought assets. It also reflected the fact that the 1 July 2011 RAB provided by the Price Regulator does not include any value relating to the Wyaralong WTP, despite Seqwater incurring expenditure during 2010-11. Any interest incurred on expenditure to date should be capitalised at the appropriate cost of debt.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that given that the submission of the WGM suggested that building the Wyaralong WTP should be deferred, possibly out to 2024-25, and that the preliminary findings of the Scenic Rim regional planning study appear to confirm this view, Seqwater has sought further advice from QWC as to whether this project is proceeding and over what timeframe. Until further advice is received, Seqwater submitted that it is proposing not to incur capital expenditure on the Wyaralong WTP in 2012-13.

Therefore in accordance with the Authority's past recommendations, if the Wyaralong WTP project is to be abandoned or deferred indefinitely, including deferral as suggested by the WGM, Seqwater submitted that the expenditure incurred to date, including interest incurred on that expenditure, would be included in the RAB at 30 June 2012.

Authority's Analysis

The Authority agrees with Seqwater's submission that if the WTP was abandoned or deferred indefinitely, the expenditure incurred to date would be included in the RAB (as the Seqwater had been directed under the Regional Water Security Program to undertake related expenditures). Until such a decision is formally made, the Authority continues to recommend that costs including interest be capitalised by Seqwater for inclusion in the RAB at commissioning. The Authority agrees with Seqwater's approach to avoid further capital expenditure on Wyaralong WTP in 2012-13.

Item 16: Lake MacDonal Dam Safety Upgrade

Seqwater's Submission

Seqwater (2012a) proposed to undertake safety upgrades to Lake MacDonal, at an estimated cost of \$25.75 million from 2011-12 to 2015-16. The safety upgrade is a regulatory requirement of the

DERM. Seqwater submitted that the works relate to a new 200m wide auxiliary spillway, improvements to the existing spillway, foundation treatment and new filter zone and earth fill on the embankment.

WGM's Submission

The WGM (2012a) recommended to Seqwater that the business case include options to lower the spillway. The WGM noted that these options would reduce the supply yield and that the impacts of this would need to be discussed with the QWC.

The WGM noted that it holds an entitlement to take 3,500 ML from this dam. It contributes about 2,600 ML per annum of the overall system yield of 485,000 ML per annum, measured on a Levels of Service basis. The WGM noted that the actual contribution depends upon the operating strategy in place at any specific time.

By lowering the spillway, the WGM considered that it may be possible to defer much of the proposed capital expenditure until demand approaches system yield. The WGM forecast this to occur between 2035 and 2041, based on the low demand forecast and depending upon the impact of climate change. At that time, the WGM submitted that the dam could be reinstated to the current level or the next supply brought forward by about six months.

Seqwater's Response to WGM's Submission

Seqwater (2012a) submitted that during planning, the WGM's suggestion of lowering the full supply level was investigated, however it is not a viable option. Lowering the full supply level of Lake Macdonald Dam would not sufficiently reduce the factors of safety due to the area's high rainfall.

Authority's Analysis

The Authority accepted the prudence of this project in its 2011-12 Final Report. While the Authority accepts that Seqwater has considered the WGM's suggestion regarding cost minimisation, this project has not yet been subject to a review of efficiency.

Item 17: Capalaba WTP upgrade

Draft Report

Seqwater's Submission

Seqwater (2012a) proposed to undertake a \$15 million upgrade to the Capalaba WTP, between 2011-12 and 2015-16.

WGM's Submission

The WGM (2012a) understood, based on Seqwater's interim statement that was provided to the QWC on 28 February 2012, that this project would address the key drivers of maintenance renewals and water quality compliance for trihalomethanes.

The WGM submitted that this capital expenditure was not required at that time, based on information that it then held.

The WGM noted that the Capalaba WTP was designed to treat up to 52 ML per day, but that production was currently limited to around 18 ML per day due to instrumentation limitations and the need for manual operation. In addition, the WGM noted that there had been instances of elevated turbidity and disinfection by-products in treated water during wet weather.

The WGM submitted that the system can be operated around these constraints over the short to medium term. The WGM submitted that supply from the Capalaba WTP would continue to be minimised, with the majority of water supplied to the Redlands area being sourced from the North Stradbroke Island WTP, due to its superior raw water quality. This was the dominant operating mode under the existing Annual Operations Plan (WGM 2011).

