

22 FEB 2011

DATE RECEIVED



Hon Stephen Robertson MP
Member for Stretton



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**Minister for Natural Resources,
Mines and Energy and
Minister for Trade**

Mr Brian Parmenter
Chair
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

17 FEB 2011

Dear Mr Parmenter

I am writing to inform you of the total approved establishment costs for the South East Queensland (SEQ) Distributor-retailers: Queensland Urban Utilities, Allconnex Water and Unitywater.

As you are aware, I requested the Queensland Water Commission (the Commission) to provide advice and recommendations to me on the appropriateness of all claims. The Commission engaged Ernst & Young to develop, in consultation with the three Distributor-retailers and councils, eligibility criteria to assess the claims and then assess all claims against the criteria (**Attachment 1**).

The review has now been completed and on the basis of the Ernst & Young report and the Commission's recommendation I have determined the total costs for establishing the three Distributor-retailers to be \$80,796,746. This is comprised of:

- \$55,152,461 in direct Distributor-retailer costs; and
- \$25,644,285 in Council of Mayors South East Queensland (CoMSEQ) costs.

The total approved costs for each of the Distributor-retailers (Distributor-retailer costs and CoMSEQ costs) is as follows:

- Queensland Urban Utilities - \$39,116,073;
- Allconnex Water - \$28,547,675; and
- Unitywater - \$13,132,998.

Further details on the establishment cost claims and approved establishment costs are set out in **Attachment 2**.

The total approved establishment costs for each Distributor-retailer are to be rolled in the Regulated Asset Base at 1 July 2010 and recovered through water retail prices over an appropriate period.

The establishment cost claims submitted by Distributor-retailers included claims for costs incurred or likely to be incurred beyond 30 June 2010. These costs have not been assessed as part of this process given that the Queensland Competition Authority is reviewing the capital and operating expenditure of the Distributor-retailers for the period 1 July 2010 to 30 June 2011 under its current price monitoring arrangements.

Should you have any further queries, please do not hesitate to contact Tracie-Lee Waldock, Acting Director Grid and Bulk Water Supply at the Commission, on telephone 3247 3031.

Yours sincerely



STEPHEN ROBERTSON MP

CRITERIA FOR ASSESSING ESTABLISHMENT COSTS FOR SEQ FOR SEQ DISTRIBUTION-RETAIL WATER AND WASTEWATER BUSINESSES

Criteria for identifying and assessing establishment costs

1. The criteria for identifying and assessing allowable establishment costs has been developed by Ernst & Young in consultation with the SEQ Councils, Distributor-Retailers, QWC and Treasury. For the purposes of determining the eligibility of claimed establishment costs, two broad sets of eligibility criteria have been identified as follows:
 - a. Eligible purpose criteria, which define the nature of costs that can be appropriately defined as establishment costs; and
 - b. Prudent cost criteria, designed to test whether the proposed level or quantum of costs being claimed is reasonable.

2. At a high level, costs are for an eligible purpose if the costs are associated with the following activities:
 - a. Implementation of the initial reform model (comprising the single Interim Distribution Entity and three separate Retailers);
 - b. The subsequent winding up these four entities under the initial reform model;
 - c. Establishing the three new Distribution-Retail entities to provide distribution and retail services in water and wastewater supply in SEQ under the revised Stage 2 reform model;
 - d. Establishment of the governance structures for the new entities including governing boards;
 - e. Transferring the assets, staff and liabilities to the new entities;
 - f. Ensuring that the entities are operational no later than 1 July 2010. That is, the businesses are able to provide the required levels of service to SEQ retail water customers at the commencement date.

3. Costs should broadly fit within the following categories of cost to be considered as establishment costs:
 - **CoMSEQ WRP costs** – these are the direct costs associated with the CoMSEQ Water Reform Project and include office and administration costs, due diligence and project costs. Included within this cost category are the costs of dedicated reform program co-ordination staff co-located in Councils which were funded under the WRP budget.
 - **QTC financing costs** – this category of costs is intended to capture the debt servicing costs associated with the QTC facility established to fund the IDE and the WRP. The actual funds allocated to particular establishment activities are captured within the other cost categories. Where Councils have internally funded reform activities, the opportunity cost associated with diversion of the funding to establishment activities is not considered to fall within this cost category.
 - **Council transaction costs** – this category of cost represents the costs incurred by Council's (or the current water and wastewater businesses) in

order to affect the transfer of the relevant assets, employees, liabilities and legal instruments from the existing businesses to the new entities. This category of cost excludes CoMSEQ due diligence costs but would capture additional due diligence activities undertaken by Councils.

