EXPENDITURE
INFORMATION REQUEST

1. TIMING

The Authority requests that SunWater responds to the following matters on or before Tuesday 28 February 2012.

2. GENERAL OPEX ISSUES

(a) SLFI

Attachment 4 of SunWater's submission dated 23 December 2011 on the Authority's Draft Report provides the following information on the attribution of the $10M in SLFI savings:

(i) $5M of the SLFI savings are due to avoided costs (SLFI target of $10M was set in last quarter of 2008-09 against the budget for 2009-10). A vacancy freeze resulted in 2009-10 actual costs being $5M below budget;

(ii) $3M of the SLFI savings are due to better recovery of non-direct costs through improved efficiencies;

The above statement is incorrect. $3m of the SLFI savings have been absorbed by a reduction in non-direct under-recoveries.

(iii) as SLFI targets were set in 2009-10 dollars, $0.6M of the savings are 'erosion' due to real increases in labour costs and increment creep (staff progress through pay bands); and

$0.6m of the SLFI savings were counter-acted by real increases in labour costs and increment creep.

(iv) of the remaining $1.4M in savings, around 50% is attributable to irrigation service contracts. This is generally explained as being due to SunWater's cost allocations which vary yearly depending on changing business conditions, and this introduces further noise into the SLFI effects on the actual costs of irrigators.

These savings aren't "due to" SunWater's cost allocation methodology (CAM), rather the savings need to be placed in the context of the cost allocations and varying business conditions.

The Authority considers that the additional information provided by SunWater does not satisfactorily explain how SLFI savings have been taken into account for the following reasons:

(i) actual non-direct costs have remained at around $25M per annum since 2007-08, whereas SunWater has previously advised that SLFI was primarily intended to permanently reduce non-direct costs. This is despite the transfer of five schemes to SEQWater;

SunWater is concerned that the premise of the above statements reveals a fundamental misunderstanding of how non-directs are allocated within SunWater according to the SunWater CAM.

There are three distinct parts to the QCA's statement to which a summary response is given below:

1. The method of allocation of non-directs to irrigation service contracts is a subset of the total non-direct allocation and is determined by the SunWater CAM, which has been largely approved by the QCA as proposed by SunWater. There has been no suggestion that the CAM has not operated in the past as described by SunWater, therefore, the $25m +/-$1m of non-directs to irrigation contracts over 2008-11 is an outcome of the CAM. That is, the $25m is the actual outcome of non-direct costs and the allocation of those costs using the CAM, and it is undisputable that these costs exist.

2. With SLFI savings that are net $1.4m to the total recoverable non-directs pool, an outcome that sees $25m +/-$1m of non-directs to irrigation contracts over 2008-11 is not an unusual or unreasonable outcome. SunWater can confirm that the net $1.4m benefit of SLFI will primarily affect the recoverable non-direct pool, however, this is not the same as saying that the SLFI program will result in a clear $1.4m step-change in non-direct costs (which is how the QCA seems to be expecting non-directs allocation to respond). The actual outcome will be dictated by the CAM and the distribution of direct labour across water supply assets and development projects.

3. All things being equal, the transfer of schemes to Seqwater will result in an increase in non-directs allocated to irrigation service contracts because the entire pool of non-directs was being spread over a smaller pool of direct labour. Moreover, the transfer did not allow for any savings in the non-direct cost pool.

Further discussion of the CAM and the impact of SLFI follows.

Non-direct costs are distributed in a systematic manner by SunWater's SAP system according to SunWater's CAM. As covered in some detail in Deloitte's 137 page report on SunWater's administration costs[1], non-direct costs are allocated to service contracts using direct costed labour as the driver. The rate applied to the allocation varies from year to year depending on the expected levels of work and the targeted recovery of overheads. SunWater's CAM has been extensively reviewed by Deloitte in their report on SunWater's administration costs and addressed in the QCA's draft report. After this extensive analysis, the QCA recommended that SunWater's proposed approach to non-direct cost allocation be accepted with minor changes.