The WGM undertook an investigation into disinfection by-product issues in the Redlands demand zone in 2011, in partnership with Seqwater and relevant Grid Participants. The WGM noted that a number of largely operational improvements had since been implemented, including blending with alternative supplies and reservoir management by LinkWater and Allconnex.

The WGM considered that improvements implemented by LinkWater, Seqwater and Allconnex proved to be effective over the 2011-12 wet season, including during a number of poor raw water quality events. WGM submitted that there were no exceedences of target values for trihalomethanes from the Capalaba WTP over that period.

Also as an outcome of that investigation, the WGM wrote to Seqwater on 23 December 2011, seeking that the Capalaba WTP:

- (a) by 2016, be capable of supplying average day demand of 7-14 ML and mean day maximum month demand of 14-30 ML; and
- (b) limit trihalomethanes levels to less than 185 milligrams per litre, 95% of the time (compared to the contractual requirement of 250 milligrams per litre).

The WGM communicated to Seqwater that, due to available storage in the area and ability to supply from other sources, the WGM understood that the Capalaba WTP may cease operation for up to a week based on raw water triggers to minimise treated trihalomethanes levels above 185 milligrams per litre. The WGM noted that this would enable the WTP to be turned off when raw water exceeds 40NTU for turbidity. The WGM noted that discussions with Seqwater had indicated that WTP is currently capable of the above requirements.

The WGM noted that, in time, the Capalaba WTP will need to be made more reliable, but forecast that this would not be required for at least five years. The WGM submitted that any upgrades for trihalomethanes compliance should only be undertaken once the above operating strategies have been demonstrated not to be effective and once all of the options recommended by the investigation have been considered in detail.

The WGM noted that it was involved in early discussions with Seqwater and other parties about maintenance requirements for the Capalaba WTP and the scope of future upgrades. In those discussions, the WGM noted that it was agreed that a sub-regional supply strategy was required in this area prior to any capital expenditure being undertaken.

Seqwater's Response to the WGM's Submission

Seqwater submitted that its primary reasons for the proposed Capalaba WTP works were to:

- (a) renew individual assets at the end of their economic life;
- (b) alter some equipment to meet environmental regulations; and
- (c) improve some equipment to meet WH&S requirements.

In the process of this planned work Seqwater submitted that it would increase the capacity slightly as it was most efficient to do so whilst addressing the actual driver of renewals. The increase in capacity was a small part of the planned expenditure in stage one.

Seqwater included some capital expenditure (\$100,000) in stage one of the Capalaba WTP for a trial of possible treatments of THM's in the stage two development. Seqwater submitted that WGM had previously agreed with the additional capacity parameters.

Authority's Analysis

In its 2011-12 GSC investigation, the Authority recommended \$0.6 million of expenditure in 2011-12 relating to an options study for this capital expenditure project, but that further expenditure could not be deemed prudent or efficient until the final project scope was defined.

The Authority did not review the Capalaba WTP for prudence and efficiency in its 2012-13 investigation, and therefore maintained its 2011-12 conclusion, pending Seqwater's provision of detailed information regarding the final project scope.

Seqwater's Submission on the Draft Report

Seqwater (2012b) submitted that the Capalaba project is separated into two distinct stages. Stage 1 (\$10 million) consists of mainly renewing parts of the WTP that are at the end of their economic life. Stage 1 is scheduled to start construction in 2012 and for completion in 2014-15.

Stage 2 (\$5 million) consists of possible improvements to the water quality. Stage 2 is only a concept at this time however, a possible start date is in 2013-14 and completion in 2015-16.

Seqwater noted the Authority has assumed these two projects are one project which is incorrect. Stage 2 does not involve proposed expenditure within the timeframe being considered in this review. Seqwater is not yet seeking approval for the Stage 2 for Capalaba.

Seqwater suggested that the WGM and the Authority are confusing Stages 1 & 2 of the Capalaba WTP Upgrade. Stage 1 includes work that is mainly renewal of assets at the end of their economic life, some parts to meet environmental regulation and replace old equipment that does not meet WH&S regulations. Seqwater noted that it has completed an extensive Business Case and has a consultant's report showing all options considered for stage 1 of the Capalaba WTP. The Business Case has now been supplied to the Authority for consideration.

Authority's Analysis

The Authority notes that Seqwater has now provided a business case for review. The Authority accepts that the submission presented by the WGM, when considered in conjunction with Seqwater's business case, appears to relate exclusively to Stage 2, which Seqwater does not propose to commence until 2013-14 at the earliest. Further review of this project is required before it can be accepted for the RAB.

