DRAFT PRICES (AND OPEX CONTINUED)
INFORMATION REQUEST

1. TIMING

The Authority requests that SunWater responds to the following matters by 16 March 2012.

2. REVENUE OFFSETS

Background

The Authority compared forecast and actual revenue offsets during the 2007-11 price path. The comparison shows that for 20 service contracts, the actual revenue offsets received by SunWater, significantly exceeded expectations. The implication of this, as stakeholders have noted, is that SunWater over recovered in those schemes during the current price path and yet customers received no adjustment in the Authority's Draft Report and draft prices.

The above statement implies that customers bear the risk (upside and downside) or revenue forecasts. This would suggest where actual revenue offsets were lower than forecast, a similar adjustment (price increase) should apply. This was not the case when 2006 prices were set. Sun has borne the outcomes of (generally) demand being well below forecast and consequently irrigation revenues being well below that assumed when setting prices. SunWater has made this point in its submission about form of regulation (refer figures 1 and 2 in particular in that submission).

The above statement could also be interpreted to mean that customers (not SunWater) were to bear operating cost risk over the regulatory period. That is, prices in the next period were to be adjusted to reflect the actual costs (including revenue offsets) over that period. This was not the case. Indeed, in its submission to the QCA in relation to recovering the cost of inflatable rubber bags, SunWater acknowledged it bears operating cost risks under the current price paths:[1]

> *SunWater accepts that the arrangements established for the current irrigation price path did not contemplate unforeseen cost imposts outside of SunWater's control. In essence, the arrangements established with Tier 1 required SunWater to bear the risk of operating costs over the term of the price path. Accordingly, SunWater accepts that it must bear the legal costs associated with the Bedford Weir incident…,*

All forecasts were reviewed and agreed through the Tier 1 process at the time. If an adjustment is to be made in the next price path for actual (versus forecast) revenue offsets, then the same should occur for all components of the cost base, including operating costs. Furthermore, it is well beyond the scope of this QCA review to interfere with the past agreed arrangements, and any adjustment for revenue offsets alone is simply cherry picking of certain elements of the cost base without considering the broader price setting process and agreed allocation of risk.

The notion of over-recovery is misguided. Government pricing policy at the time was for prices to recover, as a minimum, lower bound costs. Also, water reform policy generally sets lower bound cost recovery as the minimum target. Even if actual revenues over the last price path period were greater than the lower bound costs target (noting that water sales were generally

[1] Refer: http://www.qca.org.au/files/W-SunWater-Sub-TreatmentOfCostsRelatedToInflatableRubberDams-BackgroundPaper-0911.pdf. See page 11.

well below forecast), there is simply no basis to contemplate any adjustment in future years as the additional revenue will simply contribute towards the full costs of service (upper bound).

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Analysis of Forecast Revenue Offsets 2011-17

Table 1 (at end of document) provides SunWater's forecast revenue offsets for 2011-17. The details of the inclusions in these revenue offset forecasts are provided by SunWater in their SFM. The forecasts were estimated to be the same every year from 2011-12 to 2016-17 for all schemes with the exception of Bundaberg Distribution, Emerald Distribution and Mareeba Dimbulah Distribution where the revenue offset estimates varied from 2014-15. Theodore Distribution also had a different forecast revenue offset in 2016-17. No indexation was applied.

The variations in Bundaberg, Emerald and Mareeba are due to the application of past termination fees. SunWater's data does not support the statement that Theodore distribution has a different forecast revenue offset for 2017.

In the absence of an explanation on how the forecast revenue offsets 2011-17 were calculated by SunWater, the Authority compared the latter to three historical data as follows:

- average forecast and actual revenue offsets (2006-11);
- average actual revenue offsets (2006-11); and
- actual revenue offsets (2009-10)

Based on the above analyses, the Authority concludes that:

- the forecast revenue offsets 2012-17 for all schemes was not based on either the average actual revenue offsets (2006-11) nor the average of the actual and forecast revenue offsets for 2006-11;
- it is likely that the general approach taken by SunWater in estimating the forecast revenue offsets for 2012-17 was to estimate revenue offsets numbers as close to the 2009-10 Actual Revenue Offsets as possible; and
- in the absence of the detailed items included by SunWater in the 2009-10 actual revenue offsets, it is difficult to carry out a comparison with the detailed items included in the forecast revenue offsets for 2012-17 regulatory periods.