SunWater's CAM has resulted in an average allocation of total non-directs to irrigation of $25.7m p.a. over 2007-11. The variance from year to year is +/-$1m. This is an outcome of a multivariate allocation that takes into account the direct labour to each segment of each service contract over the period, the overhead rates set for the period and the total recoverable overhead cost pools for the period. SunWater simply sets the rates for the year ahead and the outcome is determined by SAP under the CAM approved by the QCA.

As indicated in the various QCA consultant reviews and audits of SunWater's approach and systems, the amount of non-directs received by each service contract is a result of the deterministic application of the CAM that has been accepted by the QCA. SunWater are confident that the level of non-directs that ultimately land

[1] Deloitte "SunWater Administration Cost Review Phase 2", available on the QCA website.

with service contracts relating to irrigation services are a fair and accurate reflection of those service contracts' share of the recoverable non-direct cost pools.

As explained in SunWater's submission in response to the QCA's draft report, the improved level of non-direct recoveries absorbed some of the SLFI savings. This in turn meant that the pool of recovered non-directs over 2008-11 was relatively stable over this period. This is shown in the following table.

	2008	2009	2010	2011 SFM	2012 SFM
Recovered Non-Directs ($,000 nominal)	$44k	$45k	$44k	$43k	$43k

SunWater's submission in response to the QCA's draft report showed that the net impact of the SLFI program on recovered overheads is a permanent reduction of approximately $1.4m p.a. If service contracts relating to irrigation received half of these savings then an average saving of $0.7m would be expected to flow to this sector. A saving of $0.7m achieved progressively over several years will not be obvious in an environment where irrigation non-directs are varying by +/-$1m per year. Therefore, it is not surprising that the irrigation non-directs were relatively stable over the 2008-11 period; this was simply one of many outcomes that could have occurred depending on the mix of work performed across the whole SunWater business.

The important point is that the resultant SLFI savings have been incorporated into the forecast levels of recoverable non-directs in SunWater's SFM and that Deloitte has extensively reviewed SunWater's forecast non-direct costs, acknowledged that SLFI had been implemented and judged that SunWater's administration costs were efficient (although the QCA still made some adjustments to these costs).

(ii) staff numbers increased from 526 in 2005-06 to 636 in 2008-09. That is, current employment numbers seem to have simply reverted to around previous levels after a major increase between 2005-06 and 2008-09;

SunWater is not sure where the 526 number is sourced from as the 05/06 annual report has 561 FTEs? This figure is presented in the annual report in the context of employee benefits and therefore excludes contractors. The FTE numbers for 05/06 and 06/07 with contractors included are shown with the FTE numbers from SunWater's previous submission below.

FTE	2006 actual	2007 actual	2008 actual	2009 actual	2010 budget	2010 actual	2011 actual	2012 SFM
Staff	561	569	573	562	599	494	470	521
Contractors	68	85	111	72	37	87	71	18
Total	629	654	684	634	636	581	541	539

Staff numbers (excluding contractors) were almost the same in 05/06 and 08/09, after rising slightly in 07/08 and 08/09. Since then they have steadily decreased. Overall FTE numbers peaked in 2008 but have decreased substantially since.

The term "simply reverted" would seem to reveal that too simple an approach is being taken in the analysis of the relationship between FTE numbers and the level

of non-directs. It must be acknowledged that a business is organic with FTE numbers increasing or decreasing due to a number of factors, not just a single variable that is the narrow focus of a particular piece of analysis. For example, contractor numbers will be affected by the projects being worked in any particular year and this program of work is unrelated to the SLFI program.

SunWater has taken into account past performance when forecasting staff numbers and other costs for the expected future business conditions and these forecast figures are built into the SFM at the post-SLFI levels.

(iii) SunWater has not provided details of how it records and accounts for non-direct cost under-recovery and how this effects the non-direct cost values included in its NSPs and financial model; and

SunWater disagrees. SunWater has provided details of how unrecovered non-directs affect its NSPs and the SFM. Unrecovered non-directs are transparent in the SFM and any unrecovered non-directs have, by definition, not been included in the NSPs or the SFM.