The Authority proposes to re-visit Stage 2, including the WGM's stated concerns, during the period in which Seqwater proposes to commence works.

Summary

In the Draft Report, SKM reviewed items totalling \$93.27 million in value or 28% of the proposed capex. Further items totalling \$63.92 million that were specifically identified in submissions were also reviewed.

It is noted that Seqwater has proposed reconfiguration of some items so that they now become relevant for 2012-13 GSCs. These are:

- (a) Molendinar WTP, originally a \$11.715 million multi-year project, re-estimated as a \$1.65 million project for 2012-13;

- (b) Mudgeeraba WTP, originally a \$11.165 million multi-year project, re-estimated as a \$0.5 million project in 2012-13;
- (c) Beaudesert WTP upgrade, originally a \$9.0 million multi-year project, re-estimated as a \$0.74 million project in 2012-13; and
- (d) Image Flat WTP upgrade, originally a \$11.5 million multi-year project, re-estimated as a \$1.0 million project in 2012-13.

Only one of the reclassified items (Beaudesert) is considered relevant for inclusion in the 2012-13 RAB. Table B.7 refers.

Table B.7: Reviewed Post 2012-13 Capital Expenditure (\$'000)

| <i>No</i> | <i>Project</i> | <i>Initially Proposed</i> | <i>Prudence</i> | <i>Efficiency</i> |
|---|---|---------------------------|---|--|
| SKM Sampled Items | | | | |
| 1 | Molendinar WTP - Backwash Pump | 11,715 | Renewals expenditure yet to be reviewed | Business case yet to be developed |
| 2 | Mudgeeraba WTP - Storage Works | 11,165 | Renewals expenditure yet to be reviewed | Business case yet to be developed |
| 3 | Kilcoy WTP - New WTP Works | 16,148 | Prudent | Efficient |
| 4 | Boonah Kalbar WTP Plant Automation / Pipeline Upgrade | 9,300 | Component 1 – Prudent Detailed scoping and timelines yet to be finalised for components 2 and 3. | Component 1 – Efficient. Detailed scoping and timelines yet to be finalised for components 2 and 3. |
| 5 | Lowood WTP - Sludge Handling Improvements and Other Works | 3,300 | Prudent | Business case and costs yet to be developed. |
| 6 | Jimna WTP - Upgrade Works | 1,911 | Prudent | Efficient |
| 7 | NSI WTP - Lime System & Sludge Lagoon | 4,075 | Project delayed. | Insufficient information. |
| 8 | Maroon Dam - Stage 1 Safety Upgrade | 7,250 | Prudent | Excluded due to insufficient information relating to grant funding from DERM. |
| 9 | Beaudesert WTP Upgrade | 9,000 | Revised estimate prudent. | Revised estimate efficient. |
| 10 | Flood Damage Assessment and Repairs | 19,402 | Prudent | Efficient |
| | <i>Total SKM Sample</i> | 93,266 | | |
| | <i>Total SKM Sample/Total Capex (%)</i> | 28.1% | | |
| Un-sampled Items Identified in Submissions | | | | |

| <i>No</i> | <i>Project</i> | <i>Initially Proposed</i> | <i>Prudency</i> | <i>Efficiency</i> |
|---------------------------------|---|---------------------------|--|--|
| 11 | South Maclean WTP Upgrade Works | 4,375 | Proposal withdrawn | Not assessed. |
| 12 | Image Flat WTP Upgrade | 11,500 | Not prudent. | Insufficient information to review revised proposal. |
| 13 | Canungra WTP Upgrade and Off-Stream Storage | 5,500 | Commencement and scope to be reviewed. | Not assessed |
| 14 | Kooralbyn Sludge Handling Upgrade | 1,150 | Planning studies yet to be completed. | Not assessed |
| 15 | Wyaralong WTP Design and Capitalised Interest | 5,647 | Prudent but timing to be resolved. | Not assessed |
| 16 | Lake MacDonald Dam Safety Upgrade | 25,750 | Prudent | Not assessed |
| 17 | Capalaba WTP upgrade | 10,000 | Not assessed | Not assessed |
| <i>Total Un-sampled Items</i> | | 63,922 | | |
| Total Reviewed Items | | 157,188 | | |
| Total Post 2012-13 Capex | | 331,911 | | |

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