From: Allan, Matthew [mailto:Matthew.Allan@sunwater.com.au]
Sent: Monday, 26 March 2012 5:20 PM
To: Angus MacDonald
Cc: Vanderbyl, Tom; McGahan, Peter; Rick Stankiewicz
Subject: Further support to the inclusion of non-directs in renewals

Angus

As discussed, we consider the proposition to remove the non-directs from the renewals past spend to be a serious error.

Attached are further arguments to be read in conjunction with our previous submission on this subject.

Regards
Matthew

The most disappointing aspect of the QCA's approach to this subject is that they don't appear to have properly considered our submission on the topic with a view to understanding what actually took place. Surely an unbiased, evidenced based approach requires that the QCA fairly test Indec's unsupported and unlikely proposition against the business-as-usual explanation provided by SunWater and supported by the documentation at the time.

The QCA seem to be blindly chasing cost reductions in spite of the evidence and the explanations presented by SunWater. Why does a recollection by a consultant, that flies in the face of conventional business practice and is not supported by evidence, carry greater weight than the more feasible explanation made by SunWater and supported by documentary evidence from several sources? Presumably, the QCA should be taking the time to properly consider all the evidence to ensure they have reached a balanced decision.

The biggest point that the QCA is missing in this discussion is that the relevant Tier 1 working papers are directed at what is being allocated to operating costs **not** what isn't included in renewals. The papers are describing the indirects that were allocated to operating costs in determining the operating cost base. They make it clear that indirects relevant to renewals weren't allocated to operating costs and even make the point that Engineering Services were excluded from this allocation so as to avoid **double-counting**. The QCA should ask itself, "Why would the subject of double-counting be raised in this context other than for the reason that it was intended to recover Engineering Services costs (including indirects) via renewals?". In other words, if no Engineering Services costs were expected to be recovered via renewals then double-counting would be a non-issue in this working paper.

SKM's review[1] of SunWater's renewals includes a summary of how indirects are included in SunWater's estimation process for projects beyond the 5-year horizon and indirects and overheads are included in the more detailed planning made within the 5-year planning timeframe. This approach to estimation was in place at the time of Tier 1, it therefore follows that there was an expectation that a significant proportion of the non-directs would be recovered via renewals.

The fact that only \$23m of \$52m of indirects were allocated to operating costs clearly says that Indec's assertion that indirects were "fully allocated" to operating costs is incorrect.

If the QCA follows through with this proposed cut they will be going against the evidence presented and retrospectively changing the costs incurred under a decision-making framework that they were not responsible for. In any case, if the QCA were to follow through with this intention, they themselves would be double-counting savings by removing non-directs but also removing a set % from past renewals spend that relies on an assessing of project efficiency **with non-directs included.**

See further comments against the QCA's text below.

[1] SKM report for the QCA, "Review of Selected Annuity Values for Refurbishment and Replacement ITEMS - Addendum", March 2012.

Stakeholder Comment
· Indec (2011d) concluded that from 2006-07 to 2010-11 irrigation prices allocated indirect costs fully to operating costs only and none were allocated to direct renewals expenditure. Subsequently, during the current price path, SunWater also started allocating non-directs costs to renewals expenditure, which may have resulted in these costs having been accounted for twice~~ – ~~. If so, these costs may be recovered a second time from 1 July 2012, if they lead to reduced opening ARR balances for 2012-17. That is, increased costs lead to increased negative opening ARR balances or reduced positive opening ARR balances – either way resulting prices are likely to be higher. SunWater strongly disagrees with this analysis and ~~submitted that~~ produced documentary evidence that shows that only $23 million of the total forecast $52 million in non-direct costs were allocated to operating costs. SunWater submit it was always intended that some of the balance (of the $29 million) of non-direct costs would be recovered via renewals and other projects. During the 2005-06 price review, there was a clear expectation that direct renewals costs would be allocated non-direct costs during the 2006-11 price paths. The allocation would be based on the proportion of direct labour booked against each activity for each service contract. SunWater (2012e)

Comment [SW1]: This title should be changed because this issue was internally generated by the QCA

Comment [SW2]: Indec stated this in their report but provided no evidence that this was in fact the case.

Comment [SW3]: There was no "also started", SunWater did not agree to one position and then start doing something contrary to what was agreed.
Indec's proposition, which is not supported by any evidence, would have SunWater recovering non-directs in a manner that is contrary to SunWater's normal practice and also contrary to general business practice outside of SunWater.
The QCA's approach to this subject is to assume that Indec is correct (without evidence) and then to build a story around this assumption without due consideration of the facts presented by SunWater.

Surely an unbiased, evidenced based approach requires that the QCA fairly test Indec's unsupported and unlikely proposition against the business-as-usual explanation provided by SunWater and supported by the documentation at the time.

Comment [SW4]: QCA are understating the position here. It isn't simply "SunWater submitted" but rather that SunWater has directed the QCA to documentary evidence that shows that only $23m of $52m was allocated. Are the QCA going to ignore this evidence and instead selective quote only the text that supports their "story".

Comment [SW5]: Again, it is not just our opinion but is supported by documentation, including a report by Indec themselves.

· Tier 1 Working Paper 9 specifies that an annual average of $14.8 million Indirect Brisbane Office Costs was to be recovered from irrigation schemes operating costs, allocated based on direct costs, excluding electricity pumping costs and excluding the renewals and refurbishment annuity for each scheme.

Consistent with this decision, such indirect costs would during 2006-11 price paths have been fully recovered via allocation to operating costs (not renewals), excluding electricity pumping costs. The 2006-11 prices would have reflected this decision.

SunWater subsequently allocated a portion of these indirect costs also to renewals expenditure. This is inconsistent with the Tier 1 decision. The Authority considers that this approach represents double counting if those indirect costs were allocated both to the operating costs and renewals. This will have lowered the opening ARR balances for 2012-17 by the extra indirect costs incorrectly allocated to the ARR (and thus are likely to increase prices).

Accordingly the Authority recommends that these indirect costs be removed from SunWater's ARR balances for the period 2006-12. This will, ceteris paribus, increase 2012-17 opening ARR balances in line with the Authority's estimates (and place downward pressure on irrigation prices).

The Authority notes that for 2006-12, direct renewals account for 27% of total actual direct irrigation expenditure (excluding electricity costs). It is assumed that 27% of the annual average $14.8 million of Indirect Brisbane Office Costs is to be removed from ARR accounts for 2006-12 (that is, approximately $4 million annually for the six year period 2006-12).

The share of $4 million to be removed from the ARR balance of each irrigation service contract is determined as the average annual renewals expenditure per service contract divided by average annual total irrigation renewals expenditure for the period 2006-12 .

Comment [SW6]: This is mis-quoting the intention of this paper.
The biggest point that the QCA is missing in this discussion is that these working papers are directed at what is being allocated to operating not what isn't included in renewals.

Comment [SW7]: Agree that the portion of indirect costs that were allocated to operating were intended to be fully recovered via the operating component of pricing. However, this was not the full extent of the indirects and overheads.

Comment [SW8]: This statement is simply untrue and paints SunWater in a bad light. The indirects allocated to renewals are those relevant to renewals. There were $29m of indirects not allocated to operating and this is documented. The numbers do not support Indec's assertion that indirects were fully allocated to operating costs. If the QCA has any information that they think supports this view then they should share it with SunWater for our opinion.

Comment [SW9]: The QCA propose to smear this "reduction" across the total renewals spend for all schemes which is likely to produce spurious outcomes for some schemes.