Non-direct cost under-recovery has been explained on many occasions to QCA staff and the QCA's consultants. In particular, we believe that Ralph Donnet at the QCA, Sandro Marin at Indec and the Deloitte team have a good grasp of the subject of non-direct cost under-recovery.

Deloitte covered this subject in their 137 page report on SunWater's administration costs. In section 3.3 of this report they mention a figure of $2.2m of unrecovered costs. This figure comes straight from the SFM. The $2.2m figure is also shown in Figure 3.3 of Deloitte's report "Breakdown of Administrative Cost by Function".

The Deloitte report also explains in some detail how the overheads are distributed in worked examples contained in Appendix B of their report. These worked examples were discussed by Deloitte at a joint presentation to SunWater and the QCA. The worked examples explain how the unrecovered non-direct amount of $2.2m was arrived at. The figures used by Deloitte in their analysis are extracted from the "Overhead Rates" sheet of the SFM for 2012 and represent the difference between the calculated overhead rates versus the rates that were applied to the forecast costs in the model. The calculation of the $2.2m is provided here for the QCA:

Total Costed Labour: $34.294m

Difference in Brisbane calculated versus applied overhead rates:
38.94% - 36.00% = 2.94%

Brisbane overhead under-recovery:
2.94% * $34.294m = $1.007m

Difference in Local calculated versus applied overhead rates:
65.02% - 61.34% = 3.68%

Local overhead under-recovery:
3.68% * $34.294m = $1.261m

Total overhead under-recovery: $2.268m

(iv) SunWater has not provided details of how yearly variations in cost allocations affect non-direct cost savings, particularly as the non-direct costs allocated to irrigation service contracts seem to have been relatively stable over the previous price path.

This point has been covered in the response to item (i).

Therefore, could you please provide further supporting information to explain how the SLFI policy has resulted in actual cost savings.

This is covered above and in SunWater's 23 December submission. In short, we do not see how this is relevant to the QCA's forward looking assessment of efficient costs, and question why SLFI has been the subject of such intense focus to date. SunWater has not relied on the SLFI process to justify its proposed non-direct costs, nor has it argued that SLFI is evidence that its costs are efficient. Instead, SunWater has deliberately presented its cost forecasts for scrutiny on a first principles basis (noting that Deloitte found only relatively minor areas for potential savings, even though this remains disputed by SunWater).

One reason for the QCA's interest in SLFI may be to respond to irrigator concerns about the centralisation that occurred as a result of the SLFI initiative. SunWater expects that a regulator would only need to take up these concerns if:

• the centralisation that occurred under SLFI led to inefficient costs, which is not the case as proven in the Deloitte review (indeed centralisation was supported); or

• there was a decline in service levels as a result, and there is no evidence to suggest this has occurred.

SunWater strongly suggests that the QCA instead focus on the non-direct costs as they have been proposed. SunWater is very concerned that the QCA's continued focus on and forensic examination of the SLFI program is based on a suspicion or belief that SunWater's expenditure forecasts included costs that do not exist and would not exist in the future.

Such gaming would understandably be a significant concern to the QCA.

For clarity, SunWater has not engaged in this practice, and this should be obvious to the QCA.

SunWater has been completely transparent with the QCA and its consultants about its expenditure forecasts, as it has with all other requests. The various independent reviews commissioned by the QCA have not found any evidence to suggest that SunWater's forecast and historic expenditure is not realistic or not based on actual costs.

SunWater is also extremely alarmed that the QCA has in the past contemplated reducing non-direct costs on the basis that the QCA is not satisfied that the SLFI savings have not translated to reductions in non-direct costs for irrigation prices. We have previously outlined our serious concerns with such a proposal by email. (refer email from Peter McGahan to Angus MacDonald of 21 October 2011). We have not had any response to these concerns, yet the QCA continues to ask for information about SLFI savings without stating the purpose of these inquiries.