Information/Data Request from SunWater

- please explain the basis for revenue offset forecasts for the 2007-11 price path;

  Generally the revenue offsets are based on 2010 actuals. The exceptions, which were forecast based on an assessment 2007 to 2010 actuals, are discussed below:

  - Drainage Levies – based on assessment of 2007 to 2010 actuals. It only moved $3k for whole of SunWater.
  - Drainage Diversion Charges - based on assessment of 2007 to 2010 actuals with the exception of St George which has an unstainable spike in 2010 actuals. Actuals for all SunWater totalled $55k in 2011.

- Other Fees and Charges - Minimum charge revenue was not included in the forecast as SunWater did not propose to impose the charge going forward, however it has been included in the actuals. Included in the forecast fees and charges are misc charges such as meter testing, special meter reading, meter relocation fees, water connection designs.

- Storage rental fess which were not forecast (see below)

- Land Leases - based on assessment of 2007 to 2010 actuals. There was a substantial increase in 2009 and then a slight decrease in 2010. Therefore slight decrease in forecast to $211k reflects a reasonable range. Actuals for 2011 were $208k.

- Termination fees – which are an off-system adjustments made based on the value of past fees paid projected over 10 years. (See email to Angus MacDonald on 22 August 2011)

- explain why the actuals for that period generally far exceeded the forecasts;

  According to the Tier 1 Report (p31) scheme revenue offsets included, where applicable, proceeds from housing revenues, drainage diversion fees, permanent trade exit fees, new water application fees, water storage revenues, recreational facility revenues and flood margin lease fees.

  Note that as per the above definition revenue from drainage levies and the Mareeba access charge were not forecast as revenue offsets, whereas they have been included in SunWater's actuals. This would account for a large component of the difference.

  The 2006 IPR took Mareeba's access charges into account separately when setting prices (Tier 1 Report p50). Similarly drainage costs and charges were treated separately.

- how is this being addressed, if at all?

  Refer to comments above in relation to the regulatory framework and in any case no adjustments are warranted.

- provide the basis for revenue offset forecasts for 2012-17. For example can details (such as drainage charge x number of hectares/or customers, etc.) be provided on a revenue item and scheme basis?

  Substantial information and data relating to drainage charges was provided by email to Angus MacDonald on 28 Feb 2011. The actual data used to estimate the drainage revenue offset is attached.

- our understanding is that the estimates for forecast revenue offsets for 2012-17 are based on 2009-10 Actual Revenue Offsets as closely as possible. Please confirm this or provide an alternative explanation;

  This is generally the case, refer above.

- we note that in certain service contracts (for example, Emerald Bulk and Channel, and others), you have forecast significantly lower revenue offsets for 2012-17 than the average actuals for the past five years (2006-11), or the 2009-10 actual revenue offsets. In these cases (and generally) the Authority is keen to ensure that the outcomes of the

past price path (where actual revenue offsets far exceeded forecast revenue offsets) does not re-occur. Can you therefore also explain for any scheme with a 2012-17 revenue offset forecast less than the 2009-10 Actual Revenue Offsets, exactly why SunWater has made this assessment?

Considerable detail about revenue offsets is provided is each NSP. In addition SunWater provided a submission on Storage Rental Fees providing further background around why this particular revenue offsets was not forecast. SunWater forecast total revenue offsets of $2.60 million (real) in 2012 against an actual total for 2010 of $2.88. The difference is explained by the fact that SunWater did not forecast Storage Rental Fees (which in 2010 amounted to $0.222 million) and minimum charges.

- provide details of the minimum charges to apply to irrigators on a scheme basis?

  A spreadsheet is attached that outlines the charges levied and the tariffs for the 2011 year. A total $113k was invoice as minimum charges in 2011, a year of record low usage which would inflate minimum charge revenue. The charge is applied if a customer's total invoiced amount for the year is less than the applicable minimum charge, in which case the amount invoiced is the difference between the applicable minimum charge less what has been invoiced to date.

- provide details of the calculation of revenue offsets from leases, and whether there are automatic (or built in) increases in lease charges;

  This data is attached. The forecast were based on assessment of 2007 to 2010 actuals. There was a substantial increase in 2009 and then a slight decrease in 2010. The slight decrease in forecast for 2012 of $211k reflects a reasonable range. Actuals for 2011 were $208k. There is no automatic (or built-in) rent increases involved with SunWater's flood margin leases.

- provide details of the calculation of forecasts of access charges, particularly for Mareeba; and

  This data is attached. The forecasts were based on the 2010 actuals for $610k. The 2011 actuals were $611k.

- provide details of any other revenues received by SunWater associated with the schemes listed in the Ministerial Direction as part of administering service contracts? As an example, it is understood that SunWater charge some local government authorities drainage charges. If this is so, what are these charges and which schemes do they apply?