- **New entity establishment costs** – this category relates to the direct costs and purchases of the Distributor-Retailers required to make the entities operational by 1 July 2010. These costs are distinguished from Council transaction costs which are the costs incurred by the existing water businesses to affect the transfer of the businesses. These costs will include such items as systems and process development costs, board establishment costs and implementation project costs.
4. Major information technology and systems development costs fall outside the scope of establishment costs, however short-term system interfacing and systems modification to accommodate new billing information such as branding and logos will be considered under the New entity establishment costs category.
 5. Legacy costs associated with the down-sizing as a result of the transfer of Council's water and sewerage businesses to the new entities will not form part of eligible establishment costs. Legacy costs include:
 - Payments related to the cancellation of accommodation and vehicle leases, service contracts or systems support no longer required and not novated to the Distributor-Retailer entities
 - Increased overheads due to a lower customer base for example higher call centre costs due to reduced throughput, fixed costs for systems support and corporate services spread over a smaller number of users
 - Higher energy costs per unit due to reduced purchasing power or economies of scale
 - Voluntary redundancy payments to staff
 6. Prudent cost criteria include:
 - a. Costs must be incremental to costs that would normally be incurred by the business in the delivery of its services at existing service levels (i.e. "business as usual" costs);
 - b. Expenditure should be efficient and consistent with the activities required to establish a monopoly water and wastewater business operating in a regulated and non-competitive market
 - c. Costs must be able to be substantiated by verifiable records at an appropriate level of detail
 - d. Costs cannot be claimed by more than one entity
 7. 'Business as usual' costs should be recovered through normal cost recovery mechanisms including rates and water and wastewater charges.

SUMMARY OF ESTABLISHMENT COST CLAIMS BY DISTRIBUTION-RETAIL AUTHORITY AND COUNCILS

Distributor-retailer cost claims

Tables 1 to 3 set out the total claim submitted by QUU, Allconnex Water and Unitywater for establishment costs directly incurred by them. It identifies costs incurred up to 30 June 2010 (which were assessed by Ernst & Young) and costs either incurred or likely to be incurred from 1 July 2010. The post 30 June 2010 cost claims have not been assessed. The table also identifies the total approved establishment cost claim by type of expense.

Table 1: Queensland Urban Utilities' establishment cost claim

Cost Category	Cost claimed up to 30 June 2010	Cost claimed post 30 June 2010	Total approved establishment costs
Labour	\$13,528,684	\$1,070,464	\$12,879,064
ICT	\$8,218,413	\$3,297,924	\$8,218,413
Consultancies	\$1,966,730	\$417,800	\$1,966,730
Marketing & communication	\$1,399,802	\$1,000,000	\$1,399,802
Interest costs	\$970,589	\$0	\$760,914
Other	\$2,351,222	\$570,000	\$2,351,222
Total claim	\$28,435,440	\$6,356,188	\$27,576,145

Table 2: Allconnex Water's establishment cost claim

Cost Category	Cost claimed up to 30 June 2010	Cost claimed post 30 June 2010	Total approved establishment costs
Labour	\$11,126,227	\$120,640	\$10,739,206
ICT	\$1,065,214	\$0	\$1,065,214
Consultancies	\$4,449,655	\$111,034	\$4,449,655
Marketing & communication	\$911,613	\$0	\$911,613
Interest costs	\$712,784	\$163,498	\$579,788
Other	\$2,596,028	\$47,792	\$2,596,028
Total claim	\$20,861,521	\$442,964	\$20,341,504

Table 3: Unitywater's establishment cost claims

Cost Category	Cost claimed up to 30 June 2010	Cost claimed post 30 June 2010	Total approved establishment costs
Labour	\$3,042,740	\$432,531	\$3,042,740
ICT	\$1,665,174	\$167,016	\$1,665,174
Consultancies	\$1,855,182	\$194,235	\$1,855,182
Marketing & communication	\$414,969	\$16,142	\$414,969
Other	\$256,747	\$3,284	\$256,747
Total claim	\$7,234,812	\$813,208	\$7,234,812

CoMSEQ cost claims (which include IDE claims)

Queensland Treasury has advised that the final value of the IDE debt was \$25,644,285. This was paid out in full by the Distributor-retailers on 30 September 2010 in proportion to the guarantee split between the shareholding local governments and equates to the following:

- QUU – an approved claim of \$11,539,928;
- Allconnex Water – an approved claim of \$8,206,171; and
- Unitywater – an approved claim of \$5,898,186.

Total approved establishment costs

The total approved costs for establishing the Distributor-retailers (Distributor-retailer costs and CoMSEQ costs) is as follows:

- QUU - \$39,116,073;
- Allconnex Water - \$28,547,675; and
- Unitywater - \$13,132,998.