Could you also describe how SunWater records and accounts for non-direct cost under-recovery as this is not clear from SunWater's explanation.

This is covered above and in Deloitte's report on SunWater's administration costs.

In closing, the SLFI program was implemented, resulted in many people being made redundant and resulted in significant cost savings. These savings have led to reduced unrecovered overheads for SunWater and reduced non-directs for SunWater's customers. If the SLFI program had not been implemented and SunWater had performed to the original 2009/10 budget, the non-directs cost pool would have been $10m higher resulting in potential increases of around $5m to irrigation service contracts.

The reasons for the QCA's continued analysis about past operating expenditure, and the SLFI program in particular, remains unclear and is entirely inconsistent with a forward-looking assessment of efficient costs, which we understand is normal regulatory practice.

(b) Labour productivity adjustments

In its email to the Authority dated 13 October 2012, SunWater questioned the Authority's approach to the application of a labour productivity adjustment. In particular, SunWater's reasoning appears to be that any efficiency adjustments should be applied to the cost baseline obtained by escalating costs by the estimated escalation rate of 4%. Although not clear, SunWater seems to be saying that the escalation rate already includes general productivity gains and that therefore to apply productivity gains again would be double-counting.

Therefore, could you please provide further information to clarify and support your views on this matter.

SunWater has addressed this issue in its submission on the draft report (refer pp 35-39). http://www.qca.org.au/files/W-SunWater-Submission-IrriPricesSunWaterSchemes1217-ResponseDraftReport-0212.pdf.

SunWater has not suggested that the 4% increase in labour costs already includes general productivity gains. Our submission states that:

> *SunWater considers that, to the extent the QCA or its consultant has better information on which to base future increases in labour costs, this information should be incorporated in the cost estimates. That is, the forecast 4% per annum growth in labour costs should form the new baseline estimate of wages growth over the regulatory period. Similarly, where the QCA identifies savings (as it has through the Deloitte review), these should be applied against the 4% baseline.(p37)*

Our concern about double counting arises where efficiencies or savings are imposed twice. This has in fact occurred in the draft report (as noted in our submission) as the QCA has imposed an (arbitrary) 1.5% saving on top of the efficiency savings identified by Deloitte for non-direct costs, and a 1.5% saving on labour costs for direct costs. That is, the QCA has not made a case as to why a 1.5% efficiency saving on top of the other efficiencies (eg Deloitte) is necessary.

We would be pleased to discuss this further and obtain advice from the QCA on any part of our submission that is not clear on this matter. SunWater would be interested to understand the basis for the 1.5% efficiency saving imposed, particularly given the under recovery of non-direct costs already put in place via SunWater's forecasts.

(c) Recreation costs

Could you please provide further information on recreation costs as follows:

(i) are recreation costs classified as operations costs? and

(ii) do estimates of recreation costs provided to the Authority include both direct and non-direct cost components, or direct costs only?

Routine recreation costs are classified as one of the relevant operational activities – operations, preventive maintenance or corrective maintenance. Non-routine recreation costs are classified as renewals costs. Both routine and non-routine costs have been totalled in the NSPs table (Table 4.2). Non-routine costs have been included in the NSP Table 4.2 as the forecast spend and not annuitized. Both routine and non routine costs include direct and non-direct components.

3. SCHEME-SPECIFIC OPEX ISSUES

(a) Several schemes have questioned large increases in operating cost components compared with the previous price round. For example:

(i) Lower Mary schemes: large increases in operating costs generally, and direct labour costs and associated non-direct cost allocations in particular. For example, labour costs have increased from $78,000 in 2006-07 to $202,000 in 2011-12, a 259% increase in real terms; and

Prior to 2008 the "Maryborough Scheme" consisted of the Upper and Lower sub schemes. Segments included Borumba Dam, Cedar Pocket Dam, Pie Creek distribution system, the lower Mary distribution system and Tinana and Mary Barrages. There were 4 staff in total with one supervisor located in Maryborough. In 2008 the schemes were split and SunWater retained the Lower Mary with the Mary Barrage , Tinana Barrage and the Lower Mary channel system. Staffing arrangements are now one supervisor and one operator maintainer. Efficiencies of scale were available in the past as the Supervisor supervised within the upper Mary sub scheme as well as the lower.