  All drainage charges revenue, regardless of whether it is an irrigator or not, is incorporated into forecast the drainage levies revenue offsets.

  INDEC thoroughly reviewed SunWater costing systems, including revenue offsets, and found the systems fit for purpose accurately recording cost and revenue offset information. Indec did not identify any significant issues associated with SunWater's recording of costs and revenue offset information.

3. WATER USE ASSUMPTIONS

- what water use assumptions did SunWater use to forecast variable electricity costs for 2012-17, and in particular 2012-13;

  The same water use forecasts that were outlined in the submission "Electricity Cost Background Paper", Feb 2011, on the QCA's website. The water use forecasts are the same but the electricity costs have been updated as described in subsequent submissions. These forecast numbers can be found in row 912 for each service contract's costs in the SFM.

  In reviewing the Authority's draft report, we note that the Authority has changed the water use assumptions for the service contracts from SunWater's forecast. The Authority must also adjust the ML in the electricity cost calculation accordingly to arrive at the correct total electricity cost (row 912 in the SFM). It is very important to keep the ML consistent in all parts of the cost and price calculations. This includes the Authority's pricing module. We note that there are inconsistencies in the use of ML in the Authority's pricing module which we have raised with NERA as part of their review.

- was this an all-sectors water use forecast, or an irrigation-only water use forecast; and

  The water use forecasts used were the all-sectors forecast for the relevant service contract or part thereof (i.e. Barker Barambah-Upper Redgate, Upper Condamine-North Branch and Mareeba-Relift). These forecasts are on the same basis as the actual ML used to determine the $/ML electricity costs.

- if it was irrigation only, please also provide the all-sectors (whole of service contract) water use forecast for each service contract, and the basis for that forecast.

  See above point

4. RECREATION COSTS

Bulk scheme NSPs, as opposed to distribution system NSPs, list costs associated with maintaining recreational facilities. You have clarified the nature of recreation costs in your response to our opex information request. However, some irrigators have asked QCA to confirm whether costs associated with recreational facilities are considered to be a cost of relevant bulk schemes only, or are some of these costs also allocated to distribution systems. We note that the financial model is silent on recreational costs, whereas it clearly identifies revenue offsets from recreational facilities (for Bowen Broken and Burdekin). Therefore, can you please advise where in the financial model costs associated with maintaining recreational facilities, on a service contract basis, are maintained.

The cost of recreation facilities are maintained wholly in the bulk water service contracts.

5. COST ALLOCATION – OPTIONS ANALYSIS

In SunWater's submission on the Draft Report (23/12/2011, page 31), costs associated with undertaking options analysis on renewals annuity forecasts (consistent with the approach outlined on p.115 of the Authority's Volume 1 Draft Report) will be considered an operating cost. Our understanding is that SunWater proposes to classify these costs as an activity of Infrastructure Management (Asset Management), and to allocate them as non-direct costs accordingly. Could you please confirm this, or otherwise advise.

In it response to the Authority's' draft recommendation on additional options analysis and consultation with irrigators on proposed renewals projects SunWater submitted …*"that additional expenditure is included as an operating cost. Moreover, there is an argument that this cost, which is solely a requirement for irrigation renewals, should be 100% attributable to irrigation prices."* (SunWater submission on draft report p31)

SunWater's submission was made on the basis that bulk water refurbishment projects are primarily compliance based projects and SunWater has no discretion in avoiding the costs regardless of the extent of irrigation customer consultation. This is in contrast to options analysis in distribution systems where engagement with customers could lead to significant discretionary changes to projected renewals expenditures as customers opt for alternative standards of service and asset condition. In addition the extent of asset renewal is far greater in distribution systems where pumps, motors and channels require regular renewal and frequently suffer flood damage. For these reason it is anticipated that significantly more options analysis and consultation would occur in relation to distribution systems than bulk water service contracts.

SunWater is concerned that the QCA might look to treat options analysis as a capital cost to the project. However this is a mischaracterisation of the options analysis. Rather, the options analysis in the context of the QCA's recommendations is developed purely to develop a renewals expenditure forecast, and contrasts to the type of work required for detailed analysis and review that normally comes before the investment decision. This more detailed work, which occurs just prior to carrying out the project, is normally included (capitalised) to the project cost. This work is very different to high level options analysis and irrigator consultation used for renewals programming, which SunWater submits is an operating cost.

