From: McGahan, Peter [mailto:Peter.Mcgahan@sunwater.com.au]
Sent: Wednesday, 14 March 2012 4:21 PM
To: Les Godfrey; Angus MacDonald
Cc: Allan, Matthew
Subject: RE: Recommended changes to CAM

Les and Angus,

Below is our response to Les's email below. Hopefully format is neater than the earlier version

Please note our final points below regrading application of non-direct "efficiency" gains. We believe this to be a material error that will need addressing by the Authority.

1. The forecast as represented by the SFM has two average overhead rates - Brisbane Overhead and Local Overhead

- o These averages are calculated over the many underlying resource centres
- o there are 17 resource centres underlying the Local Overhead rate
- o the attached extract of the "Overhead Rates" sheet lists the 17 resource centres underlying the Local Overhead rate
- o 7 of these are IM, 3 are ID and there are 7 others

2. The Deloitte/QCA recommendation effectively means that, rather than running with average rates across the local overhead cost pools, there should be individual rates set for individual resource centres.

- o The SFM currently supports average rates (as shown in the attachment) but also calculates the individual rates for each resource centre. Changes to the SFM would involve using these rates in the cost allocation forecast.
- o If IM and ID resource centres are taken down to into their specific rates then there would be 10 rates leaving 7 remaining.
- o If the majority of these resource centres are to have individual rates then it makes sense that all underlying resource centres should have individual rates.
- o You could create an artificial average rate by grouping some of the remaining resource centres, but this average would be rather meaningless, would be more onerous to maintain and would provide no improvement in overall cost allocation accuracy. It will be simpler, less expensive and more sensible to manage all resource centre rates individually rather than have a hybrid approach.

3. On the subject of under-recoveries

- o the applied rates are set below the full cost recovery rate with the resulting under-recovery forecast to be $2.2m in 2013 (see attachment)
- o the under-recovery is a product of the applied average rates being lower than the calculated average rates. If the average rate philosophy no longer applies then the model will need to be restructured to use individual resource centre rates. There seems to be no justification for running under-recoveries against individual resource centres.
- o while SLFI affected under-recoveries in the past, SLFI is not relevant to forecast under-recoveries

4. Application of non-direct "efficiency" gains

- It appears to SunWater that the Authority has made a fundamental error in the way in which it has applied the so-called efficiency gains to non-direct costs
- Deloitte's analysis of efficiency gains was made against total non-directs, not recovered non-directs, however the Authority has applied the efficiencies to recovered non-directs
- Similarly, the Authority applied its arbitrary "productivity gain" to recovered non-direct costs, rather than total non-directs
- This has resulted in the wrong total amount of non-directs being applied to service contracts and also the wrong proportions of non-directs being allocated to each service contract
- The only correct way to apply these imposed efficiencies is to apply them at the resource centre level in the SFM
    - Specific FTE savings should be applied to the relevant resource centre
    - Generic savings should be applied to all resource centres
    - This would then have an impact on the calculated overhead rates in the SFM, which would in turn affect the under-recoveries
- The Deloitte report in Appendix B illustrates the correct manner in which non-direct efficiency gains should be adjusted.
- Only when the savings are applied correctly through the SFM are the correct costs allocated to each individual service contract according to SunWater's proposed CAM

We look forward to your response on the above.

Peter

From: Les Godfrey [mailto:les.godfrey@qca.org.au]
Sent: Tuesday, 6 March 2012 9:32 AM
To: McGahan, Peter
Cc: Angus MacDonald
Subject: FW: Recommended changes to CAM

Peter – we think that, in principle, there is merit in SunWater's argument, but would appreciate if you could provide a brief summary of the 18 overhead rates that would be necessary under the targeted DLC option. We also understood from your recent SLFI response that under-recoveries of overhead had reduced significantly anyway, so it would be helpful if you could expand on your reasoning here.

Regards,

Les

From: McGahan, Peter [mailto:Peter.Mcgahan@sunwater.com.au]
Sent: Monday, 5 March 2012 9:10 AM
To: Angus MacDonald
Cc: Les Godfrey; Matthew Bradbury
Subject: Recommended changes to CAM

Angus,

After doing some analysis we have some concerns with the Authority's draft recommendation about changing the distribution of local overheads as presented on p237 of the draft report. Attached is a brief paper outlining out concerns.

I hope the paper provides enough information to have the Authority reconsider this recommendation, but please contact me if further information is required.

As the paper explains, if the Authority does not change the draft recommendation then changes must be made in the Authority's pricing model before prices are set.

Regards
Peter

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The information in this e-mail together with any attachments is
intended only for the person or entity to which it is addressed
and may contain confidential and/or privileged material.