(ii) Eton schemes: large increases in total operating costs for the distribution scheme, and maintenance costs for the bulk scheme;

Eton WSS and Distribution - The increases can be attributed to a rise in the direct maintenance costs associated with the mechanical and electrical assets in the scheme and distribution system plus the associated indirect costs.

Regarding operations costs, when viewed in aggregate operations cost for Eton WSS and the distribution system combined remain flat. Taking data from the

Authority's Expenditure by Activity Table[1] in the draft reports for both bulk water and distribution and averaging the 5 years to 2012 results in an average operations cost of $1,235 compare the average annual forecast operations spend of $1,239 to 2017. It is likely that inaccurate unbundling of past costs have made the historical distribution costs look artificially low, however this has been corrected in the forecast costs. When viewed as whole the operations costs remain flat.

So the increase in total operational costs can be attributed to a rise in the direct maintenance costs associated with the mechanical and electrical assets in the scheme and distribution system plus the associated indirect costs.

Although SunWater has made some general comments in its NSPs on the reasons for opex increases, it needs to provide further detailed explanations for those schemes affected by substantial opex increases.

(b) Miscellaneous matters raised by stakeholders:

(i) Maryborough Sugar Factory has asked for clarification of the following matters concerning SunWater's Maryborough office:

- in the context of revenue offsets, whether the expenses of the office are being off-set through the lease of office space to National Parks and Wildlife; and

- in the context of forecast opex, given the SunWater office in Maryborough was not considered efficient, whether the efficiency of alternative arrangements has been included in forecasts;

The Tinana depot was partially leased in August 2005. SunWater retains two sheds (one is 54m^2 the other 36m^2) and a chemical store. The workshop has a total of 144m2 of which SunWater has 72m2. Office space consists of 168m2 of which SunWater retains 20m^2.

The annual rental received by SunWater is $3,500, from which SunWater pays outgoings of electricity and rates. The lease expires in 2015.

The revenue has not been included as a revenue offset.

The cost of rates and electricity are outlined below and amount to $5,880 (in 2011 dollars):

Electricity - $650 per quarter - $2600 per annum

Rates $820 per quarter - $3280 per annum

In the forecasting model the Tinana office costs are treated as local overhead. The SLFI project identified office accommodation savings that included disposal of the depot. Whist this has not yet occurred, the forecast were prepared on the basis that the savings had been achieved and the above costs of retaining the premises were not included in the forecast costs, negating the need to treat the revenue as "revenue offset".

[1] Refer to Table 5.2 in the Eton bulk water draft report and Table 5.1 in the Eton distribution system draft report.

(ii) Mareeba Dimbulah Irrigation Area Council has requested that SunWater confirm that the cost of SunWater reading water meters for DERM is not being borne by MDIA irrigators;

SunWater maintains a separate service contract for DERM meter reading. Labour and other direct costs eg replacement meters are booked to the metering service contract when DERM meters are read and maintained. Non-direct costs are also applied.

(iii) stakeholders have questioned the level of SunWater sponsorship associated with community events. SunWater's background paper on centralised costs describes the administration of corporate sponsorship as a centralised cost (with costs being allocated accordingly). Could SunWater advise whether all sponsorship costs (that is, the administration of sponsorship and the sponsorship itself) are centralised costs, or are specific sponsorships or advertising allocated to specific service contracts (for example, Bundy in Blum, Bundaberg Sugar Industry Awards, specific advertising in relation to safe use of recreation facilities, etc.);

All sponsorship costs (that is, the administration of sponsorship and the sponsorship itself) are centralised costs.