Under SunWater's cost allocation model time is booked directly to service contract where practical and it is likely that time spend on irrigation options analysis and consultation would be booked directly to service contracts. SunWater would establish an indirect cost pool for "irrigation options analysis and consultation" and costs would be booked either directly to the service contracts or to the indirect costs pool. The indirect costs pool would be recovered against direct labour charges to irrigations service contracts and in this way the majority of the non-direct cost would be apportioned to irrigation distribution systems (as it should be). Distribution systems are almost exclusively irrigator only service contracts with non-irrigators being a very small proportion.

Allowance for this cost will need be included in the Authority's pricing model before prices are set.

6. SCHEME-SPECIFIC OPEX ISSUES

(a) Lower Mary schemes - large increases in operating costs generally, and direct labour costs and associated non-direct cost allocations in particular. Specifically, irrigators have questioned the substantial increases in operating costs from the 2006-11 price path to the 2012-17 regulatory period. For example, for the Lower Mary Distribution System (pp.40-41):

- labour costs have increased from $78,000 in 2006-07 to $202,000 in 2011-12, a 259% increase in real terms; and

  The 2007 data is not reliable at this level of disaggregation. We do not believe comparisons to this year are meaningful.

- "other" costs have increased from $12,000 in 2006-07 to $52,000 in 2011-12, a 330% increase in real terms.

Insurance costs make up the bulk of "other costs" in the distribution system at $44k in 2011-12. The past years have understated the insurance cost applied to Lower Mary Distribution as the Bulk WSS incorrectly had all of the insurance cost applied to it. This has been address in 2011 on onward and comparing "Other cost" for the combined distribution and bulk water schemes show a much more consistent number averaging $72k for the past 5 years reducing to $69k for the forecast period.

Could you please provide additional information to justify these increases. SunWater's initial response that "efficiencies of scale" are now foregone due to the reconfiguration of the scheme, does not fully explain the scale of the increases in our view.

In addition, can you provide an explanation of how the recent centralisation of customer services to Brisbane has resulted in a decrease in costs being allocated to the Lower Mary.

SunWater's assessment on the non-direct operating costs applied to the Lower Mary indicates that non-direct cost do not show a decreasing trend. The cost allocated to the Lower Mary distribution would have been higher than the current forecasts if SunWater had not taken the actions if has to reduce non-directs costs including centralising customer services. SunWater's centralised costs and SunWater's cost allocation model have been thoroughly reviewed by the Authority and largely accepted. Under the model non-direct costs are allocated based direct labour.

(b) A number of other schemes have questioned large increases in operating cost components compared with the previous price round and these will be included in a subsequent information request.

Table 1: Forecast Revenue Offsets 2011-17 (Real $'000)

	2011-12	*2012-13*	*2013-14*	*2014-15*	*2015-16*	*2016-17*
Barker Barambah Bulk Supply	19	19	19	19	19	19
Bowen Broken Rivers Bulk Supply	12	12	12	12	12	12
Boyne River and Tarong Bulk Supply	15	15	15	15	15	15
Bundaberg Bulk Supply	24	24	24	24	24	24
Bundaberg Distribution	152	152	152	151	151	151
Burdekin Bulk Supply	95	95	95	95	95	95
Burdekin Distribution	630	630	630	630	630	630
Callide Valley Bulk Supply	9	9	9	9	9	9
Chinchilla Weir Bulk Supply	4	4	4	4	4	4
Cunnamulla Bulk Supply	2	2	2	2	2	2
Dawson Valley Bulk Supply	5	5	5	5	5	5
Emerald Distribution	427	427	427	424	407	395
Eton Bulk Supply	2	2	2	2	2	2
Eton Distribution	4	4	4	4	4	4
Lower Fitzroy Bulk Supply	0	0	0	0	0	0
Lower Mary Bulk Supply	2	2	2	2	2	2
Lower Mary Distribution	13	13	13	13	13	13
Macintyre Brook Bulk Supply	11	11	11	11	11	11
Maranoa Bulk Supply	0	0	0	0	0	0
Mareeba-Dimbulah Bulk Supply	78	78	78	78	78	78
Mareeba-Dimbulah Distribution	591	591	591	589	587	586
Nogoa-Mackenzie Bulk Supply	54	54	54	54	54	54
Pioneer Bulk Supply	10	10	10	10	10	10
Proserpine Bulk Supply	169	169	169	169	169	169
St George Bulk Supply	12	12	12	12	12	12
St George Distribution	202	202	202	202	202	202
Theodore Distribution	55	55	55	55	55	53

	2011-12	*2012-13*	*2013-14*	*2014-15*	*2015-16*	*2016-17*
Three Moon Bulk Supply	2	2	2	2	2	2
Upper Burnett Bulk Supply	8	8	8	8	8	8
Upper Condamine Bulk Supply	6	6	6	6	6	6