RESPONSE ON THE AUTHORITY'S DRAFT RECOMMENDATION TO CHANGE SUNWATER'S CAM

In the QCA's Draft Report the following recommendation was made:

The Authority recommends non-direct costs be allocated to service contracts using DLCs (as proposed by SunWater with two exceptions:

a) **the overhead component of Infrastructure Management (Regions) should be allocated to the service contracts serviced by each relevant resource centre (South, Central, North and Far North), on the basis of DLC from each respective resource centre; and**
b) **the overhead component of Infrastructure Development should be allocated to service contracts on the basis of DLC from that respective resource centre.**

SunWater has reviewed the implications of this recommendation and has found that it introduces unnecessary complexity to SunWater's Cost Allocation Methodology (CAM), will introduce increased administrative costs and will generally result in increased non-direct costs to irrigation service contracts.

SunWater currently operates with two overhead cost pools: Brisbane overheads and Local overheads. Both of these pools are allocated to service contracts using average rates applied to direct labour; there is one rate for Brisbane overheads and one for Local overheads. The QCA's recommendation effectively removes many of the Local overhead resource centres from the average rate methodology and this will mean that SunWater will have to maintain around 18 average overhead rates rather than the two currently in place.

While implementing the QCA's recommendation will arguably create a more cost-reflective distribution of local overheads the impacts need to be assessed in totality to confirm that the benefits outweigh the costs. Analysis by SunWater indicates that the rebalancing of overheads will result in most irrigation service contracts being worse off under the proposed methodology. The overall increase in non-direct costs to irrigation service contracts is estimated to be around $600k p.a.; for individual contracts the maximum saving is about 1%, while the maximum increase is about 5%. These estimates are based on allocations without considering the additional costs of maintaining a more complex CAM. There will also be additional complexity in job costing which will flow to increased administration costs.

Additionally, given that the Local overhead cost pool would be moving away from an average rate approach, it would be difficult to rationalise how this cost pool could continue to run at a net under-recovery.

The table following shows SunWater's estimate of the average annual impact of the recommended changes on each irrigation service contract showing the impact of unwinding the average rate allocation method and of also removing the current under-recovery of Local overheads.

Service Contract	Estimated Annual Increase due to Multiple Local Overhead Rates	% Increase	Total Increase Including the Impact of Full Local Overhead recovery	% Increase
Barker Barambah Bulk	(0)	0.0%	7	0.8%
Bowen Broken Bulk	38	3.1%	48	3.9%
Boyne Bulk	(1)	-0.3%	3	0.6%
Bundaberg Bulk	4	0.3%	18	1.1%
Burdekin Bulk	3	0.1%	38	1.0%
Callide Bulk	2	0.1%	13	0.8%
Chinchilla Weir Bulk	2	2.1%	3	3.0%
Cunnamulla Weir Bulk	1	1.5%	1	2.4%
Dawson Bulk	1	0.1%	13	1.1%
Eton Bulk	55	2.9%	69	3.6%
Lower Fitzroy Bulk	(3)	-1.0%	(0)	-0.1%
Lower Mary Bulk	(0)	-0.1%	3	1.0%
Macintyre Brook Bulk	21	1.9%	34	3.1%
Maranoa Bulk	1	2.2%	1	3.0%
Mareeba Bulk	0	0.0%	10	1.0%
Nogoa Bulk	112	4.2%	136	5.1%
Pioneer Bulk	25	2.2%	41	3.6%
Proserpine Bulk	(1)	-0.1%	6	0.7%
St George Bulk	37	2.3%	49	3.1%
Three Moon Bulk	(2)	-0.4%	2	0.5%
Upper Burnett Bulk	(7)	-0.7%	4	0.4%
Upper Condamine Bulk	34	2.2%	46	3.0%
Bundaberg Distribution	7	0.1%	66	0.7%
Burdekin Distribution	26	0.2%	119	0.8%
Dawson Distribution	(1)	-0.1%	14	1.0%
Emerald Distribution	82	4.5%	101	5.6%
Eton Distribution	93	3.3%	114	4.0%
Lower Mary Distribution	(5)	-0.5%	3	0.3%
Mareeba Distribution	15	0.3%	62	1.2%
St George Distribution	49	3.8%	67	5.2%
Total ($2011 k real)	**$587**		**$1,089**	

Under full cost recovery, only one irrigation service contract will see a reduction in non-directs. This is before the additional costs of implementation and maintenance are included.

SunWater estimates that the additional costs associated with these recommendations are:

Implementation in SAP	\$60k
Implementation in the SFM	\$40k
Implementation in the job costing system	\$75k
Ongoing maintenance of additional overhead rates	\$45k p.a. (0.5 FTE)

SunWater notes that if the QCA were to proceed with these recommendations then the Authority's pricing model would have to be modified to reflect the recommendations and the cost base would have to be increased to reflect the additional costs. These changes would need to occur <u>before</u> prices are established.