(iv) also regarding sponsorship, SunWater's Annual Report for 2010-11 indicates expenditure for sponsorship at $64,101. Can SunWater provide an estimate of sponsorship expenditure for 2011-12?

Sponsorship expenditure for 2011/12 is estimated to cost $102,500. Included in the financial model used for NSP forecasts is $70,000 per annum.

The $70,000 is reflected at cell "W725" on the "251-Strategy" tab in the A05-Strategy.xls file in the SFM.

(v) a stakeholder has described $30,000 per annum being incurred in electricity costs associated with the Moura off-stream storage that was built for a major industrial, high-priority customer. Could SunWater please advise whether or not these costs are being allocated to medium-priority irrigators;

The Authority should note that Moura Offstream Storage is included in the Ministerial correspondence of 28 September 2010. Refer : http://www.qca.org.au/files/W-SunWater-Sub-HonStephenRobertsonMP-AssetsBulkWater-1210.pdf

SunWater's view is that the customer has misunderstood the situation. Moura Offstream Storage was built by the Queensland Government to augment system yield on the Dawson river in the 1990s (pre-SunWater). Hence its inclusion in the Fitzroy Basin Resource Operations Plan (ROP) as a scheme asset (ROP , Attachment 4.1D). As evidenced by the inclusion of the Moura Offstream Storage capacity in the announced allocation formula, all scheme customers, both high and medium priority, benefit from the operation of all the scheme assets and should be apportioned a share of all the costs.

(vi) Dawson Valley WSS & Theodore Distribution System stakeholders commented that the chemical acrolein does not reduce weeds in this system. Therefore, the $100,000 forecast on this chemical is inefficient as the drains are still clogged and are not being maintained. Accordingly, can SunWater comment on:

- the status of acrolein as a controller of weeds in channels; and
- the level of current maintenance associated with these channels.

SunWater uses Acrolein in many of its irrigation channels to control aquatic weeds, however it does not use Acrolein in drains as suggested by the question. SunWater have found Acrolein to be an effective treatment, though regular application may be required.

The use of Acrolein is an option in Theodore, as in other schemes, but the particular ongoing irrigation requirements of SunWater's customers in Theodore make the required channel shutdowns difficult to achieve on a regular basis. In addition to Acrolein, SunWater uses other weed control measures such as complete channel shutdown and dry out, and other chemical control options. SunWater's view is that the original forecast based on usage of 1-2 cylinders per annum should stay in place.

(vii) Bundaberg WSS & Distribution System stakeholders are concerned that WAE associated with the Paradise Dam have avoided ROP compliance costs and these costs have been allocated, inappropriately, to SunWater customers. Regarding cost allocation between SunWater and Burnett Water, could SunWater advise how ROP compliance costs have been allocated;

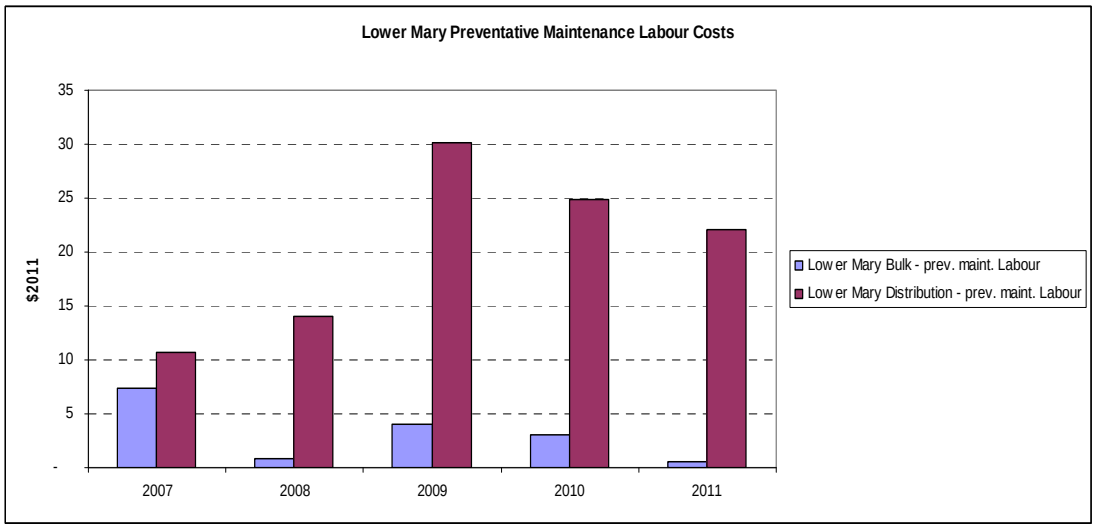
The costs of Strategic Water Management (which include the costs of ROP compliance costs) were treated as an indirect cost which was subsequently allocated to all bulk water systems including Paradise dam and Kirar weir which are external service contracts in SunWater.

(viii) Maryborough Sugar Factory has requested that SunWater clarify the comment (page 47 of Aurecon Report) regarding conversations with regional SunWater staff indicating weed control costs were high in 2010/11 for the Lower Mary WSS due to the extensive wet season experienced. There appears to be an inconsistency because this is a bulk system and stakeholders consider that in a significant wet season, floods tend to wash weeds down the river/creek alleviating the need for significant weed control.

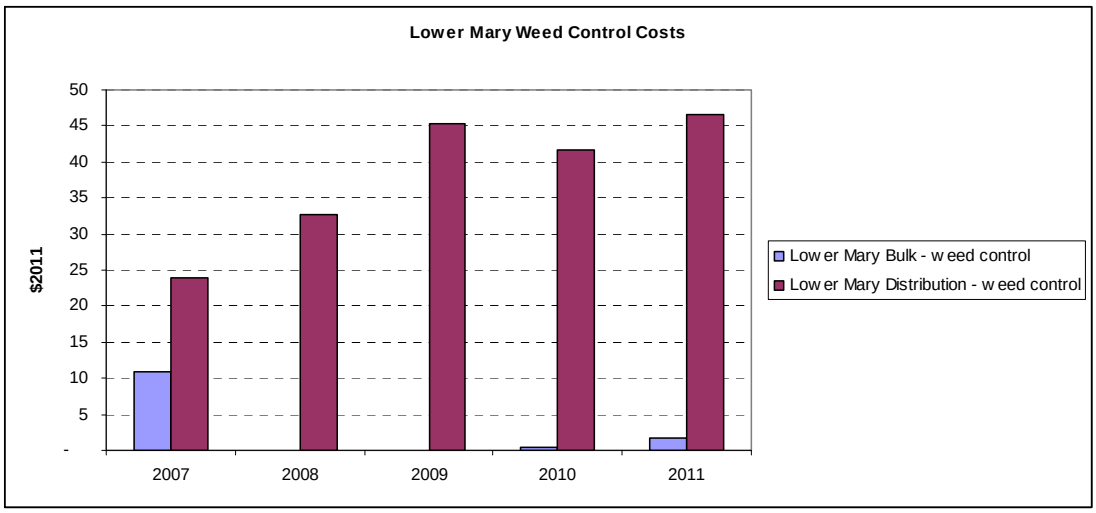
Aurecon state on page 156 of their report regarding Lower Mary Bulk WSS that:

> *"Preventive Maintenance" labour costs were relatively minor, but rose exponentially in 2011. Conversations with the SunWater regional manager highlighted that weed control costs across all schemes in the Central region were high in 2010/11 due to the extensive wet season experienced.*

However, actual preventative maintenance labour costs were lower in 2011 for Lower Mary Bulk than in previous years, as shown in the chart below. Preventative maintenance labour costs in the distribution system were also lower in 2011 than the previous two years.



The total cost for weed control in Lower Mary Bulk was only $2,000 in 2011.



So Aurecon's statement is not supported by the actual lower bound cost figures for Lower Mary; a general conversation appears to have been incorrectly applied to the Lower Mary Bulk WSS.